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Israel's Credit Rating and National Security

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S&P recently raised Israel's credit rating to AA minus. This is a welcome development of much economic value and prestige, the result of a long process of economic improvement. From the perspective of national security, the high grade reflects Israel's ability to grow in economic terms while simultaneously dealing with unusual security challenges. However, continuation of the fast economic growth trend in the long term requires tackling Israeli society's fundamental problems and the country's basic economic challenges: a low rate of participation in the work force and low productivity in some population groups, large gaps in income, immense transportation burdens, and a surplus of bureaucracy. Given these, it is essential to cultivate the economy's growth engines, led by the hi-tech sector, and to maintain a high level of security, to enable the economy to continue growing even during periods of military conflict.

The economy is one of the backbones of national security, and its credit rating is one of the measures of strength. A country's credit rating is a grade awarded by a credit rating agency, intended to assess the probability of the country's ability to repay its financial debts according to the terms of the loans (usually the bonds it issues). The higher the rating, the easier it is for the country to obtain loans, at lower interest rates. Rating agencies are businesses that are designed to issue objective ratings. The most prominent international companies that include the Israeli economy in their ratings are S&P, Moody's, and Fitch.

On August 4, 2018, S&P raised Israel's credit rating by one degree, from A plus to AA minus, with a stable outlook. This is a record for Israel. One decade ago, Israel's credit rating was A, two decades ago it was A minus, and three decades ago it was BBB minus (the lowest rating within the group of solid investments). In other words, Israel's status has improved steadily over the years until it reached this new level. According to S&P, "Israel enjoys a prosperous, modern and diversified economy, benefitting from relatively high growth rates." In its review, S&P cited historically low rates of unemployment (4.2 percent), developments in the natural gas industry, and the strength of the economic establishment, notwithstanding the fragmented political system: "Despite fragmented domestic politics, Israeli institutions are strong and accountable."

The highest rating on the S&P scale is AAA; the lowest is D. Countries with an AAA rating include Switzerland, Germany, Holland, Sweden, Canada, Australia, and Singapore. Countries with AA plus rating include the United States and Finland. AA rated countries include England, France, South Korea, Belgium, and Kuwait. Countries joining Israel at the AA minus rate include Taiwan, Estonia, Czech Republic, and Qatar. Below Israel are Japan (A+), Ireland (A+), Iceland (A), Saudi Arabia (A-), Mexico (BBB+), Italy (BBB), and others.

The rating is made principally according to the country's record of debt repayment and economic measures, above all, the ratio between public debt and product. In 2017, Israel's debt-product ratio was about 61 percent, compared to 75 percent in 2009. The multi-year decline in the ratio derives mainly from considerable growth in Israeli product. Public debt also grew, but at a lower rate (in 2017 the debt was nominally about 25 percent greater than in 2009). In the S&P assessment, the Israeli economy will grow by 3.6 percent in 2018 (compared to 3.3 percent in 2017), in 2019 by 3.3 percent, in 2020 by 3.2 percent, and in 2021 by 3.1 percent. According to S&P, the debt-product ratio is expected to continue falling in the next few years.

Israel's higher credit rating has direct significance for the economy. It will improve Israel's ability to achieve better financing terms for its external debts, and could also improve the ratings of Israeli companies whose global credit ratings were unable to rise based on the country's rating, and thus improve their ability to raise loans overseas. The Governor of the Bank of Israel, Karnit Flug, stated that "the S&P decision to raise Israel's credit rating reflects the trust accorded by international institutions to the economic policy of the government of Israel and the monetary policy introduced by the Bank of Israel." Finance Minister Moshe Kahlon expects the increased rating to save Israel billions of shekels in financing costs, which can be redirected to social ministries. However, economists believe that the improvement in financing costs will be limited, since Israel's relatively good situation in this area was already considered by the capital market even before this announcement, and interest rates worldwide are expected to rise, which will make it harder for all countries to reduce their borrowing costs. Moreover, continuing the reduction of the debt-product ratio also requires an ongoing policy of controlling public expenditure.

While the rating is largely based on specific economic measures, credit rating companies also recognize that the economy does not exist in a vacuum and is dependent on other elements of national security. In addition to economic data, the S&P report takes into account Israel's security situation and domestic situation. According to S&P, high exposure to security risks has an adverse effect on credit rating. In other words, Israel's high rating reflects extraordinary economic performance, notwithstanding non-standard security risks. This also reflects the success of the security system to allow stable economic growth in unstable security conditions. A concrete example is the contribution of the Iron Dome system to the ongoing performance of the Israeli economy under rocket fire from the Gaza Strip, particularly during Operation Protective Edge (50 days of fighting). This example clarifies that Israel’s defense costs, mainly during asymmetric war, are not necessarily a function of the enemy’s military expenses , but of the intensity of direct and indirect damage (loss of product) that the enemy can cause, i.e., the “the cost of insecurity” for Israel. The economy’s ability to function in situations of military hostility of course to a large extent depends on the nature of the hostilities.

While the new rating has economic value for Israel and its image, this should not allow the country to rest on its laurels. True, the economic forecast is for a continued high rate of growth over the coming years, relative to other developed countries, but this growth rate is expected to slow down moderately. Moreover, the rating does not reflect socio-economic parameters, such as divisions of wealth and income in the country, in which Israel is rated low among OECD countries. A continuation of the economic growth trend for the longer range requires immediate basic treatment for fundamental problems, led by low participation in the work force and low productivity among large parts of the population, enormous pressure on transportation infrastructures (among the worst in the OECD), too much bureaucracy, gaps in education, and over-concentration of people and economic assets in the center of the country. In addition, there must be further development of growth engines in the Israeli economy, above all the hi-tech sector, while a high level of security is maintained. This will be manifest in calm security conditions, or at least conditions in which the impact of security incidents on the economy is minimized.