

BANK OF ISRAEL

Office of the Spokesperson and Economic Information

Press release

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**Remarks by the Governor of the Bank of Israel at the cabinet meeting to approve the state budget for 2024**

**Bank of Israel Governor Prof. Amir Yaron delivered remarks at the cabinet meeting on the state budget. The following are the main points of his remarks.**

We are in the midst of the Swords of Iron war, and the State of Israel is experiencing a complex period. Before everything, I would like to send my wishes for success to our sons and daughters fighting on the front lines, condolences to the families of the fallen, a speedy and full recovery to the wounded, and tremendous hope for the return of our captives.

The revised state budget for 2024 is particularly challenging. The economic implications of the war are broad and significant. The Bank of Israel’s assessment is that the war’s impact on economic activity will continue during the current year, such that GDP will grow by only 2 percent—similar to 2023, in which GDP dropped sharply in the fourth quarter due to the war. The balance of risks to the forecast tends downward, particularly in view of the chance that the situation in the north of the country may worsen.

Alongside the impact to GDP, the war makes it necessary to greatly increase budgetary expenses. This increase is due to expenses that are directly related to the combat effort, such as the needs to finance reserve service and purchase ammunition, and due to civilian expenditures resulting from the war, such as the costs of housing and supporting residents who have been evacuated from the combat areas. According to revised estimates prepared by the Bank of Israel, under various assumptions regarding the intensity of the war, the war’s expenses from 2023 through 2025 are expected to total about NIS 220 billion. To this we must add the loss of revenue due to the war’s effects.

In addition to the increase in the war’s expenses, and in view of the need to strengthen the defense system and realign it due to the changing threats, we also expect a persistent and significant increase in the defense budget for the foreseeable future. This is very significant. A one-off increase in the deficit and in the debt to GDP ratio due to the costs of the war does not have a material impact on the allocation of resources in the economy over time, and can be dealt with by concentrating the budgetary effort over a limited period. In contrast, a persistent and significant increase in the defense budget from now onward, without making necessary budget adjustments against that increase, may impair economic growth and lead to a divergence of the debt to GDP ratio over years moving forward, which would have a negative impact on how the strength of the Israeli economy is perceived.

Developments in the defense sphere and in the economy, and their potential impact on significant economic indicators such as the debt to GDP ratio are also reflected in the financial markets. The original budget framework for 2023 and 2024 that the government approved at the beginning of last year reflected fiscal responsibility that took into account the significant uncertainty regarding forecast revenues when the budget was built, and which was received positively by the markets. The conservative budget that was set out at the beginning of 2023, and the reduction of the debt to GDP ratio in past decades, are now helping us, and are providing the government with certain levels of freedom in managing the economic dimension of the war subject to the necessary adjustments. However, the increase in the cumulative deficit alongside the potential realization of further crises along the way obligate the government to make the necessary budgetary adjustments in order to maintain the credibility of fiscal policy in the view of the markets and of the public.

The current budget is an important point of reference in strengthening the international markets’ trust in the Israeli economy and in maintaining the economy’s robustness, particularly in view of government announcements when approving the amended 2023 budget about a month ago that the adjustments for the war’s impact would be made in the amended 2024 budget. Therefore, as I have said a number of times in recent weeks, a decision should be made now, in the current budget, in a binding and publicly transparent manner, to make comprehensive budgetary adjustments that include significant steps to lower expenditures and increase revenue, both in the 2024 budget and in the 2025 budget, and to implement a significant portion of those decisions immediately. Moreover, in view of the fact that the increase in the defense budget is expected to remain in place over the coming years, it is proper that these adjustments be made in the budgetary base, and that they too should be persistent in nature. In addition, it is advisable to focus the adjustments on budget items that have less impact on economic growth. The monetary volume of the budgetary adjustments must be set such that it leads to a path in which the debt to GDP ratio declines following the war, and converges in a reasonable timeframe to the environment in which it was prior to the war. The necessary volume depends first and foremost on the annual increase in the defense system’s expenses. There are various estimates regarding how much that increase will be, but it is clear that it will be significant.

In order to make a more informed determination of the necessary increments to the defense budget, as well as the nature of those increments (in shekel terms or as a percentage of GDP), a committee should be set up in the near future, with the participation of defense and civilian agencies, to map out Israel’s defense needs over the coming years, and to formulate a proper multiyear budgetary program. I hope that the appointment of such a committee will be completed soon.

Until such a multiyear plan is formulated, the minimal growth rate of defense expenditures—those that would be reasonable to expect in any scenario—and in civilian expenditures of a persistent nature (rehabilitation expenses and the increase in interest payments)—must be set out in the immediate term, and we must examine the budgetary adjustments in view of the response that they provide to this increase. The assessment in the decision-makers’ proposal that this growth will be NIS 20 billion seems reasonable at this stage. The estimate of defense expenditures and the budgetary adjustments derived from it will be revised later on, as necessary, according to the path of the multiyear budget that will be formulated by the committee.

The measures proposed in the decision-makers’ proposal are in the proper direction. It is very important that these measures be implemented. I would like to emphasize that after examining the proposed measures, both on the revenue side and on the expenditure side, it seems that the total volume of the adjustments remains lower than the aforementioned permanent increase of NIS 20 billion. In particular, the volume of the proposed measures on the expenditures side is limited, which brings into sharper relief the lack of room for convergence through restrained expenditures in the budget. Moreover, the challenge becomes even more prominent in view of the fact that beyond the issue of the war, the proposed budget includes considerable increments for expenditures that were underfunded in the original 2024 budget, and that are also of a permanent nature. In view of all this, it is hard to see how we can make the aforementioned adjustments without taking measures to permanently increase revenue, such as raising VAT and other measures that are expected to general a sufficient volume of revenue. As such, it is important to adopt such measures in the current budget, in order to convince the public and the markets of the government’s determination to maintain a credible fiscal path. Moreover, given the revised scale of the necessary adjustments, it would even be proper to bring forward the implementation of some of the adjustments on the revenue side, such as VAT, to 2024, and it is certainly important to implement them by the beginning of 2025 at the very latest.

I emphasize again: In order for the markets to exhibit forbearance with regard to the large deficit in 2024, it is important that the government’s budgetary decisions lead to a situation in which Israel does not move toward an upward debt path for a prolonged period. The markets’ perception that Israel is moving toward such a path may lead to an increase in yields, a depreciation of the shekel, and inflation, and to impaired growth in the future. We are talking about risk management. In this context, I would mention that a negative response effect in the markets is not always linear. It is hard to foresee when there may be a twist in which the markets reprice this risk, but if these adjustments don’t happen, such a response is more likely. Maintaining fiscal credibility under the current circumstances requires significant effect, but it is an effort that is necessary as part of the seriousness that we must broadcast to the markets even now.

The Israeli economy is strong at its core, and it has the necessary features to prosper even at the end of the war. But this will not happen automatically. It is important to remember that economic growth relies first and foremost on a stable economy and investor security. The government’s policy in dealing with all the difficulties while maintaining fiscal responsibility is of decisive importance in the economy’s ability to recover from the effects of the war and to rapidly return to growth.

Thank you.

**Among other things, the Governor discussed specific proposals in the budget. The following are some of the points he raised:**

* With regard to the decision-makers’ individual proposals submitted to the government, I would like to note the importance of a number of measures. Advancing the imposition of a carbon tax and of a travel tax on electric vehicles are measures that would have been necessary even without the war in order to advance environmental targets, and reduce congestion and environmental damage of transportation. The travel tax, by its nature, is a step that is intended to maintain the government’s revenue from vehicle tax, instead of fuel excise that will decline as drivers transition to electric vehicles. Without the travel tax, it would be necessary to identify an alternative revenue source that would compensate for the loss of revenue from the fuel excise. Regarding a carbon tax, the proposed rate and coverage volume are actually low—particularly with regard to natural gas, which is expected to replace the use of coal in the coming years. While the tax is expected to raise certain consumer prices, there are complementary measures that have been proposed in the past, to support weaker segments of the population as the tax is implemented.
* In the decision-makers’ booklet, there is a proposal to reduce grants and support payments to businesses. This is an example of a measure that may be worth examining in greater depth were it not for the war and its needs, but in the current situation, it is the least of the bad, since some of the assistance tools provided, such as in the Capital Investment Encouragement Law, discriminate between industries and thereby distort the allocation of sources in the economy. However, the program to assimilate advanced production technologies is a tool that deals with an important issue in the economy, and it is preferable to examine it in greater depth before it is cancelled.
* I also note that the proposal to cut about 15 percent of the five-year plan for Arab society is problematic even at this time, since this program is important for advancing the integration of Israeli Arabs in the Israeli society and economy, and it is intended to reduce the underfunding of this society. This program, and Arab society in general, can potentially make an important contribution to the future growth of the Israeli economy. It is worth considering alternatives to this proposal.