

BANK OF ISRAEL

Office of the Spokesperson and Economic Information

Press release

November 15, 2023

**The Bank of Israel’s position on fiscal issues and adjustments to the 2023 budget following the “Swords of Iron” war**

In view of the development of the war and the material economic ramifications of the situation, the Bank of Israel Research Department is closely monitoring events, and is formulating a picture of the situation and policy recommendations while maintaining professional contact with the relevant government ministries.

Dr. Adi Brender, Director of the Bank of Israel Research Department, said, “The security situation requires tremendous responsibility in managing the government’s budgetary policy in order to strengthen the trust of the markets, which are examining economic developments, including the budget. It is therefore necessary to balance the need to allocate large budgets for dealing with the security situation and the necessity of demonstrating fiscal responsibility. An important way to ensure such a balance is to make necessary changes to budget priorities, while avoiding planned expenses that are not essential.”

The main points of the updated fiscal insights, as well as policy recommendations for adjustments to the 2023 budget, are below.

**Background:**

* **Israel entered the war in a strong fiscal position**: The debt to GDP ratio declined rapidly following the COVID-19 crisis, from 71 percent of GDP to 60, thanks to high growth and a rapid increase of state revenues.
* **The budget that was approved at the beginning of 2023 enabled the continued reduction of the public debt to GDP ratio**. The factors that led to the rapid increase of tax revenue subsided during 2023, and led to a contraction of revenue relative to GDP, to a level similar to the pre-COVID-19 level. In contrast, the conservative budget framework that was approved at the beginning of 2023 was low in terms of GDP relative to expenditures prior to COVID-19, such that the budget deficit in 2023–2024 was expected to be lower than 2 percent of GDP. The moderate multiyear wage agreements that were signed in the public sector also contributed to fiscal resilience.
* **The war that began with the murderous attack by Hamas on October 7 carries a significant fiscal aspect**. It has already led to a significant increase in defense expenditures, and it is making it necessary to provide assistance to evacuated residents and the families of the victims and the missing, enhance the emergency and rescue systems, and strengthen public services in order to provide a response for the entire population. In parallel, tax revenues are expected to decline due to the war’s negative impact on economic activity. **In addition to the government’s direct action, it is also necessary to assist the business sector**, by supporting the ability of firms—particularly small and medium businesses whose revenue has been impaired—to meet their expenses, get through the current period, and rapidly return to normal operations once the security situation enables it. Assistance is also necessary for employees whose employers have reduced the volume of their operations, through greater flexibility in furlough arrangements and eligibility conditions for unemployment benefits.
* **The market is monitoring the economy not just by looking at the short term, but also at the intermediate and long terms**. The fiscal implications of the war are expected to be with us in the intermediate term as well. The expenses associated with combat and replenishing military inventories will come to an end, and civilian expenditures will gradually abate as the economy recovers and the massive rehabilitation of communities that were destroyed and emergency assistance to their residents is completed. However, it is very likely that government expenditures will be higher due to a permanent increase in defense spending and an increase in interest payments due to the higher level of public debt. These expenses are expected to be much smaller than the current costs of the fighting, but they will continue over time.

**Adjustments to the 2023 budget and policy recommendations:**

1. **Alongside the need to provide a budgetary response to the needs created by the war, it is very important even during emergencies to maintain a responsible fiscal framework.** Since the outbreak of the war, Israel's risk premium has increased, which is reflected in a wider yield spread than parallel American bonds and an increase in CDS prices. The Israeli financial markets are currently very volatile, and all three ratings agencies have announced that they are examining the possibility of lowering Israel’s credit rating. In addition, the likelihood of the war expanding is not negligible, and such an expansion will further harm economic activity and require additional budgetary resources.
2. **In order to finance the expected costs of the war this year, the Minister of Finance has announced his intention to bring a NIS 31 billion increase in the state budget for 2023 to the government for approval.** This will consist of NIS 22 billion for the Ministry of Defense and a further NIS 9 billion for civilian expenditures. The planned increment to civilian expenditures reflects a budgetary expansion of NIS 13 billion, as a response to the economy’s need to deal with the war, alongside a NIS 4 billion reduction in other expenses. Of those NIS 4 billion, about NIS 0.6 billion are from sources that were not detailed, and it is unclear whether they are even available.
3. **It is important to remember that the total fiscal cost of the war in 2023 will be greater than the NIS 35 billion noted above (NIS 22 billion for defense and NIS 13 billion for civilian expenditures). In addition, the government will have expenses financed by the Compensation Fund.**  These include compensation for direct damage to property, indirect damage to businesses with a 40 km range of the Gaza Strip, damage to communities in the Golan Heights and along the northern border, and business continuity grants to businesses in the rest of the country. These costs are estimated at about NIS 15 billion in 2023, which is slightly lower than the total balance in the Compensation Fund prior to the war. Since the Compensation Fund is expected to be almost completely utilized based on existing commitments, if additional expenditures of this kind are necessary later in the year or in 2024, the government will need to finance them from the budget. Moreover, since the Compensation Fund exists for recording purposes only, the government must raise debt to cover the expenditures recorded against the Fund.
4. **The budget cut currently proposed—NIS 4 billion—is not large, and its contribution to strengthening trust in the government’s commitment to fiscal adjustments in respect of the costs of the war is thus limited.** Insofar as the government believes that this is the maximum cut that is possible at this stage of the year, it is important that the government decide when approving the increment to the 2023 budget to also cancel some of the expenditures planned for 2024, even though the plan is that most of the discussion on the 2024 budget will be delayed slightly. An examination of the budget items points to possible reductions totaling NIS 8–10 billion in 2024. Moreover, since a significant portion of the payments in 2023 in respect of coalition agreements will make it very difficult to make cuts in those items in 2024 and beyond, it is preferable for the government to announce a stoppage of these expenditures already in the current budget.
5. **It is very important for the government now to halt new expenditures that are continuous in nature, in the context of looking at the intermediate-to-long range.** As stated, a significant portion of the amounts included in the coalition agreements are continuous in nature. These are payments that, once approved, will be very difficult to halt in the coming years. While the size of these amounts relative to the total cost of the war is not large, their volume relative to the permanent increase expected in government expenditures is much more significant, so reducing them will contribute to long-term fiscal resilience.