

FDIs and COUNTRY RISK: ISRAEL

Introduction

Terrorist attacks, wars, economic crisis are part of the twenty-first century day to day business. The world seems to be unstable, unpredictable, even to a certain extent erratic. 9.11 changed our approach of security all over the world. Arab revolutions showed how rapidly a political power can be changed. Lehmann Brothers bankruptcy gave us ideas how weak are the strongest economic actors. Every day, news gives us new example of today's risky world.

In Europe before the Middle Age, risk was considered as a variable, humans cannot alter. It was seen as given by the will of God. Pascal, Fermat, Leibniz were philosophers and mathematicians who works on the concept of risk. Kierkegaard is one of the first thinkers who tried to reconcile faith and risk. He thought that there is not faith without risk. "Faith is thus a passionate commitment, not based upon reason but inwardly necessitated, to that which can be grasped in no other way"¹

With the influence of the mathematicians (probability), scientists tried to show that everything can be measured including risk. Even if future is by definition unknown. Frank Knight in the 1920's established our modern approach of risk. He differentiated "Uncertainty" and "Risk". Uncertainty is by essence immeasurable & unknown whereas "Risk" is quantifiable.

By using current available pieces of information, economic actors try to forecast future economic development. Obviously, there is always a gap between what is forecasted (i) and what actually happens in the reality (ii). This situation is not only a consequence of lack of knowledge but it can also be the result of wrong information.

Risk is a very broad topic and a large range of terminologies are used. This paper will be focused on a specific risk: "Country Risk". Country risk is defined as "all the additional risks induced by doing business abroad, as opposed to domestic transactions. When a firm starts to expand internationally, it is faced with a new

¹ Encyclopedia Britanica

environment composed of different risks and uncertainties which is not used to dealing with. Country risk encompasses all these specific sources potential difficulties encountered when investing overseas, ranging from political and social risks to macro and microeconomic risks². When Carrefour (French firm) established new retailing stores in China it has to face different aspects of the country risk.

One of the goals of the work is to be able to find reliable information about the level of risk in the given country: Israel. The fact that information is more or less available is also a first indicator of the level of risk of the country. National and International institutions publish a certain amount of data which is the base of the analysis.

All these pieces of information are essential for investors. When a firm looks for a target to realize Foreign Direct Investments (a.k.a. FDIs) it has to assess in a very accurate way what would be the country risk. FDI refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor³.

Risk is a threat for investors but it is also a necessity for profits. There is no profit without risk. A certain level of risk is indeed necessary to hope for gains. The question is not about the risk itself but more precisely till which level of risk an investor is willing to proceed to its investment. Moreover an accurate assessment of the level of risk is essential to consider the level of profits. An investor can accept to take risks if the level of profit is consistent with it.

Definition of the (illustrational) geographic & temporal frames: Israel

In order to understand how essential the assessment of the country risk is, this paper is focused on one country: The State of Israel. By using the case of Israel, the work will show all the different aspects of the country risk. Beyond the analytic work of country risk characteristics, the paper illustrates with a particular case.

The state of Israel is particularly interesting case because even if it is close to Western World standards, it experiences very different features of the country risk. Israel faces very typical risks but is also exposed to very specific attributes of the country risk.

² Country Risk Assessment : A guide to global investment Strategy (page 4) by M.H Bouchet, E. Clark & B. Gros Lambert.

³ Definitions of FDI are contained in the Balance of Payments Manual: Fifth Edition.

- Map

Israel is a Middle East country located between Egypt, Jordan, Syria and Lebanon. Jerusalem is the seat and the proclaimed capital, although Tel Aviv is internationally seen as the political and economic capital. Israel is a relatively small country (n°154) with a bit more than 20.000km² (slightly larger than New Jersey). It enjoys an access to Mediterranean Sea and the Red Sea.



The state of Israel was born in 1948 after the British withdrew from their mandate of Palestine. From 1948, Israel and the states of the regions experienced wars which alter the international relationships and the borders of the country. Israel had signed peace treaties with Egypt and Jordan. Economic exchanges exist between these two countries and Israel in particular in the tourist industry and natural resources.

The Israeli- Palestinian conflict is still one of the biggest sources of instability for Israel. Even if efforts in both sides tried to solve the situation, no consensus has been reached till today.

Israel is a parliamentary democracy. The chief of State (largely a ceremonial role) is President Shimon Peres (since 15 July 2007) and the Head of Government is Prime Minister Binyamin Netanyahu (since 31 March 2009). The Legislative branch is the Knesset (Israeli Parliament). Israel judicial branch is run by a Supreme Court. Israel is also part of various international institutions⁴. Besides the regular UN institutions, Israel just joined the OECD.

Israel population is about 7.5 million people. It is composed by around 80% of Jews. Palestinian Arabs constitute the rest of the population. Israeli Arabs are Muslims for around 75% of them and the remaining Arabs are Christians and Druzes. 63% of the population is between 15 to 64 years old and the life expectancy at birth is 81 years. The urban population represents 92% of total population.

The Israeli culture is very broad because of the various flows of migrants who came to Israel. Israel is very European and American oriented but also enjoys an African influence thanks to the last immigrations. Arab culture is central because of the historical background of the country. Jewish culture and ethics is also fundamental in the Israeli background.

As we see, Israel is a west oriented country because of history. Nevertheless the fact that it is located in Middle East has a very strong influence on the country. For western world investors the fact that Israel shares standards is a strong asset. Obviously these standards have to be put in perspective with the rest of the picture. The challenges of this small country are big: political instability has clearly an influence on economic development. For all these reasons, to get the most accurate measure of the country risk is essential for investors.

In order to have an as complete approach of the country risk as possible, country risk is divided in subcategories.

Financial Country risk (i) represents a quantitative approach of the country risk. More focused on the macroeconomic analysis, this part treats in particular liquidity and solvency risks. It goes through risks connected to the level of debts, devaluation and exchange rate risks and soundness of the banking system. Then, the paper goes in detail into Economic Country Risk (ii), describing economic background, balance of payments and inflation. The thirds part of the paper, explain the elements of Social and Political risks (iii) which can have an influence on investments. Finally, the last part of the paper treats some specific aspects of the country risk (iv).

⁴ BIS, BSEC (observer), CERN (observer), CICA, EBRD, FAO, IADB, IAEA, IBRD, ICAO, ICC, ICRM, IDA, IFAD, IFC, IFRC, ILO, IMF, IMO, IMSO, Interpol, IOC, IOM, IPU, ISO, ITSO, ITU, ITUC, MIGA, OAS (observer), OECD, OPCW (signatory), OSCE (partner), Paris Club (associate), PCA, SECI (observer), UN, UNCTAD, UNESCO, UNHCR, UNIDO, UNWTO, UPU, WCO, WHO, WIPO, WMO, WTO
(source: CIA WORLD FACTBOOK)

1. Financial Country Risk (quantitative issue)

In order to assure economic growth, an economy needs an efficient financial system. Besides an efficient market, economic actors rely on the government to guarantee the best financial conditions. In case of financial distress, the whole economy of the country can be jeopardized.

In the third quarter of the 19th century, several states of the United States to be, defaulted. The consequence for the economy was disastrous. But even in the more recent history, South America was the scene of financial disorders which lead to economic instability and political distress.

a. Level of debt and capabilities of reimbursement: Default & Credit risk

One of the most dangerous aspects of a financial crisis is a default experienced by a government. Some indicators are essential to assess the financial background of a country, in particular the level of deficit and the burden of the debt.

How is financial risks connected to country risk? A government, as any economic actor, has to meet its external obligation in full and in time. One of them is to pay back the money it borrows. There are two different aspects to take into account when we analyze such risk:

- The country's ability to pay back its obligations on time (and)
- The country's willingness to pay.

i. Budget deficit & Debts

Different indicators are used to assess the ability of a country government to pay back its obligations.

- Budget deficit to GDP ratio:

A government deficit describes how much a government spends next to how much revenues it receives. The difference has to be financed by borrowed money. In order to compare and analyze the level of deficit next to its economy, the indicator par excellence is Budget deficit to GDP ratio. It is used in order to realize how an economy can pay back its obligations. If the ratio is high, it means that the country borrows large amounts of money versus what it produces. Some countries enjoy surplus, meaning they have higher revenues than expenses.

As we can see, in the table the large majority of the OECD countries experience deficits. The Subprime economic crisis did not improve the situation because the

governments invested a lot in their economy to try to bring back economic growth. 2009 was a year in which the OECD did their very best to launch a positive trend after the crisis. Even if the expectations for future deficits decreased, they remain very high (compared to past performances).

Besides time analysis, when we compare the different countries, some countries do better than others. Germany and Scandinavian countries on one side decreased sharply their deficits. The USA, the United Kingdom, France and Southern Europe reduce their deficit not that significantly. Besides the two groups other countries cut their deficit significantly like Israel or Turkey.

Even if it cut its deficit, Israel's deficit is still high, to reassure investors of its willingness to pay, it has to continue decreasing budget deficits.

Surplus (+) or deficit (-) as a per cent of nominal GDP

	2005	2006	2007	2008	2009	2010	2011	2012
Canada	1.5	1.6	1.4	0.0	-5.5	-5.5	-4.9	-3.5
Denmark	5.0	5.0	4.8	3.3	-2.8	-2.9	-3.8	-3.0
Finland	2.5	3.9	5.2	4.2	-2.9	-2.8	-1.4	-0.6
France	-3.0	-2.3	-2.7	-3.3	-7.5	-7.0	-5.6	-4.6
Germany	-3.3	-1.6	0.3	0.1	-3.0	-3.3	-2.1	-1.2
Greece	-5.3	-6.0	-6.7	-9.8	-15.6	-10.4	-7.5	-6.5
Iceland	4.9	6.3	5.4	-13.5	-10.0	-7.8	-2.7	-1.4
Ireland	1.6	2.9	0.1	-7.3	-14.3	-32.4	-10.1	-8.2
Israel	-4.9	-2.5	-1.5	-3.7	-6.4	-5.0	-3.7	-2.9
Italy	-4.4	-3.3	-1.5	-2.7	-5.3	-4.5	-3.9	-2.6
Japan	-6.7	-1.6	-2.4	-2.2	-8.7	-8.1	-8.9	-8.2
Korea	3.4	3.9	4.7	3.0	-1.1	0.0	0.5	1.3
Luxembourg	0.0	1.4	3.7	3.0	-0.9	-1.7	-0.9	0.0
Netherlands	-0.3	0.5	0.2	0.5	-5.5	-5.3	-3.7	-2.1
Norway	15.1	18.4	17.5	19.1	10.5	10.5	12.5	11.9
Portugal	-5.9	-4.1	-3.2	-3.6	-10.1	-9.2	-5.9	-4.5
Spain	1.0	2.0	1.9	-4.2	-11.1	-9.2	-6.3	-4.4
Sweden	1.9	2.2	3.6	2.2	-0.9	-0.3	0.3	1.4
Switzerland	-0.7	0.8	1.7	2.3	1.2	0.5	0.6	0.9
Turkey	..	0.8	-1.2	-2.2	-6.7	-4.6	-3.3	-3.0
United Kingdom	-3.3	-2.7	-2.8	-4.8	-10.8	-10.3	-8.7	-7.1
United States	-3.3	-2.2	-2.9	-6.3	-11.3	-10.6	-10.1	-9.1
Euro area	-2.6	-1.4	-0.7	-2.1	-6.3	-6.0	-4.2	-3.0
Total OECD	-2.8	-1.3	-1.3	-3.3	-8.2	-7.7	-6.7	-5.6

© Source: OECD

This ratio gives a first idea on the capability of the countries to pay back their obligations. Israel does not come at the bottom of the league table of the OECD countries. .

- General government gross financial liabilities over GDP

This ratio shows how much represents the accumulated deficits of the governments over GDP. If this ratio is big, the risk of default of the government is high. When the ratio is too high, it is the capacity of the country to produce wealth to pay back its loans which is at stake. A country which does not produce enough to pay back its obligations is a very risky country.

Again as we see in this table, the level of accumulated debt over GDP went up with the subprime crisis. It is consistent with the economic policies the OECD countries implemented. Scandinavian countries perform well versus to the southern European countries. In particular, Greece, Portugal, Italy and Japan are subject to very high ratios.

Even if Israel is on a declining trend, the burden of the debt is still important. For this reason Israel's government announced that the deficit will be less and less important over the years.

	2005	2006	2007	2008	2009	2010	2011	2012
Canada	71.6	70.3	66.5	71.3	83.4	84.2	85.9	88.0
Denmark	45.9	41.2	34.3	42.6	52.4	55.5	57.1	60.0
Finland	48.4	45.5	41.4	40.6	52.1	57.4	62.7	66.1
France	75.7	70.9	72.3	77.8	89.2	94.1	97.3	100.0
Germany ²	71.2	69.3	65.3	69.3	76.4	87.0	87.3	86.9
Greece	121.2	115.6	112.9	116.1	131.6	147.3	157.1	159.3
Iceland	52.6	57.4	53.3	102.0	120.0	120.2	121.0	120.2
Ireland	32.6	28.8	28.8	49.6	71.6	102.4	120.4	125.6
Israel	93.5	84.3	77.7	76.7	79.2	76.1	73.5	70.1
Italy	120.0	117.4	112.8	115.2	127.8	126.8	129.0	128.4
Japan ³	175.3	172.1	167.0	174.1	194.1	199.7	212.7	218.7
Korea ⁴	24.6	27.7	27.9	29.6	32.5	33.9	33.3	33.4
Luxembourg	7.6	12.1	11.7	16.4	14.7	19.7	20.5	23.9
Netherlands	60.7	54.5	51.5	64.5	67.6	71.4	74.3	75.2
Norway	47.9	59.4	57.4	54.9	48.0	49.5	56.1	51.2
Portugal	72.8	77.6	75.4	80.6	93.1	103.1	110.8	115.8
Spain	50.4	45.9	42.1	47.4	62.3	66.1	73.6	74.8
Sweden	60.8	53.9	49.3	49.6	52.0	49.1	45.4	41.1
Switzerland	56.4	50.2	46.8	43.7	41.5	40.2	38.7	37.0
United Kingdom	46.4	46.1	47.2	57.0	72.4	82.4	88.5	93.3
United States	61.4	60.8	62.0	71.0	84.3	93.6	101.1	107.0
Euro area	78.1	74.5	71.6	76.5	86.9	92.7	95.6	96.5
Total OECD	76.3	74.5	73.1	79.3	90.9	97.6	102.4	105.4

© Source: OECD

Nevertheless these two indicators are measures that cannot be analyzed alone. The question is not only how much a country spends but also how it spends this very money. If the deficit is used to launch projects of infrastructures which will lead to future economic growth, a large deficit could be a positive signal. On the other hand if the money is not used wisely even small deficits are ruinous. After the WWII, when European countries borrowed money within the Marshall plan, they did very profitable investments.

The difficult question is to measure today what a “good deficit” is and what is not. What will bring economic growth and what is a waste of money?

- Israeli Government Budget

הוצאות המגזר הממשלתי(1), לפי יחידה ולפי מטרה

GENERAL GOVERNMENT EXPENDITURE(1), BY UNIT AND BY FUNCTION

NIS million, at current prices

2009

	מוסדות לאומיים National institutions	מוסדות ציבוריים ללא כוונת רווח Public NPI's	רשויות מקומיות Local authorities	המוסד לביטוח לאומי National Insurance Institute	ממשלה Government	סך הכל Total	%
GRAND TOTAL	2 711	54 227	44 691	54 093	174 355	330 075	100%
General services	14	2 380	6 646	-	33 284	42 323	13%
Thereof: Interest payments	12	761	1 155	-	26 222	28 150	9%
Defence	9	-	241	-	49 670	49 920	15%
Public order and safety	0	-	1 070	-	11 873	12 943	4%
Economic affairs	755	-	5 227	-	17 837	23 818	7%
Environmental protection	1	1	3 853	-	736	4 590	1%
Housing and community amenities	39	345	1 366	-	2 243	3 993	1%
Health	4	25 137	143	2 394	7 657	35 334	11%
Culture and religion	179	3 328	5 911	-	2 200	11 619	4%
Education	403	20 544	14 914	171	18 071	54 103	16%
Social protection	1 308	2 493	5 320	51 528	30 784	91 432	28%
Thereof: Transfers to households	127	115	3 316	46 654	23 599	73 811	22%

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○ Social Protection

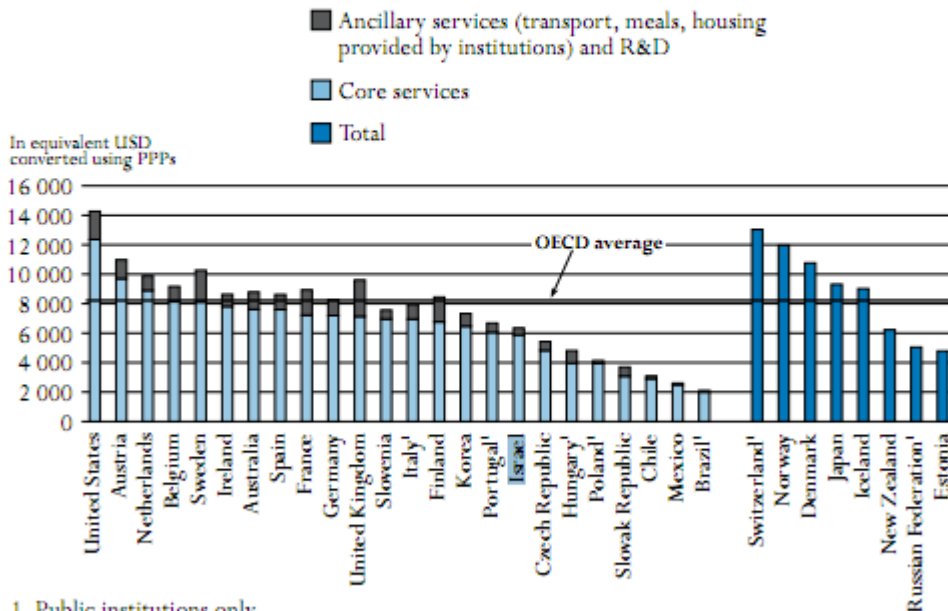
Israel established a welfare system which costs around a fifth of the government budget. This money goes to the national social security that each Israeli enjoys. The social security system is a copy of the European system. It provides, quasi freely, healthcare to each Israeli citizen. The unemployment social measures do not provide high incomes to non working people. Also, the Israeli State implemented a costly birth control policy. Families with more than two children can get significant amounts of money from the state. With a national fertility rate of 2.96, the demographic policy is a big expense for the Israeli state. This expense is a strategic cost for next generations. Children are seen in the Israeli culture as a very strong asset.

○ Education

Besides this structural cost, the Israeli government spent a large part of its budget (15%) in its education system. Israel invests billions in schools and universities every year. This strategic choice leads Israel to enjoy the highest proportion of third degrees (Phd) per inhabitant. Israelis are well trained, they go to university, even if studies are expensive.

Chart B1.1. Annual expenditure by educational institutions per student in primary through tertiary education, by type of services (2007)

Expenditure by educational institutions per student provides a measure of the unit costs of formal education. The chart shows annual expenditure by educational institutions per student by type of services in equivalent USD converted using purchasing power parities, based on full-time equivalents.



1. Public institutions only.

Countries are ranked in descending order of expenditure by educational institutions per student for core services.

Source: OECD, Table B1.2. See Annex 3 for notes (www.oecd.org/edu/eag2010).

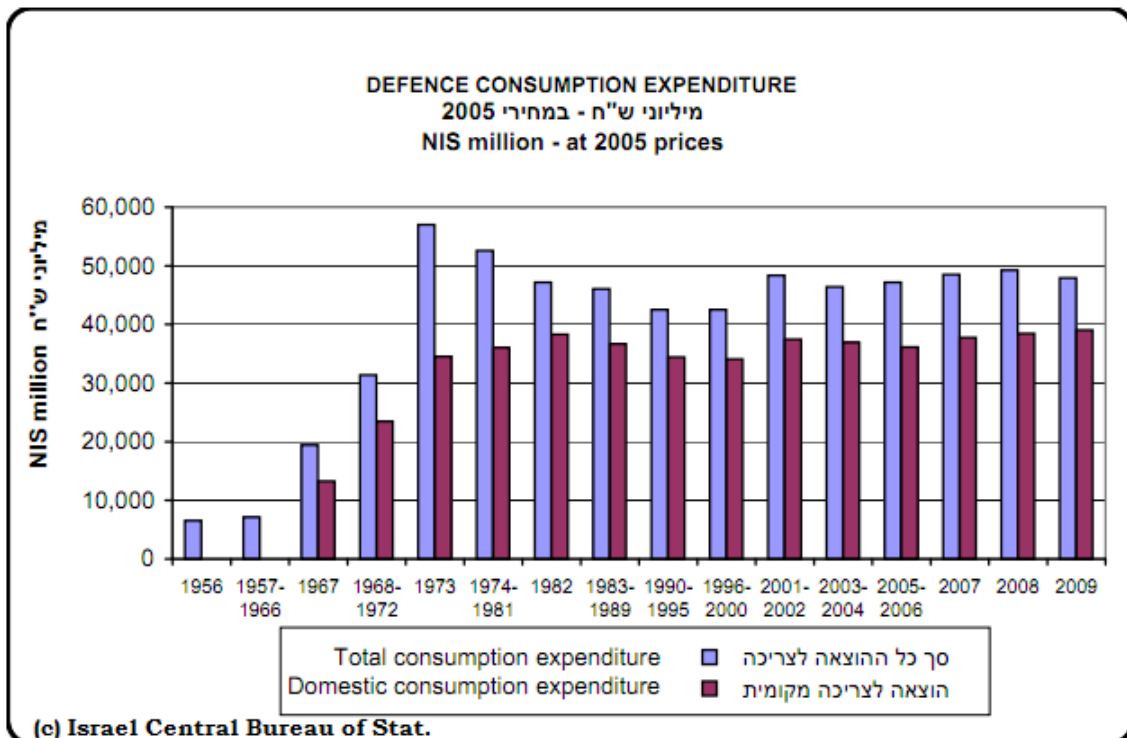
StatLink <http://dx.doi.org/10.1787/888932310282>

According to the OECD report on Education, Israel does not invest a huge amount of money per student. It spends less than the OECD average. Nevertheless, the overall amount spent by the government represents a significant cost.

- Defense

The third major cost item is military defense. Obviously, the state of Israel has to spend billions of Shekels to defend its territories. Israel obligates its citizens to serve 3 years (men) or 2 years (women) in the Israel Defense Force (aka. IDF). The soldier's payment represents a huge cost for the Israel government. Besides salaries, Israel invests a huge amount in security systems. High technology systems are implemented to defend Israel in case of war.

The last heavy investment Israel made is the Iron Dome. It cost \$1.2 billion to set up the anti-rocket system.



Defense expenses also bring to Israel large incomes. Weapons and defense system are often developed inside the country. Israeli companies take advantage of the need of new military development. The security industry in Israel is one of the leading one. Even if the defense budget is more or less stable for few years, it still represents major cost on the Israeli budget.

As we saw the government budget is devoted to regular state policies. The amount of money spent is important but not out of proportion. The political situation in the region affects the way the Israeli government spends its money, but it is consistent with Israel background.

- Deficit

The level of deficit is high but it decreases. It shows solid assets and indeed pretty low solvency risk (as shown in the Debts/GDP & Deficit/ GDP ratios).

- Debt

Israel has to deal with a big but sizeable debt burden. Besides the Solvency Risk, a country has to deal also with liquidity risks. Indeed, even a country has to deal with some deadlines for paying back its obligations. The debt aspect at stake is the question of paying "on time". Two elements need to be analyzed separately:

- The regular incomes of the country and their time basis (taxes and receipts) (and)
- Money supply.

GOVERNMENT DEBT

NIS million, at current prices

מיליוני ש"ח, במחירים שוטפים

	2009	2008	2007	2006	2005	2004	2000	
GOVERNMENT DEBT - GRAND TOTAL	596,660	546,002	523,061	537,938	553,807	548,310	422,944	חוב ממשלתי - סך כולל
<i>Domestic debt - total</i>	488,650	440,793	402,204	398,386	413,234	414,995	312,535	<i>חוב מקומי - סך הכל</i>
Residual maturity:								תקופת פירעון נותר:
Less than 1 year	60,009	48,588	46,763	50,074	48,180	49,240	39,780	פחות משנה
1-4 years	146,660	150,738	138,426	117,257	117,211	106,348	88,338	4-1 שנים
4+ years	281,981	241,467	217,014	231,055	247,843	259,407	184,417	+4 שנים
<i>External debt - total</i>	108,010	105,209	120,857	139,552	140,573	133,315	110,409	<i>חוב חיצוני - סך הכל</i>
Residual maturity:								תקופת פירעון נותר:
Less than 1 year	20,354	14,889	18,838	18,189	18,561	14,208	11,120	פחות משנה
1-4 years	25,401	29,065	31,386	37,943	36,927	37,569	35,245	4-1 שנים
4+ years	62,255	61,455	70,632	83,420	85,085	81,538	64,043	+4 שנים

As we can, the domestic debt goes up on the last decade. The burden of debt to be paid back in the coming year also rose. The technical problem is to find a way to match the amount of debt which reaches maturity and the incomes. Also the amount of external debts is pretty stable on the same period. This aspect of the debt is a consequence of the tactical decision of Israel to be less dependent on external economic actors.

THE MONETARY BASE, THE MONEY SUPPLY AND THEIR COMPONENTS							Money supply M1					
(NIS MILLION)	Capital bills and coins	Increase by %	Currency held by the public	Increase by %	Original data	Increase by %	Seasonally adjusted data	Increase by %	Of which: cash	Increase by %	Of which: cash	Increase by %
	1		2		3		4		5		6	
End of year (December)												
2006	10860.2		25202.5		36062.7		52137.8		52584		21423.3	
2007	12233.4	13%	28746.7	14%	40980.1	14%	61220.9	17%	61733.1	17%	24593	15%
2008	13644.1	12%	34176.7	19%	47820.8	17%	71894.9	17%	72466.6	17%	29940.4	22%
2009	15736.6	15%	41586.3	22%	57322.9	20%	109481	52%	110544.4	53%	35844.6	20%
2010	15886.6	1%	45049.6	8%	60936.3	6%	114466.9	5%	115513.2	4%	38623.8	8%

© Source: Bank of Israel

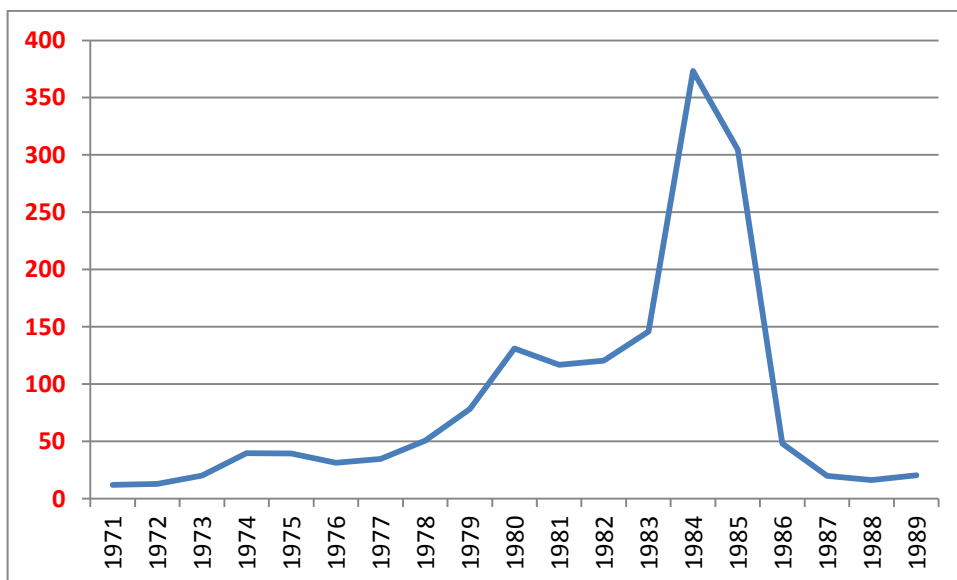
According to the data published by the Bank of Israel, money supply increased on the five last years. This piece of data is very important for assessing the liquidity risk. Even if the total debt goes up on the period, the money supply still continues to increase. For the investor, it shows that the liquidity risk does not rise.

As we noticed the Israeli governments implemented strong economic policies. They spent the collected money wisely according to the very need of the country but they are also careful to assure stability in their need of financing. The country did not activate the leverage of the debt in a too heavy way. Thanks to years of carefulness the burden of the debts is not extremely heavy for the country. Also every country does not borrow money at the same rate, depending on very large conditions; a country can benefit from very different borrowing conditions. Even if Israel is well ranked by the ranking agencies, the cost of the debts is expensive. Israel tried in the past years to limit its deficits in order to face future challenges.

ii. Monetary and credit policy

A monetary policy is the actions of a central bank that determine the size and rate of growth of the money supply, which in turn affects interest rates. Monetary policy is maintained through actions such as increasing the interest rate, or changing the amount of money banks need to keep in the vault (bank reserves)⁵.

In Israel, the monetary policy is managed by the Bank of Israel (BoI). The central bank of Israel is under the management of the governor, Prof. Stanley Fischer. The main goals of the independent central bank are (i) to maintain price stability, (ii) promote economic growth and (iii) to fight unemployment and support the stability of the Israeli financial system (iv)⁶.



CPI (from 1972 to 1989)

©Source: OCDE

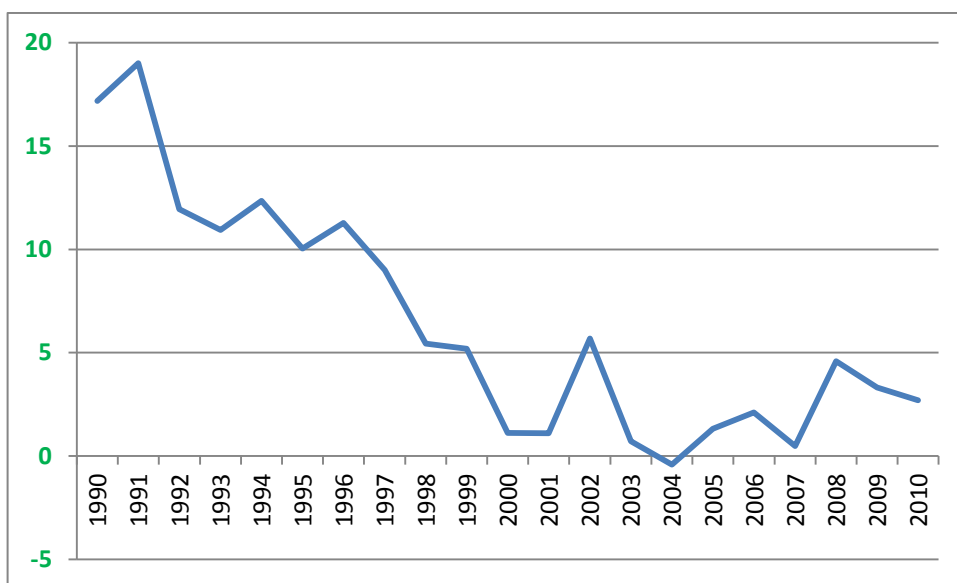
⁵ Investopedia

⁶ Bank of Israel Law 5770 -2010

Israel had experienced very high inflation period. In the 80's, the Israeli economic background was very uncertain and it was very difficult for foreign firms to deal with the Israeli currency: the Shekel. From a year to another, prices could double or triple. Investors dealt in US Dollars. Even the central bank issued bonds in Dollars or in Shekel indexed on US Dollars. The monetary policy was not efficient and it was holding back various economic projects. This difficult economic background was usually explained by the political instability inside and outside the country. The Israeli governments did not convince investors that Israel will be a good target for investments.

In 1976, the Israeli currency stopped to be pegged on the US Dollar. The currency was then indexed on several currencies. In 1985, the NIS (New Israeli Shekel) was created. To get to there, the Bol devaluated almost every year the Israeli currency. Today even if there is still kind of a exchange rate band, it has been very enlarged (44,5% in 1999). The NIS is more or less considered today as a floating currency.

This erratic monetary policy was the reason –or the answer- to the price instability. The development of the “new Israeli economy” also explains such data. In the 80's, Israel went from an agriculture oriented economy to what it is today: a service and high technology oriented one.

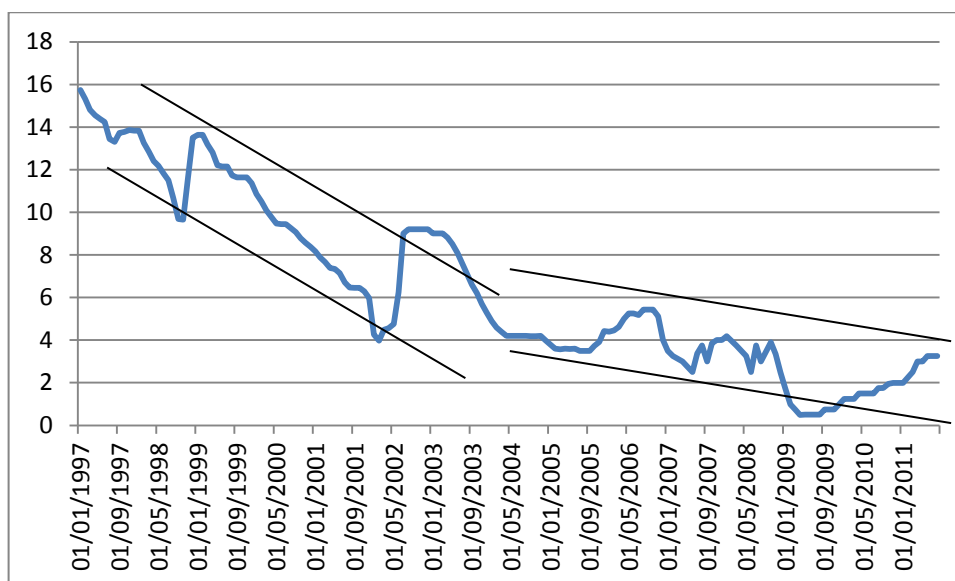


CPI (from 1990 to 2010)

© Source: OECD

From the 2000's, Israel has managed to implement an efficient monetary policy. Price stability is an essential indicator for economic stability. From several years, the central bank fought with force inflation. The trading band became bigger to leave the NIS becoming a “floating currency”. Exchange of currency became completely free (no tax on currency change). Leaving behind the devaluation tool, the Bank of Israel uses essentially the interest rate to manage its monetary policy.

Average interest on deposits in Bank of Israel



© Source: Bank of Israel

In the late 1990's, the bank implemented a strong policy of lowering rates. From a double digit rate, it came to rates under 10% in the early 2010's. The economic development was also stabilizing and Israel became a regular developed country. Its monetary policy was adapted to the new economic situation.

From 2003, the BoI had maintained an average interest rate around 3.6%. Coming from very high interest rates, the Bank decided to lower its rates to an acceptable one, but the decrease was less significant. Also because Israel experiences lower inflation, it implemented lower rates.

After the subprime crisis, the BoI decided to higher the rates very early (mid 2009), before the rest of its economic partners (USA, Europe). The reason for such moves was to attract capitals to easier economic growth and deficit funding.

For investors, Israel managed to implement a stable and consistent monetary policy. Inflation reached an acceptable level. Inflation is now comparable to the OECD level. The monetary policy and the inflation level are great indicators for FDIs. They know that at least inflation won't be a threat against their investments. The economic conditions allow foreign investors to hope for profits even if they have to deal in Shekels.

iii. Moody's approach

Ranking

Moody's had opened a subsidiary firm in Israel called Midroog. In the same way, Moody's gives rating to companies in the USA, Midroog rates Israeli companies.

Moody's rated Israel A1. It based its rating on the "high levels of economic, institutional and financial strength"⁷. Obviously the rating of Israel is negatively affected by the geopolitical challenges.

Monetary policy

Moody's underlined the fact that the BoI is currently removing its monetary stimulus (low interest rates) in order to fight inflation. The rating agency relies on the consistent monetary policy that the BoI implemented this last years.

The Israeli economy is doing well thanks to a performing hi-tech industry. For investors, it shows that the economic background is positive for investment. Inflation is indeed well managed, according Moody's Investors.

Deficit & Debt

Moody's appreciated the fact that the debt did not increase too sharply during the crisis. Moody's Investors praised the government decisions during the crisis. The debts & deficit indicators still remain high but at acceptable levels (comparable to pre-crisis standards). The solvency risk is indeed low.

The funding of the debt is more and more from domestic investors. Pension funds play a more and more important role in the domestic funding of the debt. Domestic funding is also a very positive point of the Israeli economy. It means that liquidity is no longer a problem for the debt funding. The liquidity risk is dropping.

Also the project of reductions in the budget is a positive signal sent to investors. The positive financial conditions do not hide other economic challenges but it allows at least good financial conditions for investors. The Israeli government and the BoI improved the financial stability.

Other challenges

Moody's Investors in its rating on Israel mentions geopolitical challenges. Besides the terrorist threat, the Arab revolutions increased the level of uncertainty in the region. Israel economy is vulnerable to geopolitical development and investors should take this aspect into account (this point will be developed later on in the paper).

b. Devaluation & Exchange rate

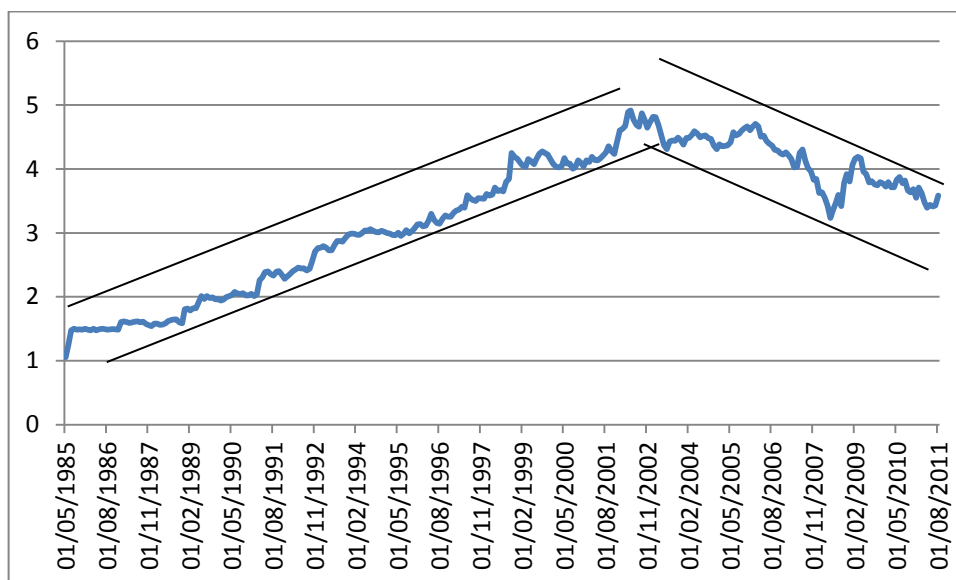
In this section, devaluation and exchange rate are seen as risks.

As an investor, devaluation can be very damageable. If earnings are made in Shekels and the Israeli government decides to devalue its currency it will impact profits for foreign companies. The BoI used the devaluation tools many times in the past. In the last ten years, the BoI did not devalue its currency. As we said previously, the Shekel is seen as a quasi floating currency.

⁷ Moody's Investors : Israel

On one hand, devaluation is still a risk but it is not likely to happen. On the other hand, sharp changes in the interest rate could have the same impact on the value of money. For the meantime, the monetary policy is consistent to the economic conditions of the country. There is no new economic development indeed there should not be any significant changes in the monetary policy⁸.

Exchange rates



NIS/Dollar representative exchange rate

© Bank of Israel

Israel developed an historic economic partnership with the USA. A large part of business deals were made in Dollars (even if they don't involve US partners) in the past. Today, deals can be more easily made in Shekels, but the NIS/ Dollar exchange rate remains important.

In the 1980's till 2000, the value of the Shekel vs Dollar was going down. The Shekel reached a top in 2001, at almost 5 NIS for one Dollar. Today, 3.5 Shekel for a Dollar is considered as a natural price. The Dollar fluctuates between 3.2 to 3.9 Shekels. For four years, it has been swinging between these limits.

For US investors, a stable exchange rate is necessary for successful FDIs. A lot of American companies have been investing in Israel for years. Intel, American express, boeing, FedEx, IBM, Microsoft, Google and so on invested millions in Israel. Such companies are exposed to high fluctuations of the Israeli currency. To attract new investors the BoI worked hard to maintain stable exchange rates.

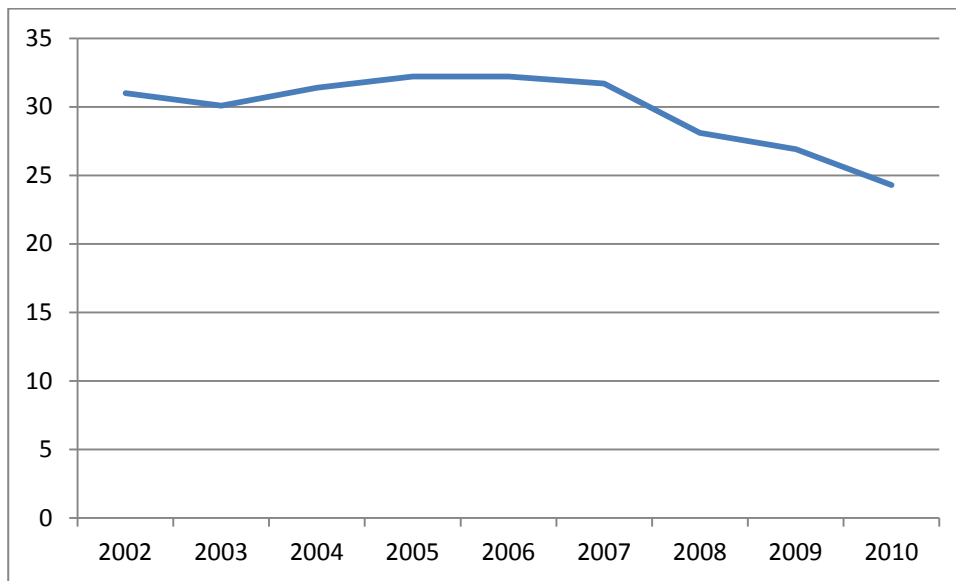
Dollarization of the Israeli Economy

If the Dollar plays a less fundamental role in the Israeli economy, it still remains an important money. As some Latin American countries, Israel owns significant reserves in US Dollars. Still, the Israeli currency is and will remain the New Israeli Shekel, but major reserves are still in US Dollars.

To appreciate the level of "Dollarization" of the Israeli economy, we can use:

⁸ Public statement of Prof. S. Fischer on inflation

- Dollarization ratio



© Source: Moody's Investors

This ratio represents the total foreign currency deposits in the domestic banking system divided by the official foreign exchange reserves plus the foreign assets of domestic banks. This graph shows well that Israel to limit its level of dollarization. This indicator shows how much savers believe in the shekel. If the dollarization ratio is high, they do not believe in the domestic currency.

The Israeli economy becoming more independent and more developed, the US past partner plays a limited role in today's Israeli economy. In the past years, investors and more broadly economic actors in Israel have decreased their deposits in foreign currencies. This ratio going down is a positive sign of shekel reputation. Investors are willing to deal more and more with Shekels.

c. Soundness of the banking system

- Structure

Five banking groups composed the Israeli banking system:

- Bank Leumi
- Bank Hapoalim
- Bank discount,
- Bank Mizrahi-Tefahot,
- First International bank

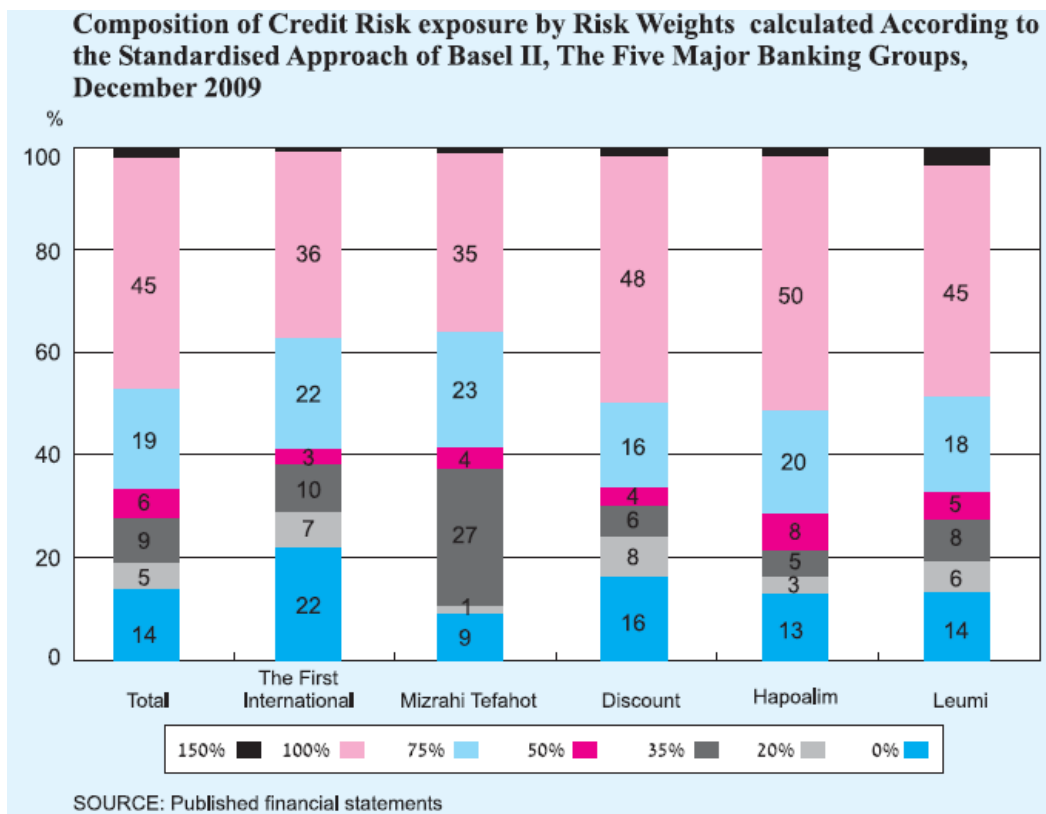
These five banks represent more or less 95% of the banking assets. They offer regular banking services. Besides the Israeli banks, some international banks open subsidiaries. BNP Paribas, HSBC, Bank of India, Dexia, and City Bank operate in Israel. "The banking sector is relatively modest

compared with the economy. The banking sector is very concentrated with the two-largest banks accounting for nearly 60% of total assets and the five-largest accounting for over 90% of total assets”⁹.

The Israeli banks develop some subsidiary companies abroad in particular in Europe (UK, Swiss, Luxembourg & France) and in the USA. These subsidiary companies are very small next to the main Israeli activities. They essentially operate to help Israeli business to develop outside the country. These companies are supervised by the local banking supervisor and the Israeli banking authority. The risk of a negative development from these subsidiary companies abroad is very little taking into account the level of supervision and the size of these banking units.

- Main risks
 - Credit risk

One of the main risks a bank has to face is the credit risk. This risk level is influenced by the credit portfolio level of risk, diversification, and country risk.



According to the composition of credit risk exposure by risk weights calculated according Basel II standards, 45% of the banking system’s credit risk is assigned a risk weight of 100%. This credit risk is essentially credit to companies. 38% is assessed between zeros and 35%, these credits are credit to the government and housing loans.

⁹ Rony Hizkiyahu, Supervisor of Banks, Bank of Israel

According to the Basel agreements, this level of risk is seen as acceptable¹⁰

Indices of Credit Portfolio Quality, the Five Major Banking Groups, 2003-09

	Year	Leumi	Hapoalim	Discount	Mizrahi- Tefahot	First Intl.	The five groups
Ratio of risk-weighted assets to total assets ^a	2003	0.685	0.711	0.581	0.645	0.654	0.669
	2004	0.674	0.714	0.588	0.670	0.617	0.667
	2005	0.679	0.719	0.600	0.673	0.614	0.673
	2006	0.670	0.722	0.598	0.666	0.613	0.669
	2007	0.690	0.728	0.619	0.682	0.588	0.680
	2008	0.695	0.723	0.648	0.669	0.591	0.683
	2009*	0.642	0.679	0.606	0.671	0.544	0.641
	2009**	0.604	0.632	0.594	0.543	0.497	0.594
Share of balance sheet credit to problem borrowers ^b in total credit to the public (%)	2003	9.8	11.3	11.7	7.7	12.3	10.5
	2004	10.7	11.5	10.2	6.5	12.7	10.6
	2005	9.7	9.9	9.0	6.8	11.9	9.5
	2006	9.8	8.5	7.8	6.0	7.6	8.4
	2007	6.5	6.4	6.3	5.0	5.1	6.1
	2008	8.5	6.1	7.0	6.7	5.9	7.0
Share of non-performing loans in total credit to the public (%)	2003	2.3	2.9	3.8	1.4	2.5	2.6
	2004	1.5	3.2	3.5	1.4	3.3	2.5
	2005	1.3	2.9	3.1	1.5	2.7	2.3
	2006	1.4	2.4	2.8	1.4	1.6	2.0
	2007	0.8	1.8	2.2	1.3	1.2	1.4
	2008	0.9	1.8	2.0	1.3	1.2	1.5
Ratio of annual loan-loss provision to total risk to the public (multiplied by 100)	2003	1.11	1.27	1.11	0.50	1.34	1.12
	2004	0.87	0.93	1.08	0.56	0.99	0.90
	2005	0.79	0.66	0.79	0.45	0.62	0.69
	2006	0.51	0.53	0.63	0.44	0.42	0.52
	2007	0.21	0.25	0.44	0.31	0.33	0.28
	2008	1.01	0.68	0.67	0.44	0.39	0.72
Share of the balance of the loan-loss provision in total problem ^b debts plus the balance of the loan-loss provision (%)	2003	31.7	33.3	36.6	31.9	25.6	32.6
	2004	30.8	34.7	40.5	37.1	29.9	34.2
	2005	34.6	38.2	42.8	37.4	30.8	37.1
	2006	33.6	41.0	46.4	40.4	41.2	39.3
	2007	40.4	44.5	48.1	43.9	50.1	44.3
	2008	35.3	44.0	43.4	34.8	44.2	40.0
2009	40.2	45.6	44.2	42.1	50.1	43.5	

^a Total risk assets are total balance sheet and off-balance-sheet assets weighted by risk. Total assets are total balance sheet and off-balance-sheet assets without risk weighting.

^b Including non-performing loans, restructured loans, loans to be restructured, loans temporarily in arrears, and loans under special supervision.

* Calculated according to Basel I directives.

** Calculated according to Basel II directives.

SOURCE: Based on published financial reports.

Also, the Israeli banking level of risk is expected to go down. The ratio of risk weighted assets to total assets is supposed to decrease in all five main financial institutions. The two biggest institutions (bank Hapoalim and bank Leumi) are more exposed than other banks to risks

Although provisions for loan loss are expected to go up, this trend is a consistent development with the rest of the international banking system. Losses are expected because of some repayment problems.

¹⁰ CHAPTER 3: RISKS AND CAPITAL ADEQUACY - 2009 ISRAEL'S BANKING SYSTEM REPORT

Exposure of the Five Major Banking Groups to Other Countries,^a December 2008 and December 2009

(NIS million)

	Total exposure ^b		Problem debts outstanding	
	2008	2009	2008	2009
AAA-rated countries	185	179	3.0	3.8
<i>of which:</i> US	108	101	2.4	2.7
UK	45	39	0.5	1.0
Exposure to other countries	69	57	1.3	1.0
<i>of which:</i> Turkey	5	4	0.0	0.1
Less developed countries ^c	14	12	0.1	0.2
Total	254	237	4.3	4.9

^aThe foreign countries are those the exposure to each of which is more than 1 percent of the consolidated assets or more than 20 percent of equity/capital, whichever is the lower.

^bThe total exposure to foreign countries includes the balance sheet exposure to foreign countries (balance sheet cross-border exposure and the balance sheet exposure of overseas offices of the banking corporation to local residents) and the off-balance-sheet exposure to foreign countries (credit risk on off-balance-sheet financial instruments as calculated for the purposes of the limitation on that type of debt).

^cLess developed countries classified by the World Bank in a low- or medium-income group. Disclosure regarding those countries is also required when the exposure to them is more than 1 percent of total assets or more than 20 percent of equity/capital, whichever is the lower

SOURCE: Published financial statements.

Another aspect of the credit risk is the country risk. Israeli banks are exposed to country risk when they invest in foreign countries. The largest parts of investments they make are in AAA-rated countries. USA and UK are historic targets for Israeli investments. Still the Israeli banks also invest in other countries but in a less significant amount. Israeli banks did not meet major problems for repayment in international transactions.

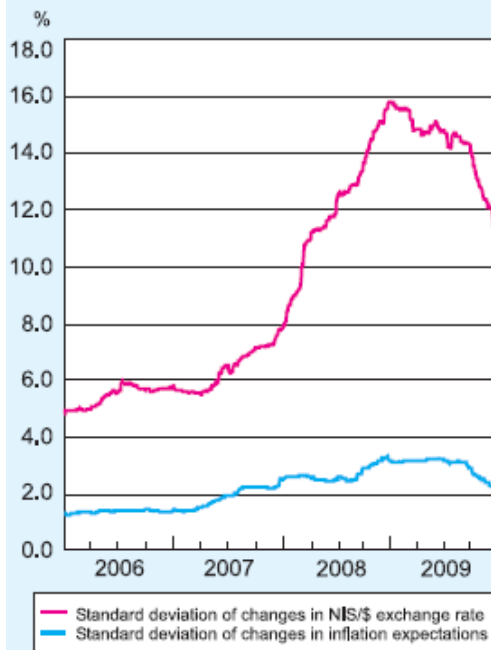
○ Market risk

“Market risk is defined as the risk of erosion in the net worth of the bank due to unexpected changes in market prices (interest rates, shares, the exchange rate and inflation). The analysis of market risk in this survey is based on VaR (Value at Risk), which expresses the maximum expected loss from holding financial instruments that are sensitive to movements in market prices for a given planning horizon and level of significance at a particular point in time¹¹.”

The volatility on the markets affected the Israeli markets. Even if the situation is more or less stabilized from 2009, the banking system had experienced high exposure to market risk. The securities did not reach the level they were before the crisis. One of the consequences of the crisis was a very sharp decrease of the interest rate of the BoI. All these financial developments had strong impact on the Israeli markets. The banking system was not weakened by these economic distresses. The concerted action of the banks and the BoI let the banking system even stronger than before. Volatility on the market was well managed by the Israeli banks. Another aspect of the market risk could be more hazardous for the banks. A too high volatility in the exchange rate could lead to inflation and perilous circumstances.

¹¹ BANK OF ISRAEL: ISRAEL'S BANKING SYSTEM 2009

Standard Deviation^a of the NIS/\$ Exchange Rate and of Changes in Inflation Expectations, 2006-09



^a Calculated on a daily basis over the previous year.
SOURCE: Bank of Israel.

The Israeli banking system is exposed to exchange rates volatility. The fluctuation in the value of the money has a direct effect on the inflation. Banks has to take into account this kind of economic development which has a direct consequence on the level of market risk.

The Bol has been working hard to stabilize the exchange rates but in a very volatile world, the Israeli banking system has to face this aspect of the market risk.

○ Operational risk

“One of the risks facing a bank in managing its assets and liabilities is operational risk, which is defined as the risk of a loss due to the inappropriateness or failure of internal processes, people or systems or as a result of external events”¹².

This kind of risk is difficult to assess with accuracy. But few passed events showed that the Israeli banking system has to find solutions to some operational risks.

Computer system failures have been experienced in the past. These problems lead to disturbances in the day to day business. The computer bugs did not have major impact on data security. Also some Israeli banks have been attacked by what the banks considered as “anti-Israeli attacks”. All these computer problems did not cause major damages to the banks.

Another operational risk is the consequence of laundering money activities inside banks. The Banking Supervision Department implemented major regulation to fight efficiently such practices. The reputation and the trust of the banking system is essential and that’s why Israeli banks implemented very tough regulations.

Other operational risks exist but the Israeli banking system does not communicate largely on it. Nevertheless the Banking Supervision Department monitors the operational risk and assures that the banking system is well protected against operational risk.

○ Liquidity risk

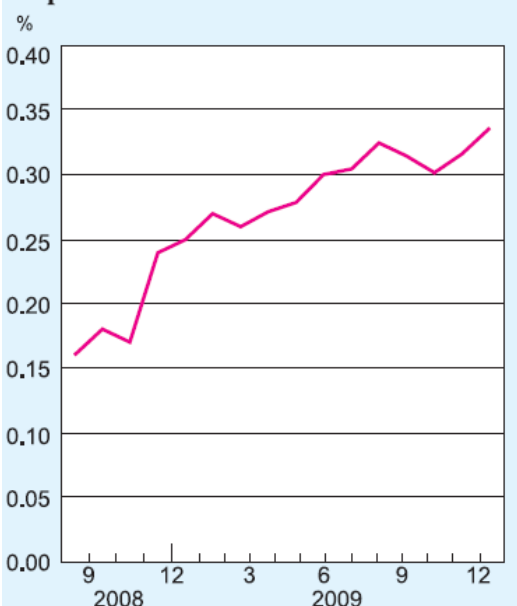
Liquidity is the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable loss. The fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes them inherently vulnerable to liquidity risk, both of an institution-specific nature and that which affects markets as a whole¹³.

¹² BANK OF ISRAEL: ISRAEL’S BANKING SYSTEM 2009

¹³ BANK OF ISRAEL: ISRAEL’S BANKING SYSTEM 2009

Lehman Brothers Trauma reaffirmed the importance of managing liquidity risk. A liquidity crunch is one of the most important risks a bank had to face during the crisis. The Basel committee established new regulations in order to improve the management of liquidity. Stress tests have to guarantee an acceptable level of liquidity.

The Ratio of Liquid Assets^a to Domestic and Foreign-Currency Liabilities With Repayment Terms of Up To One Month According to the Standardised Model,^b the Five Major Banking Groups, September 2008 to December 2009



The Israeli banking system went through the crisis without experiencing major liquidity problems. One of the reasons of such reactions is because the Israel economy is a net lender of the rest of the world. Obviously the Israeli banks' liquidities have been impacted by the crisis. In order to protect the banking system, the BoI made certain decisions. The Bank purchased an important amount of government bonds to help decline long-term interest rates and to support consequently the economy. Also, the bank purchased foreign currencies to prevent a major increase of the exchange rate conditions. The main goal of the bank was to inject liquidity into the market.

- Supervision

The Bank of Israel is in charge of maintaining the stability of the banking system. The bank supervision department is in charge of evaluating the level of risk taken by the Israeli banks. In the recent crisis, the department also offers help in case of necessity. As the 2009 ISRAEL'S BANKING SYSTEM REPORT showed, the Israeli banking system was not affected in a very limited way by the crisis. The Israeli banks did not invest large amounts in foreign financial institutions.

The Israeli banks are seen as very conservative financial institutions. They did not invest in complex financial products because they are known as very low risk takers. Clearly, the profitability of the banking system is negatively impacted by such a strategy, but on a long-term basis, the Israeli banking system is more protected than other foreign regular banking systems. Also, the strict conservatism of the Bank Supervision Department did not allow Israeli banks to take significant risks¹⁴.

Also, in order to protect the banking system, the Bank Supervision Department developed even stricter regulations. The capital adequacy has been elevated to 12% in terms of Basel I by the end of 2009. Stress tests have been implemented to assess the level of credit risk, interest rate risk and

¹⁴ CHAPTER 4: ACTIVITY OF THE BANKING SUPERVISION DEPARTMENT - 2009 ISRAEL'S BANKING SYSTEM REPORT

exchange rate risk. To avoid credit crunch, the bank of Israel meet on a regular basis all the representative of the five big Israeli banks.

The supervision of the Israeli banking system is well developed. The 2007 economic crisis showed that the financial Israeli system is strong enough to manage financial difficulties. For investors, the soundness of the banking system is essential. It is not possible for a company to realize FDIs if the banking system is not reliable. One aspect of the country risk could be if the banking system of a country collapse. According the Bol, Moody's Investors and OECD data, the Israeli banking system is reliable.

Now that the background financial conditions are assessed, economic risk need to be measured. Foreign investors do not only need only a stable financial system and a reliable state of the government finances, they need to be aware of the economic risks.

2. Economic Risk

Country risk is not only about financial risks, some economic development can have disastrous impact on the economy of a country. Some economic development can be a threat against foreign investors. Some of these economic risks can be only relative to a certain country and that 's why they part of a country risk assessment.

a. Economic growth

Economic growth is the process by which a nation's wealth increases over time. GDP is surely the most important economic indicator; it represents the total market value of the goods and services produced by a nation's economy during a specific period of time¹⁵. GDP per se is not enough to appreciate well the level of risk or the potential profit of a country. GDP has to be compared with past performances and to comparable other countries.

Analyzing GDP past performances has to go through the question if past performances are efficient bases for future forecast.

i. Level of GDP, evolution prospects & composition

¹⁵ gross domestic product (GDP). (2011). In *Encyclopædia Britannica*. Retrieved from <http://www.britannica.com/EBchecked/topic/246647/gross-domestic-product>

- Real GDP

© Source: Moody's Investors - Moody's Statistical Handbook

Real GDP (% change)

(Developing Countries Aaa to A3)

Country	Rating	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F
Bahamas	A3	-0.3	2.6	-0.9	-0.8	5.7	4.3	0.7	-1.7	-5.0	-0.5	1.5	2.5
Bahrain	A3	4.6	5.2	7.2	5.6	7.9	6.6	8.4	6.3	3.1	4.5	0.2	2.8
Bermuda	Aa2	0.1	6.4	2.9	3.5	4.6	5.4	4.6	0.7	-8.1	-4.5	-1.0	1.5
Botswana	A2	3.5	9.0	6.3	6.0	1.6	5.1	4.8	3.1	-3.6	9.4	6.3	6.1
Cayman Islands	Aa3	0.6	1.7	2.0	0.9	6.5	4.6	3.8	-0.7	-7.0	-5.5	2.2	2.4
Chile	Aa3	3.4	2.2	3.9	6.0	5.6	4.6	4.6	3.7	-1.5	5.2	6.0	4.7
China	Aa3	8.3	9.1	10.0	10.1	11.3	12.7	14.2	9.6	9.1	10.3	9.2	8.5
Czech Republic	A1	2.5	1.9	3.6	4.5	6.3	6.8	6.1	2.5	-4.1	2.3	2.2	2.8
Israel	A1	-0.1	-0.6	1.5	5.1	4.9	5.7	5.3	4.2	0.8	4.6	3.8	3.8
Korea	A1	3.8	7.0	3.1	4.7	4.2	5.1	5.0	2.3	0.2	6.2	4.5	4.5
Kuwait	Aa2	0.7	2.8	17.4	11.2	10.4	5.3	4.5	5.0	-5.2	2.0	5.3	5.1
Macao [1]	Aa3	2.9	8.5	13.3	26.4	8.3	14.4	14.7	2.8	1.5	26.2	9.0	6.5
Malaysia	A3	0.5	5.4	5.8	6.8	5.0	5.9	6.3	4.7	-1.7	7.2	5.5	5.3
Oman	A1	5.6	2.1	0.3	3.4	4.0	5.5	6.7	12.9	1.1	4.2	3.6	4.0
Poland	A2	1.2	1.4	3.9	5.3	3.6	6.2	6.8	5.0	1.7	3.8	4.0	3.7
Qatar	Aa2	6.3	3.2	6.3	17.7	7.6	18.6	26.8	25.4	8.6	16.2	20.0	7.1
Saudi Arabia	Aa3	0.5	0.2	7.6	5.2	5.6	3.2	1.9	4.4	0.6	3.8	7.5	3.0
South Africa	A3	2.7	3.7	3.0	4.6	5.3	5.6	5.6	3.6	-1.7	2.8	3.2	3.8
Taiwan	Aa3	-1.6	5.3	3.7	6.2	4.7	5.4	6.0	0.7	-1.9	10.8	4.5	5.3
United Arab Emirates	Aa2	1.8	-0.7	16.4	10.1	8.6	8.8	6.6	5.3	-3.2	3.2	3.3	3.8
Median (Aaa to A3)		2.2	3.0	3.9	5.5	5.6	5.6	5.8	4.0	-1.6	4.4	4.2	3.9
Mean (Aaa to A3)		2.4	3.8	5.9	7.1	6.1	7.0	7.2	5.0	-0.8	5.6	5.0	4.4

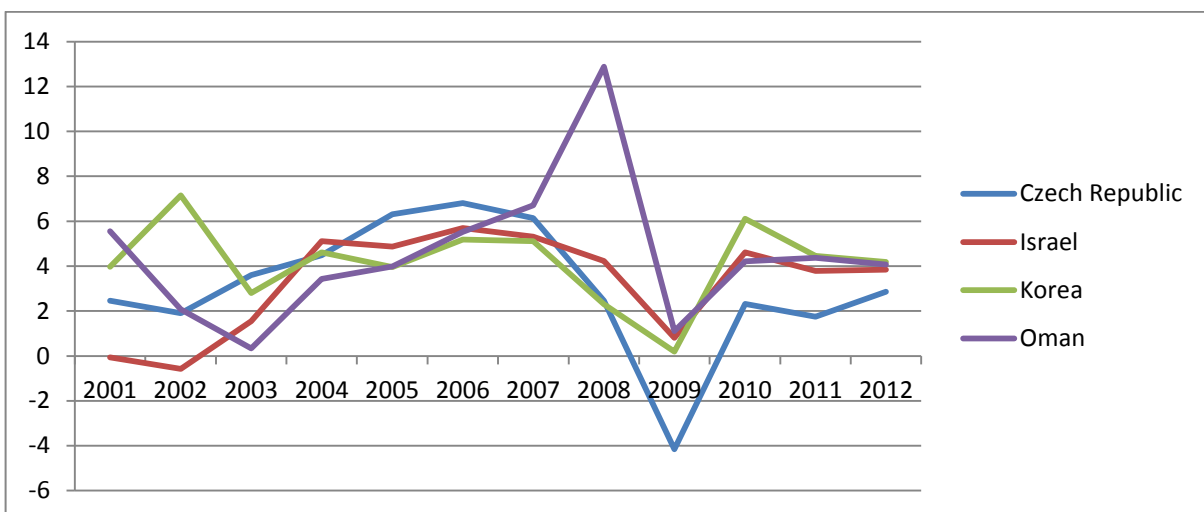
Notes:

[1] Series break in 2001

Israel GDP has been growing substantially on the last ten years at an average level of 3.15%. This high level of growth is a very good message sent to investors. Past performances show that Israel managed to produce more and more wealth.

Terrorist attacks impact the Israeli economic growth. In the early 2000's, the Second intifada and tensions on the northern border has a negative influence on the GDP. But besides political tensions, Israel managed to maintain a high level of growth on the period.

Economic Growth



© Source: IMF

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Variance	Average
Czech Republic	2.456	1.897	3.602	4.485	6.316	6.808	6.131	2.464	-4.149	2.318	1.747	2.852	8.432816205	3.07725
Israel	-0.062	-0.58	1.543	5.11	4.872	5.697	5.315	4.227	0.801	4.606	3.779	3.841	4.937522629	3.262416667
Korea	3.973	7.15	2.803	4.619	3.957	5.179	5.106	2.298	0.196	6.11	4.46	4.183	3.279451909	4.1695
Oman	5.56	2.075	0.342	3.424	3.982	5.529	6.704	12.881	1.1	4.21	4.375	4.076	10.337351	4.5215
Average	2.98175	2.6355	2.0725	4.4095	4.78175	5.80325	5.814	5.4675	-0.513	4.311	3.59025	3.738		

©source IMF

Comparing with same kind of countries is an efficient way to see if Israel growth is efficient.

Oman enjoyed higher average GDP on the period 4.52%. But Oman is more risky due to the higher volatility of its performances (variance = 10.33%).

Korea realized good performances with an average 4.16% GDP on the period. It also enjoys low volatility (3.27%). Korea and Israel are often compared for their economic performances. Even if their economies are different, they are common on several aspects. Besides their economic performances, both countries are high-technology oriented. Korea and Israel are relatively new countries and developed themselves quickly. They went through political instability and continue developing rapidly.

The Czech Republic experienced lower GDPs with an average GDP of 3.07%. The new European member had to deal with very high volatility of its GDP (variance = 8.43%).

Israel with 3.26% average GDP on the period is benefit from relatively high economic growth. Also, volatility is pretty low considering a variance of 4.93%. GDP is strongly influenced by political development in the region. Also all the comparable A1 countries had suffer from the economic crisis in 2009.

A strong economic growth is a strong asset for investors. It shows that the economic capacities to growth are high. Also it gives a hint about what can influence positively or negatively economic growth. In our case, Israel is economically impacted by political disturbances and also by the global meltdown.

b. GDP per Capita

GDP per capita (US\$)

(Developing Countries Aaa to A3)

Country	Rating	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F
Bahamas	A3	18,636	19,396	19,492	19,253	20,882	22,091	22,475	22,401	21,465	21,453	21,830	22,429
Bahrain	A3	11,722	12,132	13,729	15,603	18,338	21,163	24,180	28,436	18,851	20,728	22,539	22,878
Bermuda	Aa2	58,610	62,468	66,130	70,508	76,233	84,442	91,574	94,516	88,747	86,855	88,303	91,541
Botswana	A2	3,450	3,438	4,509	5,535	5,577	6,036	6,541	6,985	5,960	7,736	8,795	9,882
Cayman Islands	Aa3	50,717	51,522	52,054	59,373	61,490	54,504	57,834	60,061	54,634	56,810	58,290	60,048
Chile	Aa3	4,395	4,263	4,637	5,931	7,256	8,913	9,877	10,161	9,479	11,988	14,088	14,626
China	Aa3	1,017	1,108	1,243	1,458	1,724	2,078	2,651	3,412	3,744	4,302	5,044	5,843
Czech Republic	A1	6,049	7,379	8,955	10,730	12,170	13,887	16,858	20,729	18,132	18,218	19,739	21,374
Israel	A1	18,895	17,016	17,748	18,633	19,373	20,726	23,398	27,679	26,256	28,651	30,410	31,638
Korea	A1	10,176	11,497	12,717	14,206	16,413	18,401	20,045	21,886	22,601	24,633	26,681	28,784
Kuwait	Aa2	15,112	15,761	18,781	21,583	27,015	31,908	34,645	43,212	30,953	35,618	46,837	48,814
Macao	Aa3	14,191	14,931	16,672	21,022	23,588	28,426	34,425	38,311	38,541	49,240	54,619	59,094
Malaysia	A3	3,903	4,159	4,459	4,956	5,342	5,999	6,987	8,096	7,204	8,800	9,664	10,529
Oman	A1	7,941	8,070	8,528	9,601	11,805	13,784	15,374	21,749	16,256	18,640	22,246	22,430
Poland	A2	4,979	5,184	5,675	6,620	7,963	8,956	11,152	13,885	11,288	12,269	13,582	13,754
Qatar	Aa2	27,023	28,392	32,777	41,623	48,469	58,058	65,865	76,459	59,984	73,128	106,106	109,602
Saudi Arabia	Aa3	8,664	8,734	9,729	11,116	13,648	15,050	15,850	19,150	14,677	16,980	22,138	23,518
South Africa	A3	2,638	2,440	3,648	4,695	5,234	5,468	5,930	5,642	5,733	7,293	8,437	8,427
Taiwan	Aa3	13,113	13,370	13,748	14,985	16,023	16,451	17,122	17,372	16,327	18,677	20,792	22,959
United Arab Emirates	Aa2	32,621	32,791	35,017	39,305	43,989	52,520	57,520	66,074	55,080	59,719	69,870	71,638
Median (Aaa to A3)		10,949	11,814	13,223	14,596	16,218	17,426	18,584	21,817	18,491	19,702	22,192	22,918
Mean (Aaa to A3)		15,693	16,202	17,512	19,837	22,127	24,443	27,015	30,311	26,296	29,087	33,500	34,990

© Source: Moody's Investors

GDP per capita gives a more approximate approach of the value of goods produced per person in a country in a given period of time. It equals the total GDP divided by the total number of people in the country.

This indicator gives a clue about how much a worker produces wealth in the given country.

Units	2 001	2 002	2 003	2 004	2 005	2 006	2 007	2 008	2 009	2 010	2 011	2 012	Variance	Average
CzechRepublic	6 024	7 375	8 954	10 726	12 186	13 912	16 935	20 816	18 171	18 288	20 738	22 610	31 910 461	14 728
Israel	19 813	17 842	18 423	19 302	20 062	21 465	24 135	28 437	26 874	28 686	30 934	32 082	26 716 720	24 005
Korea	10 655	12 094	13 451	15 029	17 551	19 707	21 653	19 162	17 074	20 591	22 961	24 415	19 024 834	17 862
Oman	7 940	8 070	8 529	9 601	11 806	13 784	15 369	21 745	16 255	18 657	21 421	21 706	29 561 960	14 574

©

Source

IMF

Note: Gross domestic product per capita, current prices (U.S. dollars)

When we compare with the three other comparable countries¹⁶, Israel has the highest GDP per capita. With a little bit more than 7 million inhabitants, Israel gets an average GDP per capita of 24K\$.

Even when we compare with the same category countries going from Aaa to A3, Israel is above the median. This indicator is often criticized¹⁷ but it gives an indication of the relative command over resources in international commerce possessed by the average individual within a given country¹⁸.

¹⁶Same category A1 countries according Moody's Investors

¹⁷ Even when we PPP indicators the results are not that different. The first GDP per capita is still Israel.

Even if this indicator is essential for investors, to know how much they can expect from the workers in Israel, it is not enough to assess the income per capita and income distribution. Indeed a high GDP can hide very unfair income distribution. It can also be far from the real income of the country¹⁹.

ii. Income per Capita, income distribution

<u>Disposable income</u>						
Transaction	B5_NS1: Net national income at market prices					
Measure	HVPVOB: Per head, US \$, constant prices, constant PPPs, OECD base year					
Frequency	Annual					
Time	2005	2006	2007	2008	2009	
Country						
<u>Luxembourg</u>	46 735	43 973	50 186	46 591	39 489	
<u>Norway</u>	35 301	35 972	36 168	36 008	34 050	
<u>Switzerland</u>	30 206	30 772	30 181	28 148	32 358	
<u>United States</u>	33 495	34 274	33 941	32 928	31 819	
<u>Australia</u>	26 326	27 037	27 861	28 088	27 551	
<u>Sweden</u>	26 896	28 084	29 301	29 041	26 421	
<u>Netherlands</u>	26 477	28 045	28 748	28 051	25 965	
<u>Canada</u>	26 027	26 836	27 013	26 767	25 411	
<u>Austria</u>	25 281	26 016	26 657	26 628	25 401	
<u>United Kingdom</u>	26 016	26 179	27 042	27 071	25 291	
<u>Denmark</u>	26 311	27 230	27 151	26 747	25 003	
<u>Belgium</u>	24 449	24 804	25 417	24 907	24 303	
<u>Finland</u>	24 031	24 835	25 856	25 741	23 752	
<u>Germany</u>	22 622	23 537	24 088	24 042	22 966	
<u>Ireland</u>	24 877	26 198	26 395	24 473	21 659	
<u>Israel</u>	19 852	20 682	21 316	20 826	21 084	
<u>Italy</u>	21 922	22 068	22 196	21 268	20 183	
<u>Japan</u>	21 686	21 894	22 333	21 449	20 099	
<u>Greece</u>	19 267	20 072	20 707	20 555	19 719	
<u>Spain</u>	19 777	20 144	20 328	19 846	19 111	
<u>Korea</u>	17 430	18 025	18 832	18 638	18 790	
<u>Slovenia</u>	17 504	18 423	19 532	19 764	18 297	
<u>Czech Republic</u>	14 082	14 852	15 497	15 412	15 051	
<u>Portugal</u>	14 743	14 642	15 032	14 669	14 413	
<u>Poland</u>	10 641	11 251	12 049	12 927	13 129	
<u>Estonia</u>	13 353	14 575	15 916	15 269	12 513	
<u>Hungary</u>	11 998	12 294	12 214	12 317	11 563	
<u>Chile</u>	9 830	10 761	11 503	11 273	10 966	
<u>Mexico</u>	9 304	9 742	9 981	10 019	9 089	
<u>Russian Federation</u>	8 725	9 765	10 891	11 665	..	

© OECD

¹⁸ Moody's Investors

¹⁹ This problematic aspect is well known in small countries like Liechtenstein or Monaco for example.

Disposable income represents the very amount a household can spend or save after income taxes. For investors disposable income is important for two reasons. It shows (i) if there is a domestic market, if people are capable to consume new articles. It also helps to predict (ii) if social tensions could erupt I the country.

According the OECD statistics²⁰, Israel is pretty much in the middle of the disposable income. It is above the other A1²¹ countries of its category. The developed western countries lead the top of the ranking. Israel passed above other countries like Portugal, Italy, Greece and Spain. Japan is also behind Israel performances for 2010.

Disposable incomes did not only go up during the last five years. Various countries experience reductions in their disposable income. Few reasons can explain this negative variation of the disposable income. PPP can interfere in the level of disposable incomes. Inflation can erode the value of the incomes. Also tax raise can interfere in the level of the income. And finally, decreasing incomes can lead to decreasing disposable incomes.

Israel can indeed be an average target for development of new market opportunities. Israelis earn sufficient amounts of moneys to consume as regular OECD country citizens. On the other hand the average level of disposable income could represent a relatively high level of income for investors who would be willing to start up companies back in Israel. The level of income has to be compared to the high level of productivity. Indeed Israelis enjoys a very high GDP per capita which shows that the potential productivity is high.

²⁰ For thoses countries OECD have gathered data

²¹ Moody's Investors

Deciles

2009

	עשירונים									
	10	9	8	7	6	5	4	3	2	1
Upper limit (NIS)	-	27 800	20 132	15 581	12 492	10 017	7 969	6 179	4 588	3 087
Age of head of household	46.6 ±0.6	45.5 ±0.6	44.6 ±0.7	44.6 ±0.8	45.2 ±0.8	45.3 ±0.9	46.4 ±1.0	47.1 ±1.1	52.3 ±1.1	53.8 ±1.2
Number of years of schooling of head of household	16.2 ±0.2	14.8 ±0.2	14.3 ±0.2	13.8 ±0.2	13.2 ±0.2	12.9 ±0.2	12.7 ±0.3	12.0 ±0.2	11.6 ±0.3	11.0 ±0.4
Number of persons per household	3.9 ±0.1	3.9 ±0.1	3.9 ±0.1	3.6 ±0.1	3.5 ±0.1	3.5 ±0.1	3.3 ±0.1	3.2 ±0.1	2.7 ±0.1	2.0 ±0.1
Number of standard persons per household	3.1 ±0.0	3.1 ±0.0	3.1 ±0.1	2.9 ±0.1	2.9 ±0.1	2.8 ±0.1	2.7 ±0.1	2.6 ±0.1	2.3 ±0.1	1.9 ±0.1
Gross monthly income per household (NIS)	42 521 ±1,402.8	23 375 ±656.9	17 700 ±315.7	13 991 ±243.3	11 186 ±197.2	8 951 ±162.6	7 035 ±133.5	5 383 ±107.5	3 845 ±96.4	1 803 ±297.1
Net monthly income per household (NIS)	31 204 ±1,081.7	19 224 ±429.4	15 352 ±235.6	12 458 ±198.0	10 167 ±167.1	8 267 ±143.1	6 557 ±120.4	5 069 ±99.2	3 625 ±93.0	1 627 ±299.2
Net monthly income per standard person (NIS)	9 986 ±368.7	6 204 ±156.4	5 008 ±105.1	4 259 ±90.7	3 559 ±87.4	2 946 ±79.0	2 444 ±70.4	1 941 ±56.9	1 555 ±49.5	856 ±161.4

© Central Bureau of Statistics: Israel

The deciles analysis gives a more accurate view on the repartition of the wealth between the people. In this table, the first major information is the median wage per household which is around 10K NIS (=1. 921€ or 2.767 \$). 50% of the Israeli households (not individuals!) earn less that this amount of money and 50% earn more. This amount decreases by 17% to get the net monthly income per household. The median income is relatively low to an OECD country.

From June 2011, Israel faces major social challenges. For the first time in its history, hundreds of thousands went to demonstrate to get a better welfare state. More than political tension, Israel goes through unprecedented social tensions. The social movement is led by students and young workers. They demand higher minimum wages and better living conditions.

The minimum wage in Israel equals 4.100 Shekels²² (=784€ or 1.136\$). Israelis works 6 days a week (from Sunday to Friday morning). Israelis work between 43 to 45 hours a week according labor law. They get 36 hours resting time during week ends²³.

Israelis work more than the average OECD amount of working hours. Part of the new generation does not accept the working conditions that they judge as poor ones. They demand better working conditions and stricter labor regulations. They ask for more "Social Justice". The middle class ask for a more proactive social policy. Protestors look for more social protections and demand the intervention of the government.

Besides their call for better working conditions, the Israeli new social movement asks for affordable places to live. The protestors ask for the government to recognize as a basic right the right to housing. Indeed the price of housing in Israeli increased significantly and young people and families

²² <http://www.hilan.co.il/calc/MinimumWageCalculator.aspx>

²³ <http://www.moital.gov.il> Minister of Business and Industry

do not find affordable place to live. They demand rent-controlled housing and constructions of housing at moderated rents. Also they ask to raise taxes for high income households and lowering taxes for middle class workers²⁴.

All such huge social movements are very new for Israel. For decades Israel managed to improve slowly the social conditions. The protestor's expectations are very high and the Israeli government faces massive demonstrations all over the country.

At its creation, Israel was more socialist oriented. Kibbutzim²⁵ and cooperatives played a key role in the establishment of the Israeli economy. The very beginning of the country used socialist and even communist business units to develop Israel. Today Israel has turned completely to be a capitalist state. Even if some historical kibbutzim still play a role. Israel liberalized markets and passed important reforms to promote economic freedom. Prime Minister Netanyahu is seen as one of the founders of these reforms²⁶.

The social tensions could be considered as a threat for investors. Investors don't know how the government and the markets would react to longer social protests. The risk of violence that has been seen in other OECD countries is extremely low. Demonstrations in Israel are usually low but history has shown that they can go on for long. The protestors do not ask the Prime Minister or the government to quit but to act. Political tensions are not at stake.

Nevertheless Israel cannot easily implement social reforms without increase its level of deficit. This political move could have consequences to investors. As published in its last report, Moody's Investors warns investors in case of increasing level of deficit. It based its rating only on expectations that the Israeli government will lower its deficit and debt. A downgrade of the Israeli sovereign debt would be a negative message sent to investors.

The situation should be solved in the short term, but for the meantime social tensions are relatively high and should be monitored with special attention by investors.

c. Balance of Payment

The balance of payments describes all the economic transactions (trade, financial and monetary exchanges) between a country the rest of the world during one year.

As the equation describe it

$$\text{Balance of payment} = \text{Current account} + \text{Capital account} + \text{Financial account}^{27}$$

²⁴ The People ask for Social Justice <http://i14.org.il/>

²⁵ A kibbutz is an Israeli collective settlement, usually agricultural and often also industrial, in which all wealth is held in common. Profits are reinvested in the settlement after members have been provided with food, clothing, and shelter and with social and medical services. Adults have private quarters, but children are generally housed and cared for as a group. Cooking and dining are in common. The settlements have edged toward greater privacy with regard to person and property since the formation of Israel in 1948. The kibbutzim, which are generally established on land leased from the Jewish National Fund, convene weekly general meetings at which the kibbutz members determine policy and elect their administrative members. (Source: kibbutz. (2011). In *Encyclopædia Britannica*. Retrieved from <http://www.britannica.com/EBchecked/topic/317247/kibbutz>)

²⁶ He leads few of them between 2003 and 2005 as Finance Minister.

²⁷ Balance of Payments Manual, 5th Ed. International Monetary Fund, Washington D.C., USA, 1993

i. Trade balance

For investors one of the most important account is the trade account which is part of the current account. The current account shows flows of goods, services, primary income, and secondary income between residents and non- residents²⁸.

Subject	Current account, balance in millions						
Measure	US-Dollar converted, Seasonally adjusted						
Time	2004	2005	2006	2007	2008	2009	2010
Frequency	Annual						
Country							
United States	-630487	-747590	-802636	-718094	-668853	-378431	-470242
<u>G7</u>	-	-	-	-	-	-	-
	361448.7	519589.8	576183.6	395849.6	434864.1	206092.3	-321653.7
<u>OECD – Total</u>	-	-	-	-	-	-	-
	318691.6	-517551	589941.6	-530629	-665242	197757.7	-258666.5
<u>Euro area (17 countries)</u>	-	-	-	-	-	-	-
	76643.3	14547.15	12812.85	14581.96	195790.8	69139.24	-77007.67
United Kingdom	-	-	-	-	-	-	-
	45655.74	59698.25	82691.73	73001.72	43538.48	37194.39	-71456.96
Italy	-	-	-	-	-	-	-
	16196.64	-29378.9	48118.49	51626.87	67256.84	44007.55	-66463.32
Spain	-	-	-	-	-	-	-
	54871.77	83095.85	110848.5	144101.6	153040.7	-75688.2	-64107.72
Turkey	-	-	-	-	-	-	-
	-14432.1	22311.34	32251.74	38439.68	41963.59	13992.27	-47825.43
France	-	-	-	-	-	-	-
	11134.88	10348.92	12984.81	25905.84	49307.36	39456.34	-44575.02
Greece	-	-	-	-	-	-	-
	13314.14	18323.19	29820.76	44630.63	50875.69	35869.27	-31849.5
Portugal	-	-	-	-	-	-	-
	-15446.2	19790.59	21571.48	23374.67	31724.84	25509.57	-22596.1
Poland	-	-	-	-	-	-	-
	-13258	-7242	-13147	-26501	-34957	-17155	-20982
Czech Republic	-	-	-	-	-	-	-
	5738.787	1662.569	3417.921	5573.289	1340.437	6025.892	-7295.375
Mexico	-	-	-	-	-	-	-
	5237.374	5079.691	4801.497	8977.249	16349.19	6289.375	-5690.034
Ireland	-	-	-	-	-	-	-
	1078.735	-7133.75	7864.933	13836.85	15285.98	6290.676	961.197
Indonesia	-	-	-	-	-	-	-
	1562.52	277.557	10859.49	10492.59	125.245	10628.49	5653.91
Israel	2095.1	4379.9	7503.3	4247.8	1945.3	7043.9	6432.7
Korea	-	-	-	-	-	-	-
	32312	18606.2	14083.4	21769.8	3197.5	32790.6	28213.4
Norway	-	-	-	-	-	-	-
	32884.07	49148.2	58014.04	54708.38	78475.76	43711.07	51281.09
<u>OECD - Europe</u>	-	-	-	-	-	-	-
	130400.5	72469.09	50341.7	10494.61	86649.88	88688.27	69036.36
<u>Germany</u>	-	-	-	-	-	-	-
	127764.8	140321.8	181999.9	247984.1	226372.7	185805.3	186883.9
Japan	-	-	-	-	-	-	-
	172158.4	163927.1	168408	211372.3	158424.3	141996.2	195651.5
Brazil	-	-	-	-	-	-	-
	11737.6	13984.65	13621.48	1550.784	28192.03	24302.23	..
China	-	-	-	-	-	-	-
	68659.2	160818	253268	371833	436107	297142	..
India	-	-	-	-	-	-	-
	698.2009	10367.13	-9513.76	10685.99	37230.96	..	..
Russian Federation	-	-	-	-	-	-	-
	59511.75	84602.17	94686.39	77768.31	103660.7	49365.29	..

Israel benefits from positive current accounts. It means that Israel exports more goods, services and incomes to the rest of the world than the other way around. The balance is positive for year and well ranked in the OECD group.

²⁸ Israel Central Bureau of Statistics definition

It is usually the case of the developing countries which export a lot or countries which enjoys natural resources (like oil and gaz).Germany and Japan are good example of countries which historically export a lot (heavy industrialized countries).China and India export a lot because they export large amount of products for the rest of the world. Some country are between, Brazil, Korea and Indonesia produce a lot and take advantage of their natural resources. Norway and Russia benefit from large exports of oil and gaz.

	2010	2009	2008	2007
Current account				
Receipts				
Exports of goods and services	80 511	67 881	81 471	71 434
Income	5 835	5 694	7 244	10 875
Current transfers	9 465	8 395	9 424	8 528
Total current account receipts	95 810	81 970	98 140	90 837
Payments				
Imports of goods and services	75 980	63 132	84 313	73 549
Income	12 078	10 783	11 359	11 135
Current transfers	1 056	993	943	1 272
Total current account payments	89 113	74 907	96 614	85 955
Balances				
Trade in goods and services	4 531	4 749	-2 841	-2 116
Net income	-6 243	-5 089	-4 115	-260
Net current transfers	8 409	7 402	8 481	7 257
Current balance	6 697	7 063	1 525	4 882

© Source: Central Bureau of Statistics: in million of US\$

The trade of goods and services represent around 70% of the total current balance. For potential investors it shows that Israel is already a good target for exports. Goods and services are sold all over the world from Israel. In the past the situation has been inversed.

Israel has been importing for years, in particular military equipments. It still does but the exports today exceed imports. The trade balance is now positive. In the sector analysis, a more exact analysis will be done to understand which part of the economy has a bigger impact on the exports.

ii. Capital and financial accounts

This part of the trade balance is essential for investors. It shows if investors put their money in Israel. An account which records transactions that involve financial assets and liabilities and that take place between Israeli and foreign residents²⁹. The components of the financial account are classified by types of investments (domestic and foreign).

²⁹ CBS, STATISTICAL ABSTRACT OF ISRAEL 2010

INTERNATIONAL INVESTMENT POSITION (1)

\$ Million

	Annual data		נתונים שנתיים	
	2010	2009	2008	2007
A. Assets				
1. Direct investment abroad				
Equity capital and reinvested earnings	48 935	45 013	43 046	39 108
Other capital	16 034	12 358	11 364	10 726
Direct investment abroad – total	64 969	57 371	54 410	49 833
2. Portfolio investment				
Equity securities	34 845	25 337	12 870	16 931
Banks	-	-	-	-
Other sectors	34 845	25 337	12 870	16 931
Bonds and notes	26 835	24 089	20 526	25 191
Government	4	1	7	17
Banks	5 996	7 026	6 549	7 449
Other sectors	20 835	17 061	13 970	17 726
Portfolio investment – total	61 680	49 425	33 395	42 122
3. Other investment				
Government	473	633	495	534
Banks	15 544	17 282	22 113	29 558
Other sectors	34 489	34 829	34 877	39 860
Monetary authorities	220	220	220	220
Other investment – total	50 726	52 964	57 705	70 172
4. Financial derivatives (net)	-135	-68	-67	73
5. Reserve assets	70 945	60 614	42 514	28 557
Assets – total	248 185	220 307	187 957	190 757
B. Liabilities				
1. Direct investment in Israel				
Equity capital and reinvested earnings	74 208	64 888	58 369	57 151
Other capital	3 608	4 276	3 800	3 399
Direct investment in Israel – total	77 816	69 164	62 169	60 550
2. Portfolio investment				
Equity securities	71 278	68 650	44 961	59 670
Bonds and notes	36 643	26 496	26 406	27 383
Monetary authorities	10 840	1 156	195	194
Government (2)	18 789	18 183	17 658	19 835
Other sectors	7 014	7 157	8 553	7 355
Portfolio investment – total	107 921	95 146	71 367	87 053
3. Other investment				
Government (2)	9 318	10 477	10 176	11 758
Banks	29 879	27 754	26 716	26 951
Monetary authorities (s.d.r)	1 307	1 385	164	169
Other sectors	25 270	22 878	21 104	21 190
Other investment – total	65 773	62 494	58 160	60 068
Liabilities – total	251 510	226 804	191 695	207 670
C. Net international investment position				
1. Net direct investment	12 848	11 793	7 759	10 716
2. Net portfolio investment	46 241	45 721	37 972	44 931
3. Net other investment	15 047	9 530	455	-10 104
4. Net financial derivatives	135	68	67	-73
5. Reserve assets	-70 945	-60 614	-42 514	-28 557
Net international investment position – total	3 325	6 498	3 738	16 913

(2) Financial positions of the public sector include accrued interests, according to the recording of interests in the Income Account of the BOP

(3) FDI positions in Israel have been adjusted since year 2000.

© Source: Central Bureau of Statistics: in million of US\$

According to this document, it is clear that Israel invests a lot outside the country. Israeli investors look for targets to buy equity. They make foreign direct investment for billions of dollars. They also realize portfolio investments. They buy again for billions of bonds and equity. This trend grows year after year. Israeli investors invest massively abroad.

For investors the message can be seen in different ways. Foreign investors could see this trend as negative because it could mean that Israeli investors do not find new opportunities inside the country that's why they look outside the country. On the other hand, serious investors can easily understand that investors look for diversification and new opportunities outside the country. A country in which investors would only put their money inside their country would be a risky and strange country. Investors can understand that cash can be transferred easily outside of Israel and that the country is well integrated in the global market.

The second part of the document shows well that money gets in Israel. Israel takes benefits of a positive net position concerning direct investment. FDIs realized inside the country represents a bigger amount than Israeli investment abroad. Israel remains a target for investors. This position is a great message sent to foreign investors

iii. Reserves

Reserve assets are external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing). Includes changes in foreign currency reserves held by the Central Bank abroad (not revalued)³⁰.

³⁰ CBS, STATISTICAL ABSTRACT OF ISRAEL 2010

IMF Data Template on International Reserves and Foreign Currency Liquidity

Official reserve assets	77 896.38
(1) Foreign currency reserves (in convertible foreign currencies)	74 084.18
(a) Securities	69 373.53
<i>of which: issuer headquartered in reporting country but located abroad</i>	
(b) total currency and deposits with:	4 710.65
(i) other national central banks, BIS and IMF	195.43
(ii) banks headquartered in the reporting country	
<i>of which: located abroad</i>	
(iii) banks headquartered outside the reporting country	4 515.22
<i>of which: located in the reporting country</i>	
(2) IMF reserve position	493.49
(3) SDRs	1 359.58
(4) gold (including gold deposits and, if appropriate, gold swapped)	-
— volume in millions of fine troy ounces	
(5) other reserve assets (specify)	1 959.13
— financial derivatives	
— loans to nonbank nonresidents	
— reverse repo	1 959.13

©Source: IMF in US dollars, millions

The amount of reserves has been growing for several years. The BoI has been buying \$100m USD on a daily basis to increase the level of foreign currency reserves. The goal of such transactions is to maintain a certain exchange rate with the dollar. The BoI intervenes when the board thinks that the rate of the shekel is inconsistent with the economic conditions and when the market does not function correctly. The decision to buy dollars is based on the on the economic activity, on export and other economic factors. The bank also fights inflation.

The BoI reserves reach a maximum to their current level: \$77bn USD. Prof. Stanley Fisher explains its strategy of buying foreign currencies in order to secure exchange rates and as part of its response to the global crisis³¹.

³¹ Q&A on the Foreign Exchange Markets

iv. Trade openness

Openness of the Economy

(Developing Countries Aaa to A3)

Country	Rating	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F
Bahamas	A3	87.1	86.4	86.2	93.8	98.4	102.6	105.9	107.0	91.4	91.0	94.4	94.7
Bahrain	A3	142.8	148.2	145.5	164.7	176.0	171.7	162.1	171.2	140.1	135.0	140.4	138.1
Bermuda [1]	Aa2	97.4	96.4	101.1	101.8	100.6	112.8	121.2	112.2	102.0	104.0	102.2	104.1
Botswana	A2	79.6	82.0	79.7	81.1	85.7	77.7	82.9	85.0	80.9	81.0	85.4	89.8
Cayman Islands [2]	Aa3	53.8	48.6	51.6	64.6	63.1	76.3	72.7	68.4	75.8	74.3	78.5	79.1
Chile	Aa3	65.1	65.7	68.9	72.3	74.1	76.5	80.5	85.7	69.5	75.1	79.0	84.8
China	Aa3	44.1	48.9	58.3	66.8	68.9	70.3	68.0	62.3	49.1	56.4	56.5	57.2
Czech Republic	A1	133.2	122.5	125.8	140.2	141.2	149.4	155.1	149.6	132.7	153.8	173.5	174.7
Israel	A1	69.1	73.7	74.0	82.6	85.6	85.0	86.2	81.6	66.9	72.0	72.3	74.5
Korea	A1	73.2	65.6	68.5	77.6	75.8	78.0	85.5	92.8	79.6	86.6	98.2	97.9
Kuwait	Aa2	86.8	81.2	86.6	89.3	92.2	89.7	91.7	91.8	84.4	86.7	88.8	87.1
Macao	Aa3	169.0	175.5	176.2	173.8	157.6	151.7	159.8	161.6	144.4	158.1	142.9	139.6
Malaysia	A3	203.4	199.4	194.2	210.4	213.2	211.1	200.8	183.6	171.3	176.0	187.0	198.7
Oman	A1	81.2	77.4	82.9	90.6	89.8	88.8	96.9	96.2	94.1	101.6	109.2	108.6
Poland	A2	57.8	60.7	69.3	77.3	74.9	82.5	84.4	83.8	78.9	83.9	86.9	88.6
Qatar [2]	Aa2	102.5	94.6	91.0	91.4	98.9	100.9	89.3	93.9	81.0	88.8	87.9	87.5
Saudi Arabia	Aa3	64.0	65.0	70.2	78.5	88.6	95.1	102.7	105.2	97.3	97.1	96.8	96.5
South Africa	A3	56.2	62.0	53.4	53.1	55.2	62.5	65.7	74.2	55.7	54.9	55.5	60.2
Taiwan	Aa3	94.0	97.0	104.2	118.8	119.4	129.0	135.0	140.7	116.0	138.8	138.8	136.1
United Arab Emirates	Aa2	89.0	93.7	102.7	116.1	119.6	117.4	138.3	147.3	139.7	138.6	128.5	128.8
Median (Aaa to A3)		84.0	81.6	84.5	89.9	91.0	92.4	94.3	95.0	87.9	89.9	95.6	95.6
Mean (Aaa to A3)		92.5	92.2	94.5	102.2	104.0	106.4	109.2	109.7	97.5	102.7	105.1	106.3

Notes:

[1] Balance of Payments; Series break in 2004
 [2] Balance of Payments

© Source: Moody's Investors

The level of trade openness is fundamental for investors. It shows if there is a market for FDIs. Also if the openness of the economy is high it shows that trade is a driving force of the economy. The indicator of trade openness of the economy is based on the idea that there is a link between openness and economic growth.

Usually economists claim that this indicator is not perfect for a technical problem. Foreign trade is valued in USD whereas GDP incorporate non tradable goods sector and domestic services. By doing so, the GDP can be underestimated and the openness of the economy can be overvalued.

Besides the extreme results shown in the table, Israel is pretty much in the average level of openness. Next to its category (ie. A1) competitors, the country is doing good. Korea gets better performance because of its export of heavy industrialized products (car) Oman benefits from oil exports.

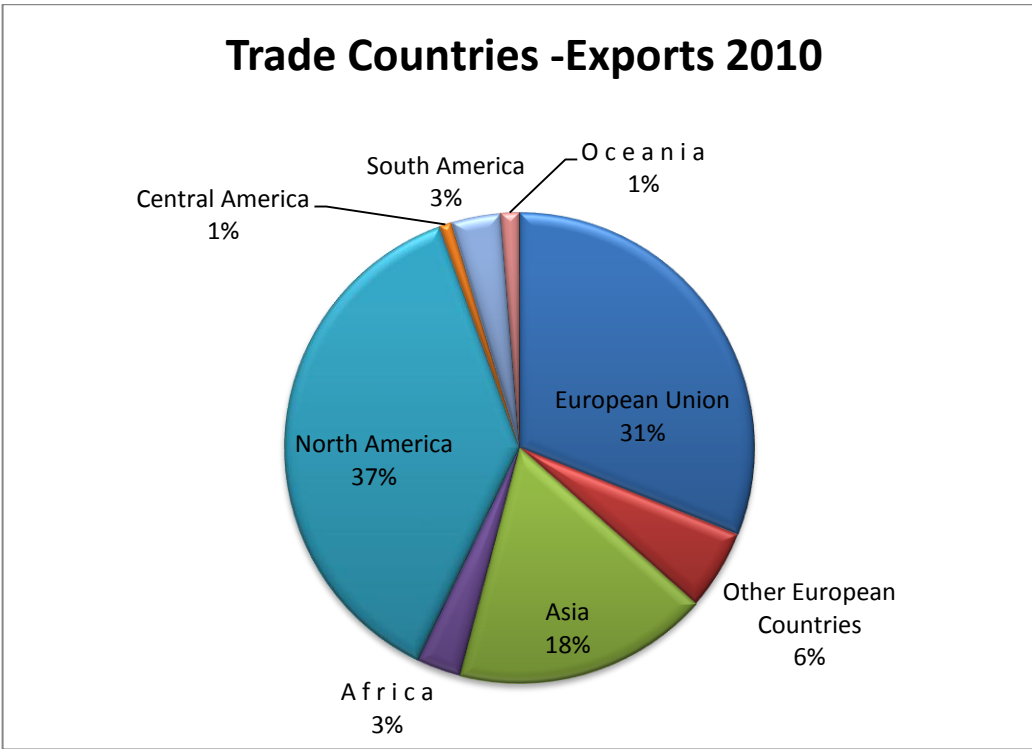
Besides two periods of difficulties Israel has been growing year after year. In the early 2000's Israel exported less because of the Second Intifada which hurt strongly the economy. The second period is the global meltdown that the world endured in 2009. Israel has been also affected by the decrease of the global trade .

Israel is an opened economy. Its economic growth relies on the foreign trade. Exporting and importing is one of the key of the Israeli economy.



Israel has developed strong economic relationships with its partners all over the world.

The first economic supplier of Israel is the EU. 45% of the goods and services imported to Israel come from the EU. The weight of Europe in the imports of Israel has not been significantly modified for years. The second strong supplier of Israel is Asia with a bigger and bigger role played by China. Israel still import a lot from the USA, but less than in the past.



Israel's customers are firstly American. They buy a large part of the exports. The EU in second position, still buy a lot from Israel, only in third spot comes Asia. The growing position of the Asian

countries is a new development of the economy. Israeli businessmen try to deal with Far East countries.

d. Sector analysis

The sector analysis consists in describing the current and past conditions of the different sectors of the economy. The goal is to provide prospects of the different sectors . the analysis is a key tool for investors. It shows which part of the economy plays a more fundamental role than the other.

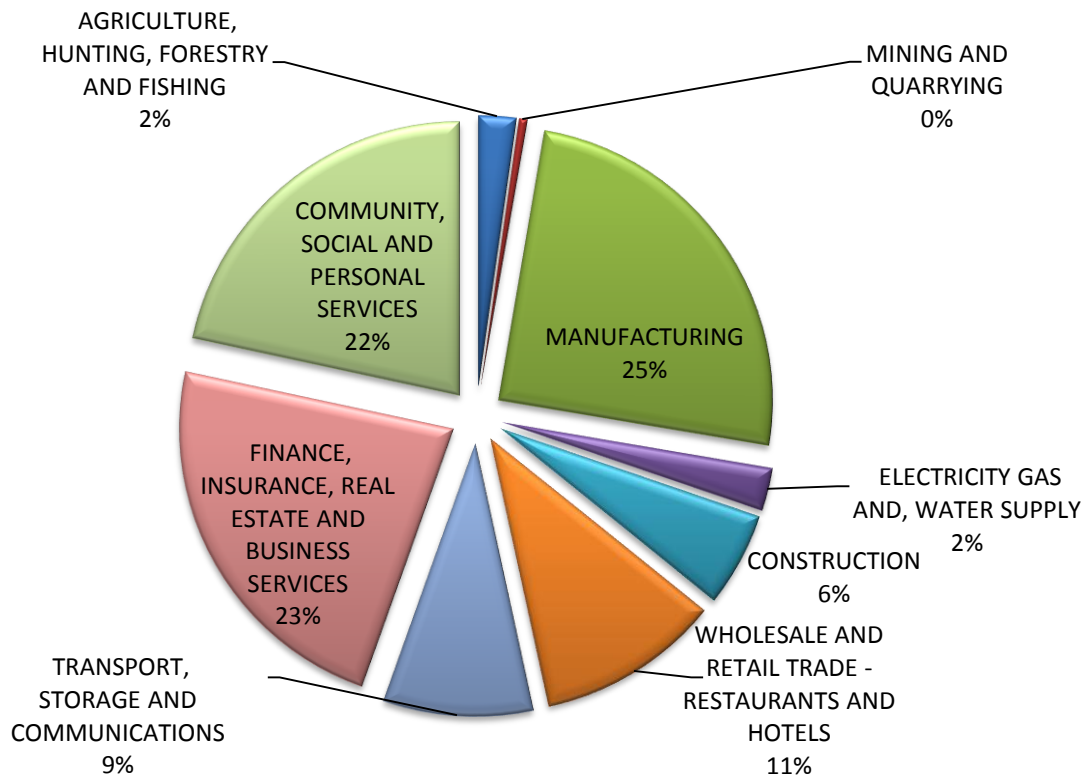
One of the tools that the OECD provides to establish the sector analysis is the STAN database for structural analysis. The STAN database for industrial analysis provides analysts and researchers with a comprehensive tool for analyzing industrial performance at a relatively detailed level of activity. It gather information on the different activities of the economy. To understand well which sector plays a more essential role in Israel, we used the production by sector of activity.

Production by sector of activity

Time	2006	2007	2008
Industry			
CTOTAL TOTAL	1 197 070 207 291.00	1 280 300 236 209.00	1 339 508 917 147.00
AGRICULTURE, HUNTING, FORESTRY AND FISHING	25 103 000 000.00	27 334 000 000.00	29 502 000 000.00
MINING AND QUARRYING	4 970 456 000.00	5 294 841 000.00	6 604 550 000.00
MANUFACTURING	321 104 544 000.00	337 335 159 000.00	334 395 450 000.00
ELECTRICITY GAS AND, WATER SUPPLY	27 153 497 357.00	28 653 772 040.00	33 904 409 901.00
CONSTRUCTION	64 512 852 512.00	70 154 776 913.00	74 844 030 604.00
WHOLESALE AND RETAIL TRADE - RESTAURANTS AND HOTELS	122 761 082 145.00	133 334 674 039.00	144 947 728 906.00
TRANSPORT, STORAGE AND COMMUNICATIONS	97 138 409 436.00	107 779 121 464.00	118 257 668 113.00
FINANCE, INSURANCE, REAL ESTATE AND BUSINESS SERVICES	276 763 780 103.00	296 557 905 172.00	307 176 439 675.00
COMMUNITY, SOCIAL AND PERSONAL SERVICES	257 562 585 739.00	273 855 986 581.00	289 876 639 947.00

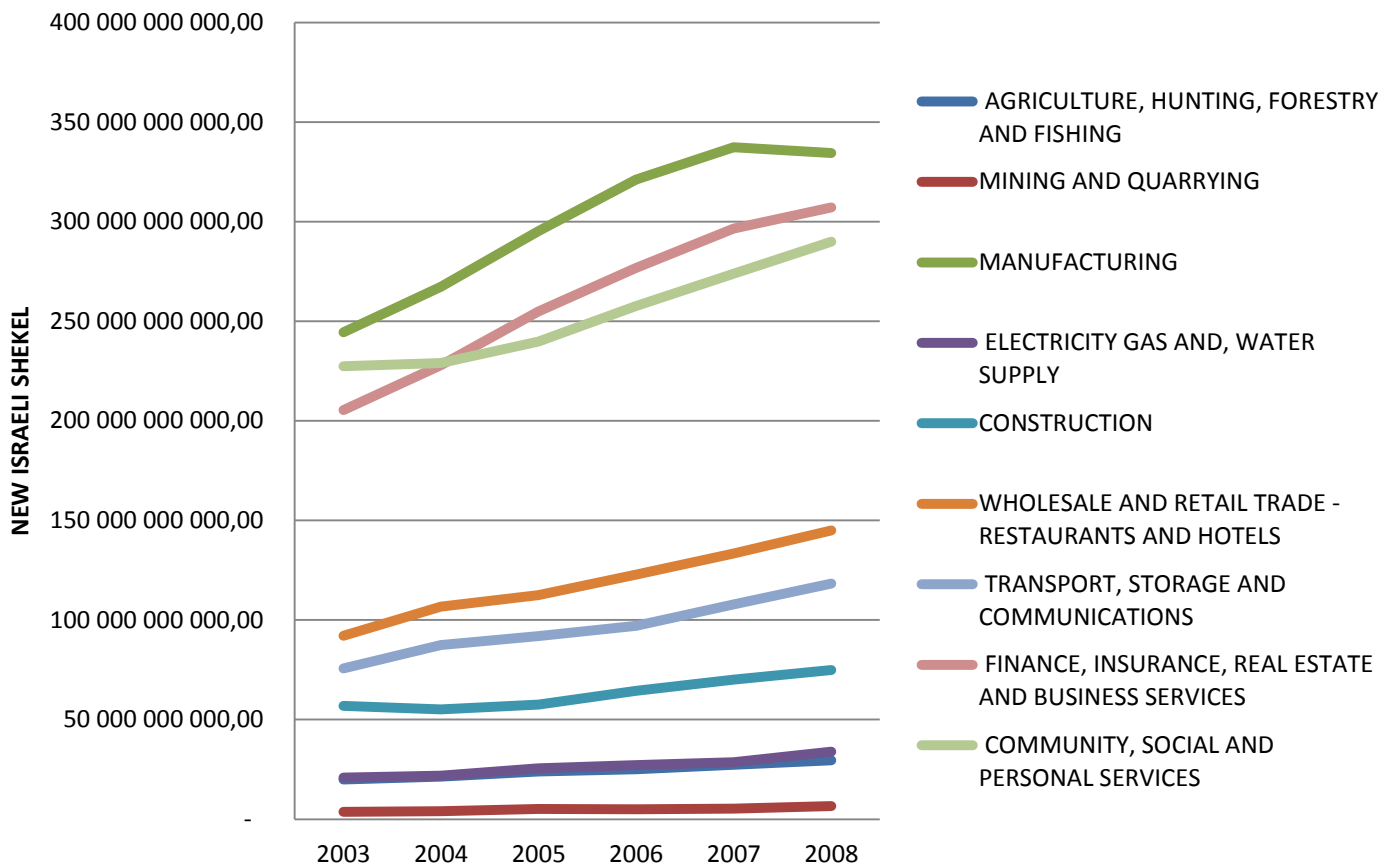
© Source: OECD

Prod. by activity



© Source: OECD

Evolution of the Israeli Production



Israel's industry is playing a predominant role in its economy. Manufacturing represents a quarter of the total production. The food industry and the high tech industry represent a large part of the manufacturing sector. The sector has been growing for years. In 2008 it decreases lightly. When we add all the different aspects of the industry sector (energy) we reach 32% of the economy. Only 16,2% (CIA world factbook) of the population works in the sector which means that the industry worker are pretty productive.

The finance industry is growing very significantly in the last decade. As we said before, the finance sector is very concentrated. Five banking groups are responsible for 90% of the banking sector. Besides the banks, some funds play a growing role in Israel. Insurance companies became huge companies in Israel. They play a role of investor in the economy. Also in the same sector the real estate is one of the main sector of the economy. Tel Aviv and Jerusalem became one of the most expensive cities of the world. Some investors see this rising price of the real estate as an opportunity for investments. They look for people from abroad (USA and Europe) to buy luxurious properties in Israel. Besides private houses, business real estate is also going up. Some analysts describe these new developments as a real estate bubble. This sector could be very affected if a real estate bubble would burst (Also even the OECD did not gather yet the info for 2009, the banking industry was affected by the crisis). The finance sector pass the service sector for several years.

Services sector goes up for years. The economy becomes more advanced and looks like more the developed OECD countries. Services are going up and represent more than a fifth of the Israeli economy. Israel develops its education services. Also the administration services expanded significantly in the recent years. Also security services grew more and more in the past decade due to security challenges.

When we gather all the different elements of the services (services, finance...) we reach to 65%(CIA World Fact book) of the GDP. Services are today the first sector of the Israeli economy.

Other sectors play a significant role like tourism. Israel welcomes thousands of thousands of tourists every year. It takes advantage of the historic and religious sites. The infrastructures and services to serve tourists are constantly developing. Agriculture is seen by Israelis as a strong asset. Israelis are very proud of their agriculture given the hard environmental conditions. Israel exports large quantities of fruits all over the globe.

In the future mining will be more and more important. Israeli found major offshore gas resources. These resources can alter the repartition of the different sector of the economy in the short term future. Close to zero, thz sector could become one of the most important of the Israeli economy.

For investors, the sector analysis is essential. It gives an outline of the Israeli economy. It helps to understand what the competencies of the Israelis are. In what sector should an investor look at? In which sector Israel already benefits from a know-how?

The economic indicators show real opportunities in Israel. From real GDP to income per capita, the Israeli economy grows and presents positive future prospects. Israel, as a member of the OECD, plays in the big league. The potential economic growth is high. The country enjoys also high

productivity which is a great asset for investors. Investors believe in the future of the country as we saw it in the elevated amount of FDIs inside the country.

Nevertheless such economic positive symptoms go with some risks. Even if economic risks are low, the Israeli economy is exposed to risks which can lead to economic slowing down. Some sociopolitical risks can have disastrous consequences on the Israeli economy.

3. Sociopolitical Risk (qualitative & quantitative issues)

By combining social risks with political risk, an economy can be heavily destabilized. Even if economic basics are strong, social tensions can curb economic growth. A country that is subject to political tensions can suffer a lot from shaky government. An economy that would face external political tensions can be heavily affected.

Investors need to take into account these kinds of risks even more when they make investment in developing countries or in certain tensed areas. Nevertheless risk is a need for profitable investments. Without any risk, investments won't bring profits.

a. Social indicators:

In order to assess the social and political tensions in a country some basic indicators can help to measure the level of development of the country. If economic growth does not go with human development, social tensions can become a major challenge for the country.

i. level of development: HDI

The International Human Development index is one the most important development indicator. It measures the level of life expectancy, knowledge and descent standard of living. UNDP publishes the indicator once a year and make a ranking of the countries according the level of HDI.

HDI Rank	Country	1980	1990	2000	2005	2006	2007	2008	2009	2010
1	Norway	0.788	0.838	0.906	0.932	0.934	0.937	0.937	0.937	0.938
2	Australia	0.791	0.819	0.914	0.925	0.928	0.931	0.933	0.935	0.937
3	New Zealand	0.786	0.813	0.865	0.896	0.898	0.903	0.903	0.904	0.907
4	United States	0.81	0.857	0.893	0.895	0.897	0.899	0.9	0.899	0.902
5	Ireland	0.72	0.768	0.855	0.886	0.891	0.896	0.896	0.894	0.895
6	Liechtenstein	..	..	..	0.875	0.882	0.884	0.888	0.889	0.891
7	Netherlands	0.779	0.822	0.868	0.877	0.882	0.886	0.888	0.888	0.89
8	Canada	0.789	0.845	0.867	0.88	0.883	0.885	0.886	0.886	0.888
9	Sweden	0.773	0.804	0.889	0.883	0.885	0.885	0.885	0.884	0.885
10	Germany	..	0.782	..	0.878	0.881	0.883	0.885	0.883	0.885
11	Japan	0.768	0.814	0.855	0.873	0.877	0.88	0.881	0.881	0.884
12	Korea (Republic of)	0.616	0.725	0.815	0.851	0.858	0.865	0.87	0.872	0.877
13	Switzerland	0.8	0.824	0.859	0.87	0.873	0.876	0.871	0.872	0.874
14	France	0.711	0.766	0.834	0.856	0.86	0.864	0.867	0.869	0.872
15	Israel	0.748	0.788	0.842	0.861	0.864	0.869	0.87	0.871	0.872
16	Finland	0.745	0.782	0.825	0.863	0.868	0.87	0.871	0.869	0.871
17	Iceland	0.747	0.792	0.849	0.881	0.883	0.888	0.87	0.869	0.869
18	Belgium	0.743	0.797	0.863	0.858	0.861	0.864	0.865	0.865	0.867
19	Denmark	0.77	0.797	0.842	0.86	0.861	0.864	0.865	0.864	0.866
20	Spain	0.68	0.729	0.828	0.848	0.852	0.857	0.861	0.861	0.863

On the 169 countries ranked in the UNDP publication, Israel is ranked n°15. Israel's HDI has been growing for years to reach, in 2010, 0, 872. The Israeli GDP is ranked number 52 and even behing for real growth rate of the GDP. It shows well that Israel economic growth leads to human development.

The HDI is not a perfect assessment of the human development. Indeed the three factors taken into account are equally ranked in the calculation (1/3). For this reason for a more accurate assessment of the human development, we need to analyze the different component of the human development that could lead to socio political tensions.

ii. Labor indicators

Unemployment rates in Israel

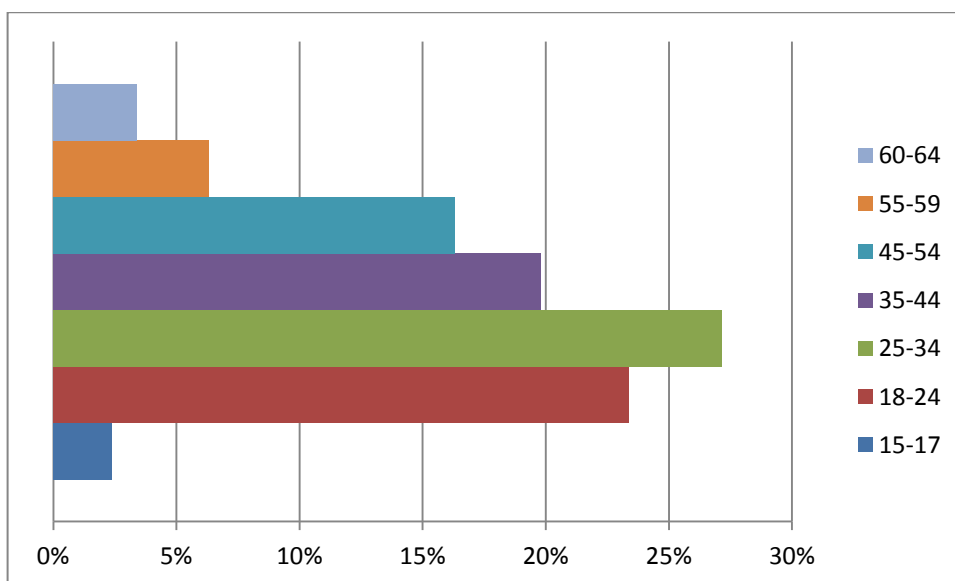
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Rates, total	8.9	8.8	9.4	10.3	10.7	10.4	9	8.4	7.3	6.1
<i>Rates, men</i>	<i>8.5</i>	<i>8.4</i>	<i>8.9</i>	<i>10.1</i>	<i>10.2</i>	<i>9.5</i>	<i>8.5</i>	<i>7.9</i>	<i>6.8</i>	<i>5.7</i>
<i>Rates, women</i>	<i>9.4</i>	<i>9.2</i>	<i>9.9</i>	<i>10.6</i>	<i>11.3</i>	<i>11.4</i>	<i>9.5</i>	<i>9</i>	<i>7.9</i>	<i>6.5</i>

© International Labor Organization

Unemployed people represent 6.7% of the population (CIA World Fact book- 2010). According the ILO, unemployment has been decreasing for years in Israel. Again in the early 2000's, Israel faced increasing unemployment due to the Second Intifada, but besides this period unemployment is very low in Israel.

Women are more exposed to unemployment than men, even if the delta has been reduced in the last years.

Unemployment rates by age



Young people in Israel are more exposed to unemployment than the rest of the population. Almost half of the unemployed people are under the age of 34.

The repartition of the unemployed people by age explains well the 2010 social tensions in Israel. The young generation who demands more "Social justice" is the same who endure the most complicated social conditions. This distribution is a major challenge for the Israeli government. Besides the fact that they want a more efficient welfare state, the young part of the population is not satisfied by the current socio economic situation.

When foreign investors look for place to invest, the social tensions that the country experiences during the summer 2011 can curb the willingness to invest in Israel. Investors see as a threat social uncertainty. The Israeli government has to find quickly solution to ease the social conflicts.

Remarks on the Israeli unemployment

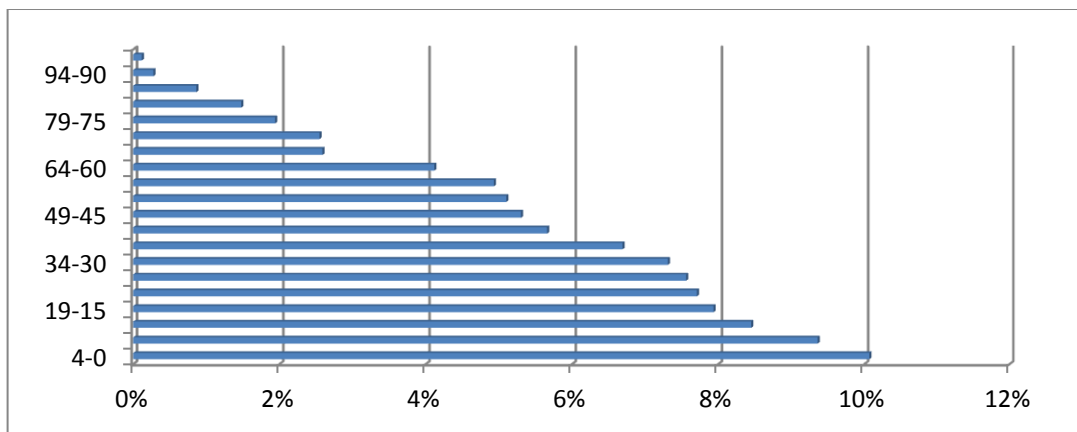
- Young men and women in Israel have to serve three years in the Israeli Defense Forces. It means that the unemployed rate does not give an exact description of the regular working people. Then when they finish their service, soldiers go back to civil life and some of them join universities. Meaning the rate of unemployment between 18 to 21 is close to zero. Consequently the rate unemployment between 21 to 24 is very high in Israel.
- Yeshiva students: in Israel, a lot of people learn in rabbinical colleges (yeshiva). Thousand of men who join these programs and get social benefit from the state. The people who attend rabbinical colleges learn for years in their program. They are not taken into account in the national statistics because of the definition of unemployment. To be considered as unemployed, a person has to look for a job. In these programs, people do not look for a job and therefore are not considered as unemployed people.

iii. Population structure (World Bank indicators)

The population structure is a key tool to understand an economy. If the population is getting older and older, it means that the working forces are not important. Also a question is often raised about the way to finance the pensions. If the young generation is not big enough to finance the pensions of the older one, the burden for the state can be important. Some countries experience this problem in Europe and in Asia (Japan).

Also a too important young generation can also be a problem to finance their needs (education, unemployment...). It is often the case in some developing countries (Maghreb, sub-Saharan countries...).

Population structure by age



© Source: Central Bureau of Statistics

- People between 0 to 14 represent around 27% of the population. They are the young generation. They don't work and are the coming working generation.
- 15 to 64 are about 62% of the population. These people are the working forces of the country.
- 65 and over are about 10.1% of the Israelis. This repartition of the Israeli population is a regular one. The population is getting older year after year because the life expectancy is going up.

With a median age of 29, Israel is a relatively young country for OECD countries.

Male and female population

- 50.6% of the total Israeli population are woman
- 49.4% of the 7.49 million Israelis are men.

Cultural and ethnical background of the population

20% of the Israelis claim they are Arabs. They are usually coming from old Palestinian families who were present before the establishment of the State of Israel. These Israeli Arabs live all over the country but mainly in the West Bank. They are mainly Muslim but around 2% the total population is Christian.

80% of the Israeli population is Jewish. Coming mainly from Europe and the USA, the Jews immigrated to Israel from the early 1920's. Besides the Jews who immigrated to Israel, some Jews live in the region even before. Very small Jewish communities used to live in Jerusalem, Safed and Jaffa.

Population Growth

According the World Bank, the Israeli population is growing by 1.8% (annual growth). This rate is unchanged for at least the last 5 years. Also the population as a high net migration rate with 2.08/1000. Israel attracts migrants. Migrants come mainly from Europe and the USA.

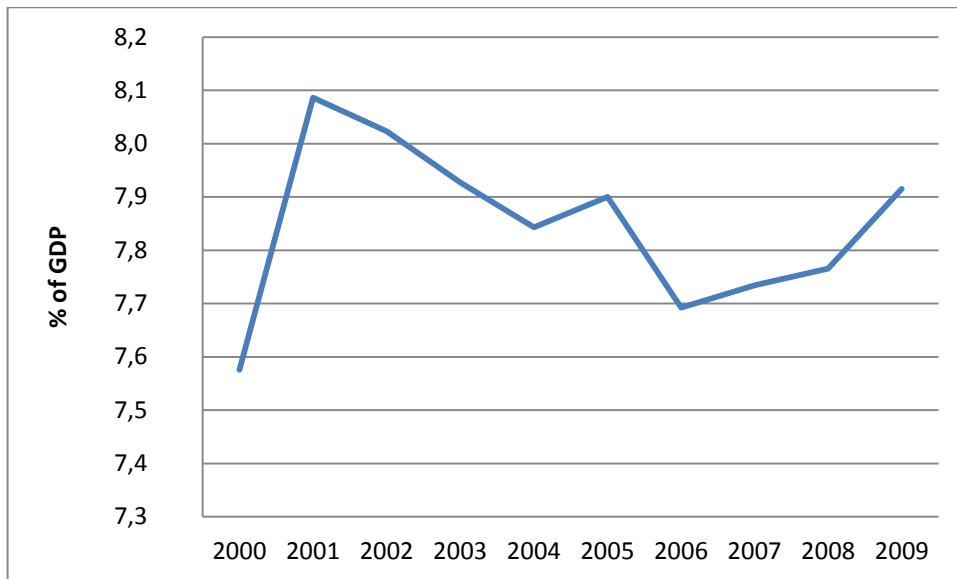
No red flags need to be mention about the demographic data. The population is growing slowly and the age and sex structure of the population is normal.

The ethnical reparation of the population can be seen as source of tension. Israeli Arabs are not usually fighting against the rest of the Israelis. In case of political tensions, they occur between Palestinians and Israelis.

iv. Health care

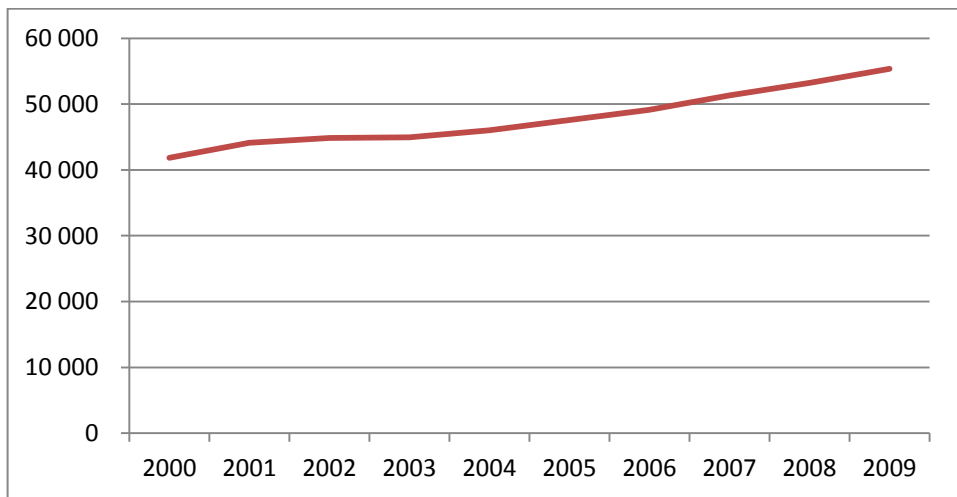
A health care system can be very onerous to a government. Even if the quality of the care is fabulous, the cost of such a system can be prohibitive for a part of the population.

National expenditure on Heath over GDP



The expenditure on health over GDP is pretty much stable . It fluctuates between 7.5 to 8.1% of the GDP. Such variations are not only due to health expenditure but also to the fluctuating GDP. The early 2000's were hard for the Israeli economy, that's why the expenditure on heath was growing.

National expenditure on Health (in millions of NIS)



The cost on health has been always growing for at least 10 years. From 41 billions shekel (2005 prices) it grew to 55 billions shekel in 2009. Such increase is due to the rise of the cost of the health care in general but also to the growing population.

Repartition of the expense on Health by expenditure

Medicines and medical supplies bought by households	Private physi-Cians	Dental care	Hospitals and research	Public clinics and preventive medicine	Govern-Ment admin-istration	Total
3%	4%	10%	38%	43%	1%	40 263
3%	4%	10%	38%	43%	1%	42 540
3%	4%	9%	39%	44%	1%	43 285
3%	4%	9%	38%	44%	1%	43 422
3%	4%	9%	38%	44%	1%	44 521
3%	4%	9%	37%	45%	1%	46 044
3%	4%	9%	37%	45%	1%	47 590
4%	4%	10%	36%	45%	1%	49 598

© Source: Central Bureau of statistics

Absolute no significant change can be noticed in the repartition of the expenditure. Clinics and hospitals are the biggest expenditures but they are stabilized in the overall weight of the healthcare.

Healthcare is not a major burden for the government budget. It grows but follows the economic growth and is well monitored in order not to weight to increase largely.

Quality of the healthcare system

- The density of physicians per capita is one of the highest in the world. With 3.4/1000, Israel is ranked number 10 in the world (according OECD data).
- Israel is the 10th country for the number of beds on 1000 people (3.7). (according OECD data).
- Vaccination rates (Immunization against DTP & Measles) are consistent with the rest of the OECD countries.
- Infant mortality is very low (ranked n°200 by the CIA World Fact book).
- Life expectancy at birth: 80.96years

All these piece of information try to show that the health care system is comparable to any developed country.

For investors, besides the fact that the health care system is an opportunity for investment, it also shows that the country is well adapt to take care of its population. Strong health care system is a basic need for a country to function efficiently. The Israeli health care system is well developed and offers a large number of services.

By law, every person who lives in Israel has the right to Social Security. The health expenses are reimbursed by the National Social Security. Nevertheless according the World Bank, Out-of-pocket health expenditure (% of private expenditure on health) is about 71%. This figure shows that the money spent by Israelis on the health care system is still pretty high. To get access to health care, Israelis have to spend large amount of money. Even if the quality of the health care system is good, access to it is not obvious.

Access to health care is also one of the reasons, Israelis demonstrate. On one hand, they ask for cheaper health care conditions. On the other hand, doctors ask for better wages. In 2011, Israel went through a 5-month strike which led to a 50% increase wage for certain physicians. The health care system is a very tensed issue in Israel, for several years. The government move is very significant and hopefully will pacify the social situation.

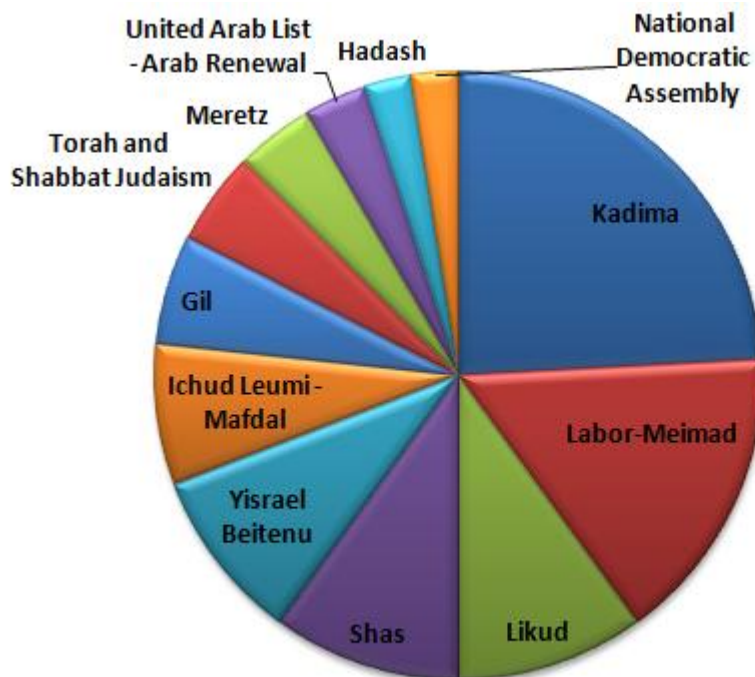
b. Political stability

Social issues can lead to economic problems but political instability is also a threat against the economy. Political risks are part of the country risk. From inside the country, investors can be exposed to political risk. From abroad, some political conflicts can have a ruinous impact on the domestic activity.

- i. Internal: Government stability, Corruption, internal tension
 - Government stability

The state of Israel is a parliamentary democracy. Parties play a fundamental role. The legislative branch dictates what the executive one can do. By voting for one of the 120 Members of the Knesset (MKs), the Israeli decide also who is going to be Prime Minister. For these reasons, parties in Israel have to conciliate and negotiate agreements to lead the country. Close to the French model of the 4th Republic, parties accept to bring up (and down) governments.

Knesset members



Last election took place in 2009. Kadima got the largest number of ballots but did not manage to make up a government. A coalition has been formed between the four parties: Likud (Right) , Labor(left),Shas (Religious party), Ysrael Beitenu (Far Right). Binyamin Nethanyahu run this very heterogeneous coalition.

The current government is stable and does not meet any major disagreement. Nevertheless the Israeli political system is not that stable. In the same way the 4th French Republic was enduring political instability due to the dispute between the parties, Israeli current political system is often taken hostage by the parties. In case of disagreement the government can fall easily.

The Israeli political parties are used to this system and often reach agreements. But in 63 years of existence, Israel had voted 17 times for the Knesset. The Knesset is elected for 4-year terms but the MKs don't usually reach the end of their term (average 3.7 years).

Political risk is a very negative message to investors. Political instability is part of the country risk and can be very costly for investors. Usually in case of emergency, the Israeli government is more stable, but to embark on reforms, the government usually does not reach agreements. Important reforms are hard to implement because of the difficulty to reach agreements. It is even harder to agree when the coalition is so broad. From far right to labor, the government has to deal with very different approaches on various issues.

Part of the country risk assessment is about political stability. Israel showed political efficiency in case tensions with its neighbors but it still has to prove its efficiency to implement reforms. On the other hand, some reforms have been successfully executed. Israel realized economic reforms to join the OECD. They put into action new practices to meet the OECD standards. The Israeli banking system also implemented huge reforms to meet the BIS standards concerning the Basel Agreement. Israeli banks now abide by Basel II. They managed to instigate new practices when political pressure was pushing for it.

Israel need to show to investors that internal political stability can be improved. The political system has been giving room to every part of the Israeli society and managed well to run the country for years. Supreme Court is an efficient watchdog and improved the Israeli political life. But tensions between social groups are often the roots of political instability.

ii. External: Conflict, wars, foreign influence

International political tensions are part of the Israeli day to day life. From the very first day of existence, the state of Israel has been going through tough periods. Israelis fought during several wars which even put under question the very existence of the State.

Lebanon, Syria share borders with Israel and are at war for years. The last international armed conflict occurred in 2005 with Lebanon. It symbolizes well the new kind of conflicts in he regions. The fight was between a terrorist organization and a sovereign nation. Hezbollah and Israel fought for a month and number of people lost their lives in the conflict. Besides occasional conflict, there is no major hostility at the Lebanon border.

In Syria, protestors challenged Bashar al-Assad in 2011. Consequently the international issues were less crucial for the Syrian government. Israel does not fear from immediate tensions from its northern border.

Israel signed a Peace agreement in 1979. From this time, the former belligerents were at peace. Egypt went through political tensions which led to Mubarak eviction in 2011. The temporary power assured that Egypt wanted to go according all the past treaties. Nevertheless Israel relied on Egypt for its oil and gas supply. The pipeline between Egypt and Israel was damaged several times from Mubarak fall. Some political difficulties can be expected from the west-southern border.

Hussein I of Jordan and Yitzhak Rabin signed a peace treaty in 1994. Israel and the son of the late king Hussein I respected the treaty since that time. The Jordan border does not worry the state of Israel. Israel and Jordan are willing to save the peace even if some groups try to destabilize the bilateral relationships. But besides political tensions, the two countries work together on economic and environmental projects. Jordan exports and imports from Israel. Also they have been working together to save the Jordan River and the Dead Sea. Water is an issue in the region than can bring closer or... farer.

The current and hottest issue for external political tensions comes from terrorist threats. The Palestinian terrorists have already destabilize Israel in the past. The first and the second Intifada had terrible consequences on Israel. Besides the human cost on both sides, the Israeli economy has been affected by the terrorist tensions with Palestinians. The early 1990's and the early 2000's were tough years for the Israeli economy. The first and second Intifada led to economic recessions and curb the FDIs.

For investors, terrorism is the biggest threat. Economic growth can be jeopardized by terrorist tensions. Hamas, Al Aqsa Brigades and others look for the full destruction of Israel. On the other hand Israel has been fighting them for years. Operation cast in gaza in 2008 was a Israeli reaction to terrorist attacks. Besides bomb attack on its territory, Israel also endures rockets from its southern and –sometimes- from its northern border. One million Israelis are under the potential fire.

From both sides of the border, civil populations are exposed to dangerous reactions. Also, economic development is often put at risk in case of conflict. In Israel and in the Palestinian Territories, the economy is endangered by a few extremists.

Prime Minister Salam Fayyad of the National Palestinian Authority promoted economic growth as an answer to extremists. He supports that economic development will lead to the establishment of an independent state for his people and to peace with Israel. The problem is that this kind of projects is vulnerable and when extremists operate, they often ruin the plan.

- Is political instability a concern for investors in Israel?

Conflict and terrorist threat is today an aspect of the Israeli country risk. Investors have to take it into account. The main risk would be a sudden attack which would lead to a change in Israel economy. Defense spending is about 6% of the GDP. In case of an unprecedented event this spending can increase rapidly. The Israeli budget could be altered and the level of debt then would change. This kind of rapid development is had to predict for investors but it is part of the Israeli country risk.

For investors, an unexpected change of the given economic conditions is a major risk that's why Israel is a risky country. As Moody's Investors said in its report :

In most other countries, high economic, institutional and government financial strength would result in a country's rating range (or at least the upper end of the range) being in the Aa universe, according to Moody's Sovereign Bond Methodology. By contrast, Israel's rating range, at A1-A3, is lower, reflecting our medium assessment of event risk, which not only reflects Israel's geopolitical challenges but also its proven track record in handling them successfully.

© Source: Moody's Investors : April 6th, 2011

The Israeli economy is affected by security challenges. Israel challenges had to deal with a large number of threats and went through with no major consequence. The economy was temporarily affected and recovered rapidly. On a short term view, in case of major event, the economy is affected but Israel has proved in the past that it knows how to deal with shocks as Moody's report claim:

The Israeli economy has a proven track record of dealing with shocks; over the past decade, these have included: the collapse of the dot-com bubble (which was particularly significant given Israel's hi-tech-driven growth model), the collapse in global demand after 9/11, disengagement from Gaza in 2005, the incapacitation of a sitting prime minister (Ariel Sharon), Hamas's victory in the Palestinian elections in early 2006, the rise of Iran as a regional power and its increasingly overt nuclear ambitions (which are seen as posing an existential threat to Israel's existence), charges of misconduct against members of successive governments, the war in southern Lebanon in 2006, the incursion into Gaza in late 2008-early 2009 (Operation Cast Lead) as well as the global crisis. There were never any questions about Israel's ability to service its debt during any of those episodes.

© Source: Moody's Investors : April 6th, 2011

c. Regulatory risk as a country risk

Investors are not under cover in case of regulatory changes. Laws and regulations can change quickly and alter the way businesses operate.

i. Customs

Israel is a member of the WTO and consequently it is subject to international regulations concerning customs duty. It cannot increase the taxes that significantly without explaining its move. Yet, government still enjoys large possibilities to increase customs.

Israel did not publish any piece of information on its willingness to increase customs. On the contrary, FDIs are considered by the government as a driving force. There is no major issue that the state of Israel would change its custom policy.

ii. Tax law

- The standard Israeli corporate tax rate is 24%. Corporate tax rate will be gradually reduced to 18% in 2016.³² Israel tax at this rate the undistributed profits of companies. Corporate tax should not change on a short term basis.
- Dividends are taxed between 20 to 25%³³.
- The VAT rate is 16%³⁴.

No major changes should affect the current tax law. The Israeli government did not make any announcement in this way.

The only concern that some investors could have is about the new gas resource. In December 2010, some Israeli American investors found a gaz reserve off Haifa shore. The gas reserve discovered off the coast of Israel represents \$95 billion. The government of Israel had officially said that it would change it tax policy on gas companies.

iii. Corporate law

Israel corporate law is built on the same model than other developed countries. The Israeli regulations were shaped on the ancient British model. British law influenced a lot, the way Israeli law functions.

Company law defends all the rights and of all the stakeholders of the company. It also present the different responsibilities of all the actors of the company. According the form of the company, it protects more or less the shareholders. Shareholders have the right to get dividends and to vote at the General Annual Meeting.

It defines what the corporate governance regulations are and who is in charge of the company. It defines how a company can be established and terminated.

No major risk can interfere against FDIs. No major change is expected on this field. The foreign firms can pretend to the Israeli justice as the rest of its residents.

³² Deloitte

³³ Depending on the origin of the shareholder and the quantity of shares he owns

³⁴ From 1.1.2010

iv. Trade agreement

Israel had signed different trade agreement:

- Free trade agreements: It let investors of these countries to export and import without paying taxation

Free Trade Area Agreements
Mexico U.S.A E.U. E.F.T.A. MERCOSUR ³⁵
Qualified Industrial Zones (QIZ) Agreements³⁶
Egypt Jordan

- Israel signed also international agreement in order to avoid to “pluri- citizenships” to pay big amount of taxes.

Avoidance of double taxation			
Austria	Luxemburg	France	S.Korea
Belarus	Mexico	Germany	Spain
Belgium	Netherlands	Greece	Sweden
Brazil	Norway	Hungary	Thailand
Bulgaria	Philippines	India	Turkey
Canada	Poland	Ireland	U.K.
China	Romania	Italy	U.S.A
Czech Rep	Russian Fed.	Jamaica	Ukraine
Denmark	Singapore	Japan	Uzbekistan
Ethiopia	Slovak Republic	Latvia	Switzerland
Finland	S.Africa		

- Israel signed international agreements to protect FDIs in Israel and Israeli investments abroad.

³⁵ Under Negotiations

³⁶ In 1996, U.S Congress authorized designation of qualifying industrial zones (QIZ's) between Israel and Jordan, and Israel and Egypt. The QIZ's allow Egypt and Jordan to export products to the United States duty-free if the products contain inputs from Israel (8% in the Israeli-Jordanians QIZ agreement, 11.7% in the Israeli-Egyptian QIZ agreement). Source: Ministry of industry, trade and labor (Israel)

Protection of Investments	
Albania	Moldova
Argentina	Mongolia
Armenia	Poland
Belarus	Peru ³⁵
Bulgaria	Romania
China ³⁷	Serbia-Montenegro
Croatia	Slovakia
Cyprus	Slovenia
Czech Republic	South Korea
El Salvador	South Africa ³⁷
Estonia	Thailand
Ethiopia	Turkey
Georgia	Turkmenistan
Germany	Ukraine
Guatemala ³⁷	Uruguay
Hungary	Uzbekistan
India	Azerbaijan ³⁷
Kazakhstan	Lithuania
Latvia	

Besides all these agreements Israel is still negotiating, with countries all over the world, to open even more its economy. The high number of treaties is a good signal sent to investors.

Sociopolitical risks are difficult to predict in countries where political structures are well established. In Israel, this kind of risk exists to a certain extent but there are very specified. A large internal political crisis is not a risky event. Political instability can occur momentarily, but should affect largely the economy. Israel political system could be improved but performs reasonably well. The institutions are well organized and are strong enough to protect the interest of foreign investors.

The biggest country risks are armed conflicts and act of terror. Based on historic facts, conflicts happen regularly in the region. They don't ruin the economy but they definitely slow down the economy. Shock after shock, the Israeli economy can manage periods of troubles. But in anyway, foreign investors have to know that the Israeli market is definitely impacted in case of armed conflict or acts of terror.

4. Country Specific risks

³⁷ To be ratified

Besides regular aspects of country risk, some specific need to be described. Specific risks are relative to a certain country, which are fairly predictable and can have an impact on FDIs.

a. Natural disasters

- Severe drought

Water problem becomes a worldwide problem. Israel does not have large access to drinkable water. With a growing population, Israel has to find a solution to this chronic problem. Israel agriculture is exposed to water shortage. Economic consequences are expected in case of Israel does not solve the problem. More broadly, water shortage is a fundamental problem in the region.

The Israeli government found several solutions:

- Building of seawater desalination plants
- Brackish water desalination plants
- Rehabilitation of saline polluted and depleted wells
- Treatment and reuse of sewage effluents for irrigation
- Water import

The cost of such supply development plan requires \$4billion investment³⁸. Besides the required investments, Israel will have to continue relying on external water supply. Experts still think about alternative solutions, but the very costly infrastructures slow down the decision making process.

- Earthquake

Israel is located between the Arabian tectonic plate, the Eurasian one and the African one. The risk of earthquake is high. No destructive earthquake happened in the recent history. But still, the risk of massive earthquake exists.



The last important earthquake happened in 2004, with a 5.3 magnitude. But in the history of the region, people related that damages resulted to the 1837 and 1927 earthquakes. Obviously, infrastructure were less strong than today. According specialists³⁹, the epicenter was close to Safed, and the city was completely destroyed. The magnitude of the 1837 earthquake was close to 7.

Such earthquakes can provoke damages. Israel is no well equipped in case of seism. Constructions are not earthquakeproof. When Foreign Direct Investors want to put their money in Israel they need to take into account this risk into account. Even it is not likely to happen.

©Source:

Geology.com

³⁸ Israel Ministry of Foreign Affairs

³⁹ Arieh (1967), Ben-Menahem et al. (1976) and Vered and Striem (1977)

b. Conflict & terrorist risk

Terror attacks are not per se a specific risk. The United States, Spain, England, Norway have been exposed to terrorism. But terror is part of Israel life, Israelis are well trained to protect themselves against terrorist threat.

The IDF works in order to defend the Israeli population. Soldiers are part of the Israeli picture; they are trained to be aware of the terrorist threat. Armed conflicts are also a potential risks but they are a complete other issue. The Israeli army is strong relatively to its neighbor's ones. Armed conflicts are regular and they part of Israel recent history. A nuclear Iran would change completely the balance of power in the region. Israel is seen as the only nuclear power in the region, a nuclear challenger would be a real threat for Israel.

Besides armed conflicts, terror attack interrupts life of civilians and the economy of the country. A large number of people work to make the Israeli population safer. Besides regular defense forces, all around public places, transportation and malls people work to protect the Israelis.

Due to its geographic location and its history, armed conflicts and terror are specific risks for Israel. The way the Israeli economy deals with these risks is essential for investors. Large amounts of moneys are invested in the defense sector, but when conflicts happen they cost a lot.

c. Hyper openness

Israel's first ally is the United States of America. Israel relied a lot on "Uncle Sam" from the very beginning of its existence. Israel current exploited resources are limited, so to compensate tough given economic conditions. Israel is very open to foreign investments.

Exports and imports are driving forces of the country. Buying from Europe and selling to the USA, Israel is well integrated in the global market. Huge reserves in US\$ are hoarded up by the Bank of Israel.

All this economic openness, which is usually seen as a force could be a threat. If an economy relies to much on external factors, the vulnerability of the country can become very elevated. An economy should be able to rely more on its own internal resources.

Internal consumption could play a bigger role in the economy. The Israelis can strengthen their economy by improving their own forces within the country. Infrastructures could be improved in particular concerning public transportation (trains & airports). The internal Israeli market did not reach maturity yet, Israelis could rely on themselves to improve their own economic conditions.

Conclusion:

Country risk is a threat for FDIs. When investors come to Israel, they don't first look at the risk, they first look at opportunities. When Warren Buffet invested in Israel a journalist wondered why he did such moves. He answered "If you're going to the Middle East to look for oil, you can skip Israel. If you're looking for brains, look no further. Israel has shown that it has a disproportionate amount of

brains and energy,”⁴⁰ Investors look for what a country can offer. Israel main force is not its resources, it is people. Israelis are hard workers, they work a large amount of hours and are very productive. They are very qualified and are well trained. The average level of education is very high and Israelis are entrepreneurs. Management is part of their basic training. The Israeli Army Service force people to take responsibilities at a very young stage of life⁴¹.

Obviously, risk is also to take into account but investors have to compare the level of country risk and the profit opportunity to invest in such country. Economic risks are pretty low and economic conditions are relatively good. The social environment is more or less stable and massive changes should not happen suddenly.

The main question is to see if Israel is an opportunity for investment. Given the financial, economic, sociopolitical low risk the major aspect of the country risk is armed conflict with neighbor countries or terror attacks. The risk is permanent but attacks are far from being regular. As an investor, risk must be compared to profitability. If the project is very profitable, a certain level of risk should be accepted.

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