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Fitch Changes Israel's Outlook To Positive

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Fitch Ratings-London/New York-18 December 2006: Fitch Ratings has today changed the Outlook on the State of Israel's foreign and local currency Issuer Default ratings ("IDR") to Positive from Stable. The ratings are affirmed at foreign currency IDR 'A-' (A minus) and local currency IDR 'A'. The Short-term rating is affirmed at Short-term 'F1' and Country Ceiling at 'A+'.

"The Positive Outlook reflects the Israeli economy's increased dynamism and resilience following the reforms of recent years, demonstrated by the limited economic impact of the war in Lebanon and the strong rebound now underway," said Richard Fox, Head of Middle East and Africa Sovereign Ratings at Fitch. "The strengthened policy framework has also endured a change of government and the political fallout from the war. External solvency indicators have continued to improve and strong inward and outward investment reflect Israel's growing integration with the world economy. Last but not least, Israel's public debt ratio has declined and over the time horizon of the rating Outlook should fall below its previous low in 2000."

The Israeli economy grew 6% in H106. Although GDP then fell in Q3 due to the disruption caused by the war and the loss of tourism, it has recovered strongly in the current quarter. Growth for the year as a whole should be at least 4.5%, in line with potential. Investment in machinery and equipment has picked up, although construction remains sluggish. Meanwhile, the current account surplus will increase to over 4% of GDP this year, with overall net external assets expected to reach 24% of GDP. Israel's net external creditor position and high per capita income exceed those of many more highly rated sovereigns. Financial markets took the war in their stride with the shekel now 5% stronger against the US dollar than in mid-July and interest rates having been cut to below US rates again. Foreign direct investment, both inward and outward, is at record levels.

Israel's public debt ratio will improve by 6% to 7% of GDP this year. Nevertheless, at around 90% of GDP, it remains higher than most rated peers' and continues to constrain creditworthiness. Israel needs more room for manoeuvre in the fiscal area than its rated peers, given the vulnerability of public debt dynamics to unexpected security developments, as demonstrated again this year.

The decline in the debt ratio has slowed since the war. Moreover, having already increased the cap on real spending growth to 1.7% for 2007 from 1%, spending will now increase further because of the war and the state deficit ceiling for 2007 will remain at 3% instead of declining to 2%. Greater fiscal flexibility would be achieved more quickly with more ambitious fiscal targets, especially given the current buoyant growth backdrop. The 3% state deficit ceiling translates into an internationally comparable general government deficit of nearer 5% of GDP. However, this year's outturn for the state deficit will be only 1% to 2% of GDP, the second year in a row it has undershot the ceiling. Fitch foresees further improvement in the debt ratio over the next two years, provided the government sticks to the 2007 budget parameters and GDP growth remains above 3%. This year has demonstrated that Israel's improved debt dynamics are now more robust, even faced with quite extreme security challenges.

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