September 29, 2024

The two notch downgrade

- **According to Moody's, the escalation of geopolitical risks was the major factor.**
- **A Baa1 debt rating usually characterizes countries that are much less wealthy and developed than Israel.**
- **A major advantage that Israel has over countries with low credit ratings is the high savings rate of households.**
- **Moody's dismal report could affect fiscal policy next year.**
- **Construction activity declined sharply in the second quarter of the year.**
- **The interest rate will not decrease anytime soon. The country's risk has increased, and with it the risk of high inflation.**

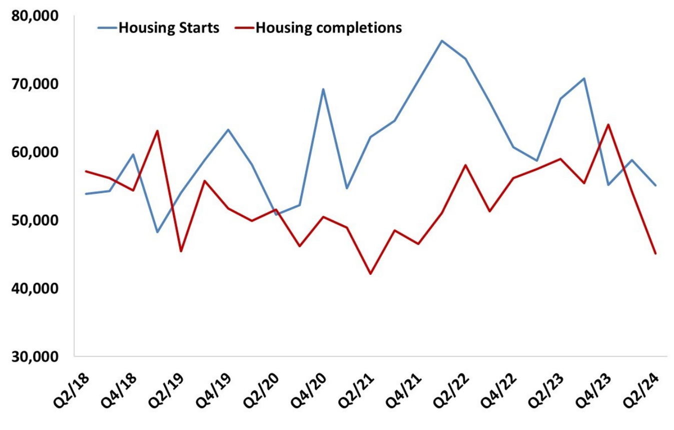
The weekend was full of geopolitical and economic developments. The assassination of Nasrallah and senior Hezbollah figures in Lebanon raised morale in Israel, but it also increases the chances of a direct confrontation with Iran. Moody's surprised over the weekend when it decided to reduce Israel's credit rating by two grades to Baa1. Moody's had previously warned that the expansion of the war in Lebanon would result in a downgrade. But the assumption of most economists was that it would be satisfied with one notch.

What caused Moody's to reduce two notches? **According to the rating agency, the escalation of geopolitical risks was the major factor.** Moody's notes that it does not see an exit strategy on the horizon, and therefore the damage to the country's resilience is continuous and not temporary. In addition, Moody's is of the opinion that domestic politics are also not supportive: the war undermines the strength of government institutions, and economic policy does not strive to offset expenses due to the war. The result of these factors is a very negative assessment of the state of the economy in the coming years: low growth and high deficits.

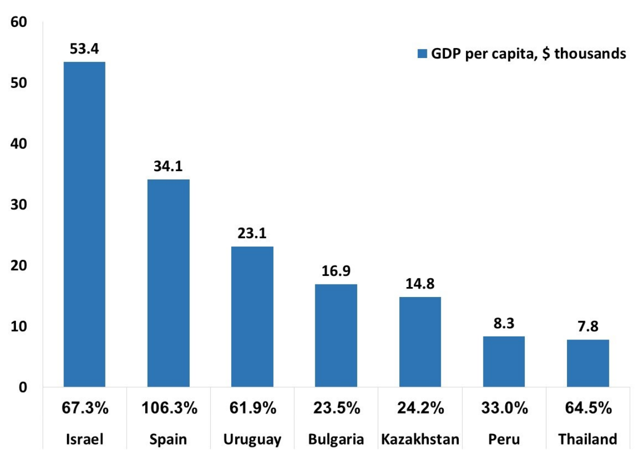
A Baa1 debt rating usually characterizes countries that are much less wealthy and developed than Israel. As can be seen in the graph below, Israel's per capita GDP level is significantly higher than other comparable countries. Spain's GDP per capita is the closest to Israel, but Spain has a high public debt of 106% of GDP. It is difficult to argue with the debt rating of a country at war, because the potential for possible downside scenarios is significant. At the same time, we tend to assess that Israel's economic data will justify a higher debt rating following the cessation of hostilities, even if in the short run the government debt continues to climb.

There is a large gap (3 notches) between Moody's rating and that of S&P. Israel's sovereign risk premium reflected in

Construction activity contracts sharply
Housing starts and completions,
Source: CBS



Countries rated Baa1 by Moody's: Israel stands out with high income
GDP per capita and public debt to GDP ratio, Source: IMF



markets (bonds, CDS) is more in line with Moody's rating. S&P and perhaps Fitch are also likely to respond with rating reductions.

The debt market in Israel was not encouraged by the downgrade, and bond prices traded on an upward trend on Sunday morning. **A major advantage that Israel has over countries with low credit ratings is the high savings rate of households. Despite the high fiscal deficit, household savings remain high, and to some extent will even increase, due to the government's deficit policy. At the end of the day, these savings are channeled into financing the deficit.** Investors are demanding additional risks, but the risk premium are still such that the state can finance the deficit and roll over the debt.

Construction activity declined sharply in the second quarter of the year. Residential starts declined to a quarterly level of 13,800 units, the lowest figure since 2020. An even sharper decline occurred in residential completions to a quarterly level of 11,300 units. In the past four quarters, the completions reached only about 55,000 housing units - a figure below that required from the demographic needs of the State of Israel; even before taking into account the number of evacuees from the North who are relocating towards the center of the country. The result is increasing pressure on rental prices, which will continue to affect inflation in the coming months.

Moody's dismal report could affect fiscal policy next year. The Ministry of Finance has already published a plan to reduce the budget deficit to no more than 4 percent next year, but many questions remain regarding the measures that will be required to reduce the deficit. A more explicit presentation of the proposed fiscal measures, in addition to the tax increases already announced, could slow future debt rating reductions, as well as reduce the risk premium reflected in the markets.

The interest rate will not decrease anytime soon. The country's risk has increased, and with it the risk of high inflation. The derivatives market currently reflects stability in interest rates until the third quarter of 2025. Our inflation forecast for the next 12 months is 3.0 percent, and we believe that the risks are skewed to the upside, in view of the high government deficit, the shortage of workers, and the expected increase in rental prices.

BOI Rate and CPI Forecast			
BOI Rate		CPI	
December 2024	4.50%	Sep 2024	0.0%
12M Forecast	4.00%	Oct 2024	0.5%
		12M Forecast	3.0%