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To:
The Government and the Knesset Finance Committee

I am honored to hereby present the Bank of Israel's Annual Report for the year 2025, pursuant to Section 54 of the Bank of Israel Law, 5770–2010.

During 2025, the Israeli economy operated under the shadow of the continuing war that began on October 7, 2023, although its intensity gradually declined over the course of the year, particularly toward its end. Operation "Rising Lion" in June was brief and had only a limited annual impact on economic activity. Despite the ongoing conflict and the challenges it posed, the resilience of the Israeli economy was evident, and its performance improved relative to the previous year. Growth accelerated, inflation moderated and returned to within the target range, unemployment remained very low, the risk premium declined to near prewar levels, and capital markets recorded particularly strong results.

Nevertheless, the war's consequences—including labor supply constraints and the fiscal costs of the conflict—continued to weigh on the economy. These effects were reflected in a significant loss of output relative to the prewar growth trend, a decline in per capita income, and a notable increase in the debt-to-GDP ratio. In addition, the costs of rehabilitation due to material damage and human physical and psychological harm will continue to burden the economy in the coming years.

At the end of February 2026, Operation "Roaring Lion" began. As of the writing of this report, the operation is still ongoing, and it is too early to assess its full economic implications. This report focuses on developments in 2025, and hence does not refer to this operation. Nonetheless, the analysis presented herein underscores many of the challenges and insights relevant to the functioning of the economy and the management of economic policy under conditions of heightened uncertainty and prolonged conflict—circumstances characterized by elevated fiscal expenditures, disruptions to economic activity, and extensive mobilization of the military reserves. These conditions highlight, once again, the critical importance of maintaining macroeconomic policies that support stability, proper functioning, and recovery of the economy.

The ongoing impact of the war, together with the improvement relative to 2024, was reflected in overall economic activity. In 2025, GDP grew by 2.9 percent—an acceleration from the 1 percent growth in the previous year—while business sector output, which had contracted in 2024, expanded by 3.2 percent. However, both the GDP level and the pace of growth remained below the long-term trend. The main factor constraining faster growth was the labor supply constraint, primarily due to extensive reserve duty and the absence of Palestinian workers. Although this constraint eased somewhat over the course of the year, primarily toward its end, it remained significant. Combined with strong labor demand—partly driven by high fiscal spending—it resulted in a tight labor market, very low unemployment, and rapid wage growth in the business sector. The supply constraint also led to a marked increase in imports. Residential construction investment rose sharply, and housing starts reached particularly high levels, though activity in the industry has not yet returned to its prewar level. The increase in Israeli and foreign workers largely offset the decline in Palestinian labor, yet some shortages persisted in the construction industry amid its rising activity. Exports, which had contracted in 2024, increased during 2025, though it remains uncertain whether this represents a broad recovery, particularly in goods exports.

Developments in the financial system and capital markets reflected the improvement in economic conditions and supported continued recovery. Equity prices rose sharply, and credit to the business sector—both bank and nonbank—expanded significantly, including through large-scale corporate bond issuance. Consumer credit also grew, contributing to the recovery, with notable expansion in nonbank consumer lending, reflecting, among other things, increased competition in this segment following recent reforms, including the establishment of the credit data registry. The expansion of credit occurred while low levels of loan repayment arrears were maintained.

Inflation for the year totaled 2.6 percent—within the target range and below the previous year's rate. The disinflation process throughout the year was volatile, and for much of the year inflation exceeded the upper bound of the target. The moderation of inflation was supported by monetary policy and the appreciation of the shekel against the US dollar, driven largely by a decline in Israel's risk premium—reflecting security developments and fiscal restraint measures—as well as by global weakness of the dollar. Conversely, the tight labor market exerted upward pressure on prices.

Given inflation that was above the target range for much of the year, supply constraints, and significant geopolitical uncertainty, the Monetary Committee maintained the policy interest rate at 4.5 percent for most of 2025. This stance, combined with declining inflation expectations, led to higher real yields, thereby restraining aggregate demand and contributing to disinflation. Under prevailing supply constraints, a faster rate reduction would have had limited—if any—impact on growth while significantly increasing inflationary pressures. In November, following a decline in inflation and inflation expectations and in view of the ceasefire agreement, the Committee reduced the rate to 4.25 percent. The appreciation of the shekel, continued security stabilization, and signs of easing labor market tightness led to an additional reduction in January 2026 to 4.0 percent.

Although defense expenditures in 2025 were similar to those in 2024, the fiscal deficit declined to 4.7 percent of GDP. This improvement reflected tax measures introduced in the 2025 budget amounting to 1.5 percent of GDP, as well as expenditure restraint—mainly a temporary freeze on public sector wages. These steps—necessary in view of rising debt and defense spending—helped strengthen market confidence in Israel's economy and in the government's capacity and commitment to address the consequences of security shocks, particularly given the prevailing uncertainty. During the year, the expenditure ceiling was raised due to unexpected defense costs. However, the actual deficit did not exceed its planned level, due to stronger-than-expected revenues. The public debt-to-GDP ratio rose slightly to 68.5 percent, following a sharp increase in 2024, and remains significantly above its prewar level. The structural deficit remains higher than desirable for debt reduction. The government's decision to increase the defense budget following Operation Roaring Lion, with only limited fiscal adjustments, is expected to lead to a further rise in debt in 2026—the fourth consecutive year of increase.

The economy's resilience in the face of the challenges since the outbreak of war more than two years ago has been supported by macroeconomic assets built in prior years, including a low prewar debt-to-GDP ratio, credible monetary policy, high foreign exchange reserves, a persistent current account surplus, and a robust financial system. Preserving these assets remains essential to ensuring the economy's resilience. However, looking ahead, these strengths alone will not suffice to meet the challenges ahead. The long-term implications of the war—including persistently high defense spending and an increased burden of military service—add to the economy's structural challenges, notably low labor productivity. Addressing these issues requires substantial investment in human capital and physical infrastructure, as well as measures to increase labor force participation among Arab women and *Haredi* (ultra-Orthodox) men. Public investment in human capital should be focused on institutions that effectively equip individuals with skills relevant to the labor market. Expanding participation in military service across broader population groups would help mitigate the economic burden of defense obligations. Furthermore, the rapid development of artificial intelligence necessitates appropriate preparation, which may require significant investment in the development of physical infrastructure and in the adaptation of human capital, to fully realize its potential and maintain Israel's global competitiveness.

Addressing these challenges will require an increase in selected components of public expenditure. The need to reduce the debt-to-GDP ratio, maintain it at a prudent level over time, and create fiscal space to respond to future shocks—alongside relatively low civilian spending—underscores the difficulty of securing funding sources for these expenditures and the potential need to increase government revenues to achieve these objectives. It is essential that the government formulate a comprehensive strategic plan to address these challenges. The Bank has previously presented foundational elements for such a plan in special reports issued at the outset of prior governments' terms, and this report includes updated recommendations. The underscored need for optimal budgetary resource allocation, together with the prospect of diminishing extraordinary shocks, highlights the importance of restoring orderly budgetary processes, fundamentally improving transparency in budget preparation, and defining fiscal targets supported by credible measures to achieve them.

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Governor of the Bank of Israel