ISRAEL’S ECONOMY IN WARTIME

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MAIN POINTS OF THE ADDRESS TO THE 2026 ISRAEL ECONOMIC ASSOCIATION CONFERENCE BY GOVERNOR OF THE BANK OF ISRAEL

- Historically, wars tend to drive up inflation and reduce GDP. However, the Israeli economy has shown strong resilience during the war, experiencing a relatively moderate impact compared to other wars globally. Yet the war caused a sharp contraction, mainly due to supply constraints in the labor market; Headline growth indicators have improved, but a significant gap from the prewar trend still remains.
- The labor market remains tight, although it has eased somewhat compared with 2024. The number of foreign workers remains below its prewar level.
- Housing starts increased, while housing prices declined for most of the year.
- The high-tech sector continues to play a key role in the economy. Capital raised by high-tech firms remains relatively high.
- Following the outbreak of the war, Israel's risk premium increased sharply. However, driven by subsequent geopolitical developments, it has since declined and currently stands at pre-October 7th 2023 levels. The shekel appreciated against the US dollar, reflecting the decline in the risk premium, gains in US equity markets, and the weakening of the US dollar. The current account balance remains in surplus.
- Inflation in Israel declined, mainly due to lower inflation in tradable goods, and is now below the OECD median.
- Changes in the interest rate path of major central banks have been influenced by geopolitical developments and oil prices.
- In most OECD countries, policy interest rates remain on an upward trend, whereas in Israel they are being reduced.
- Israel's fiscal trilemma involves reducing the debt to GDP ratio while accommodating higher defense spending and performing investment expenditure.

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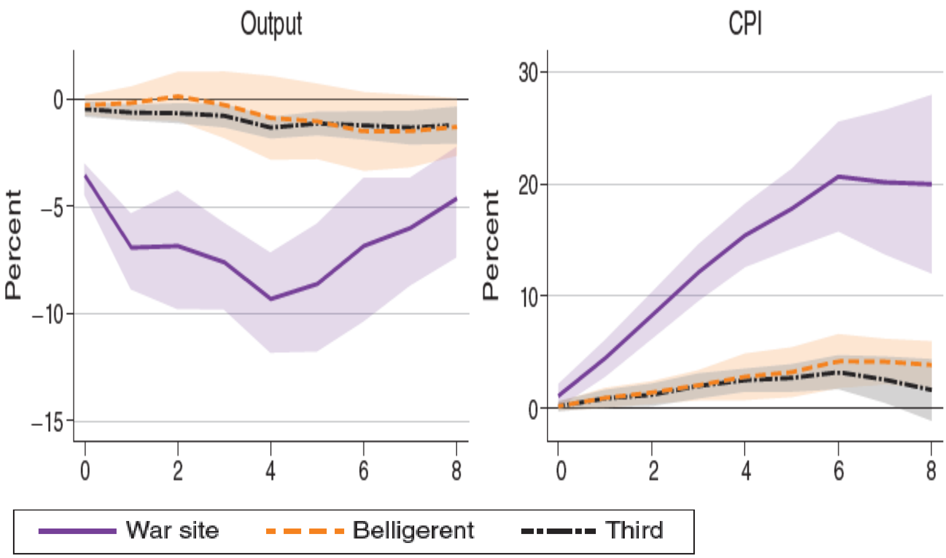
1. GDP IN WARTIME

Wars lead to a marked increase in the inflation rate and to an adverse impact on GDP

Figure 1 | Changes in inflation and output (relative to trend) following the outbreak of war.

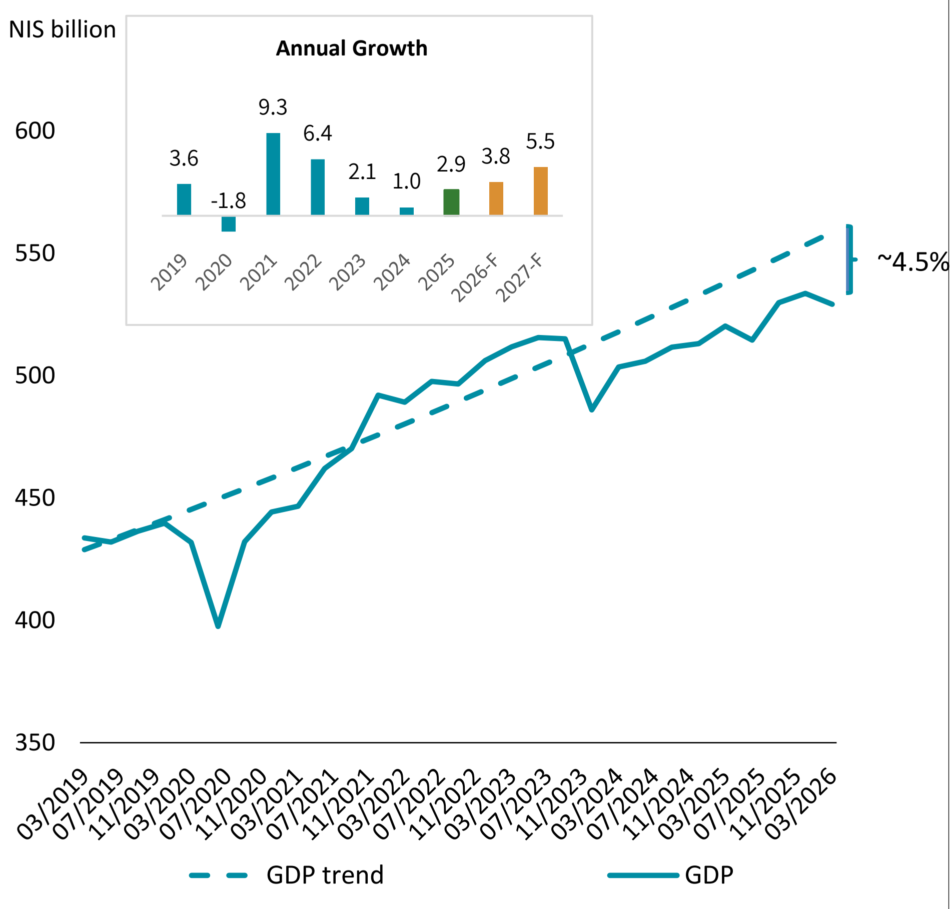
The horizontal scale shows the number of years since the onset of the war.



Federle, J., Meier, A., Müller, G. J., Mutschler, W., and Schularick, M. (2026). The Price of War. American Economic Review.

Figure 2 | GDP and GDP Trend

03/2019-03/2026, Seasonally Adjusted, at 2025 Constant Prices



An upward trend in credit card expenditures has been seen since October 7th 2023; the decline in credit card expenditur e during Operation “Roaring Lion” was similar to that in “Rising Lion”, ending with a notable recovery.

Figure 3 | Credit card expenditure index
28 days moving average, Seasonally adjusted,
2025:Q1=100, 01/2023-06/2026

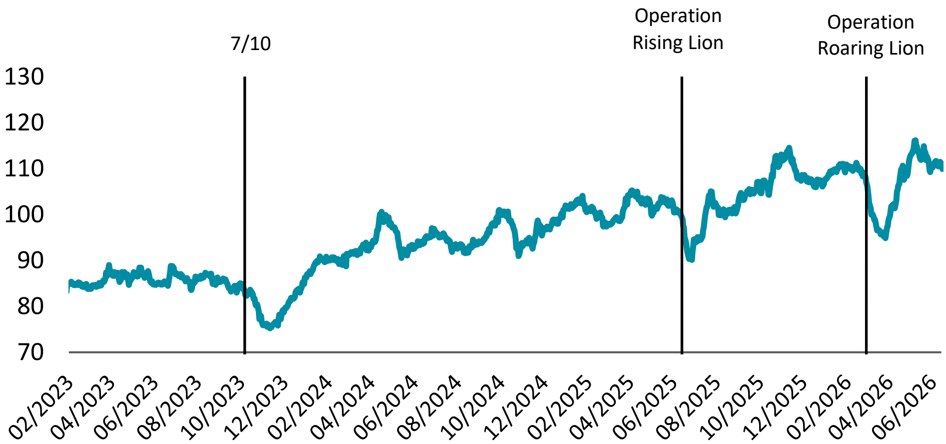
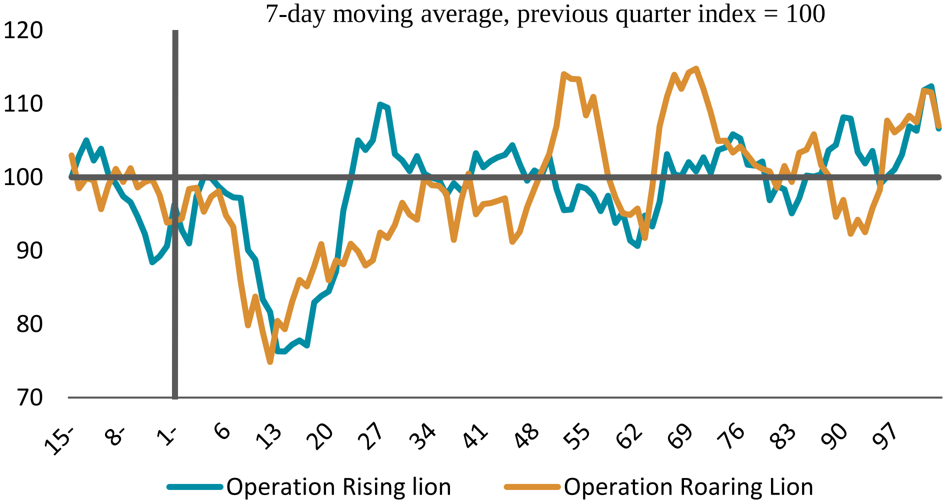


Figure 4 | Development of credit card expenditures
7-day moving average, previous quarter index = 100



Based on Central Bureau of Statistics and Shva.

2. BARRIERS TO GROWTH- LABOR-FORCE SUPPLY CONSTRAINTS, CREDIT, AND RAW MATERIALS

The constraints on credit and raw materials are around their prewar level, with an increase in the most recent data.

Figure 5 | Share of businesses reporting severe credit constraints, bank and nonbank credit by businesses size
05/21-05/26

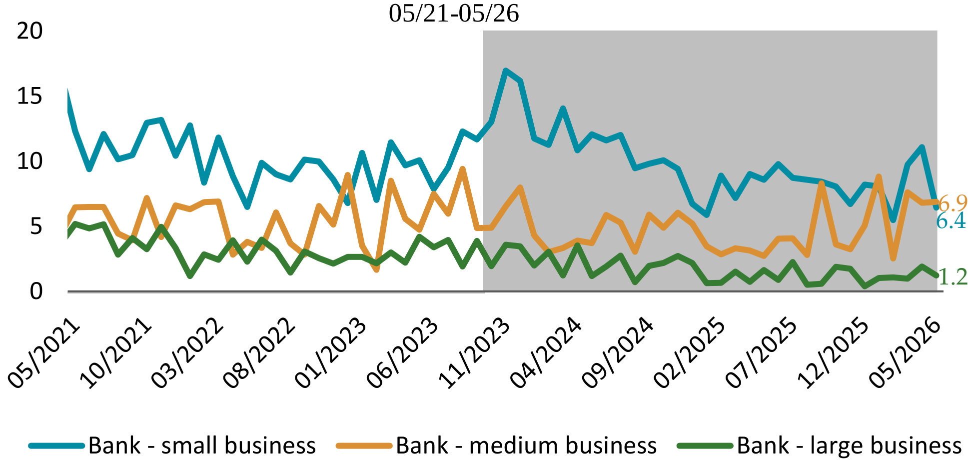
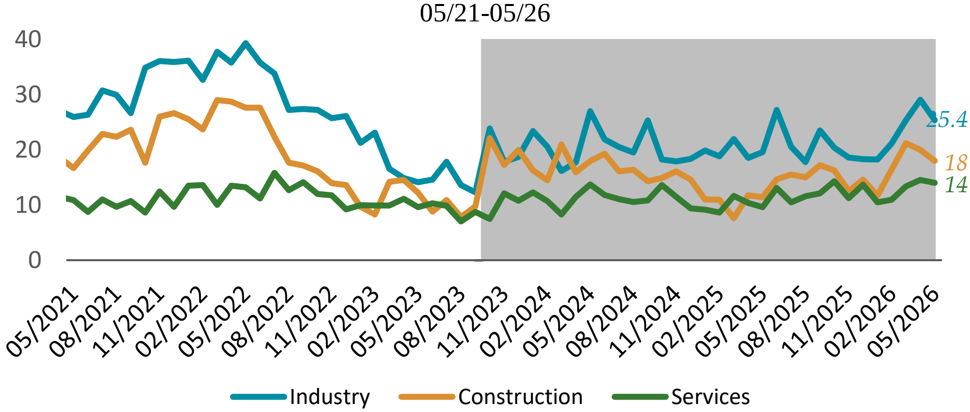


Figure 6 | Share of companies that reported in the Business Tendency Survey a moderate or severe constraint of equipment and raw materials, by sector
05/21-05/26



SOURCE: Bank of Israel and Central Bureau of Statistics.

Growth in business and consumption credit occurred in parallel with expanded activity

Figure 7 | Non-performing loans (NPL) ratio
2019:Q4 to 2025:Q4

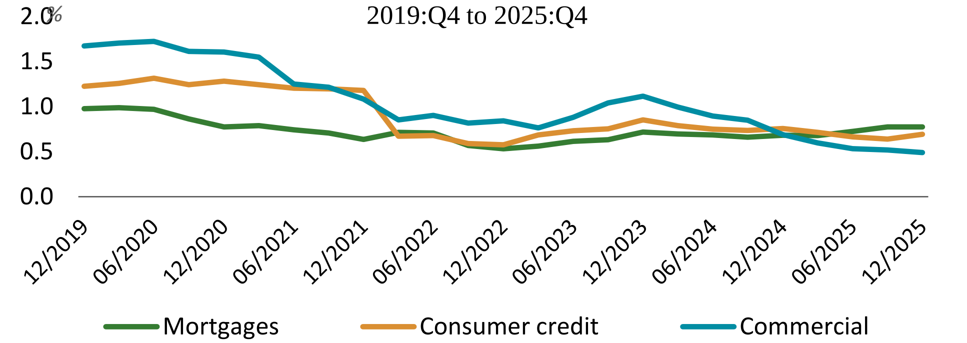


Figure 8 | Distribution of debt in the nonfinancial business sector
Current prices, NIS billions, 2018-2025

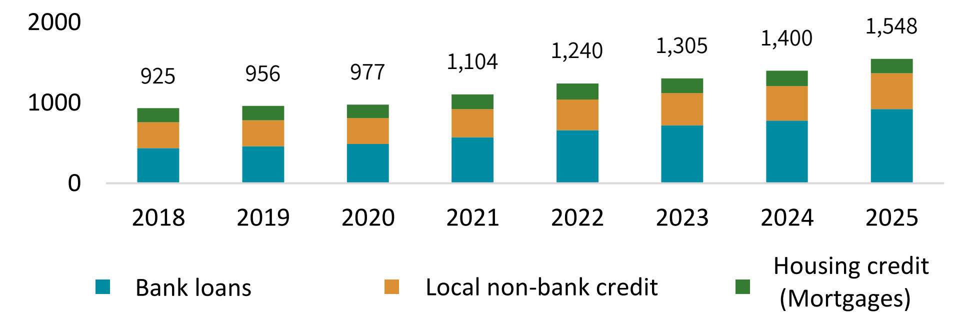
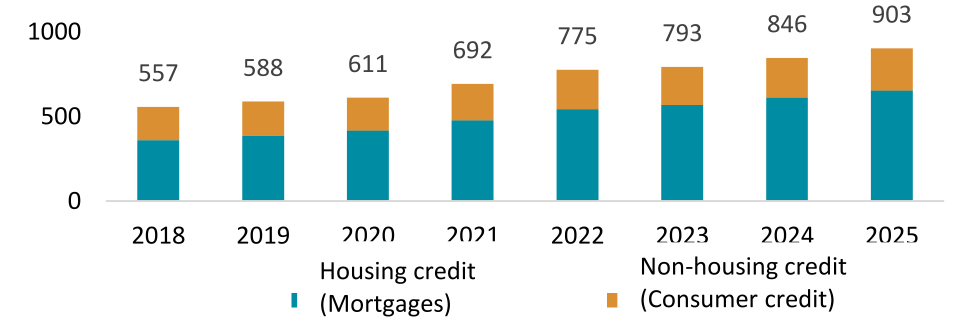


Figure 9 | Distribution of household debt
Current prices, NIS billion, 2018-2025



SOURCE: Based on Central Bureau of Statistics.

The labor market remains tight, despite some easing compared with 2024

Figure 10 | Non-Israeli Workers

Ages 25-64, Seasonally Adjusted, 01/2021-03/2026

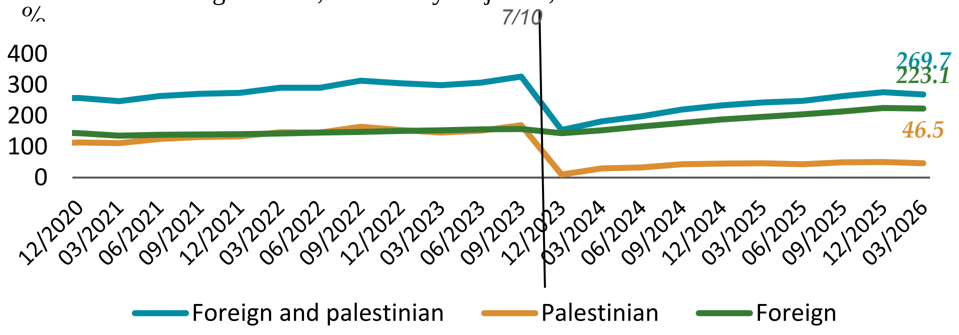


Figure 11 | Temporarily absent from their work due to military reserve service

Thousands*

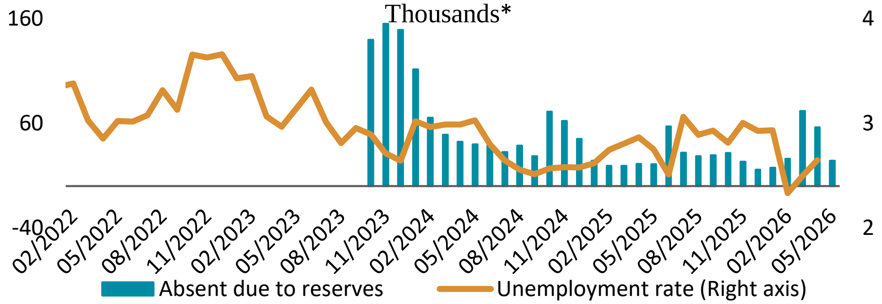
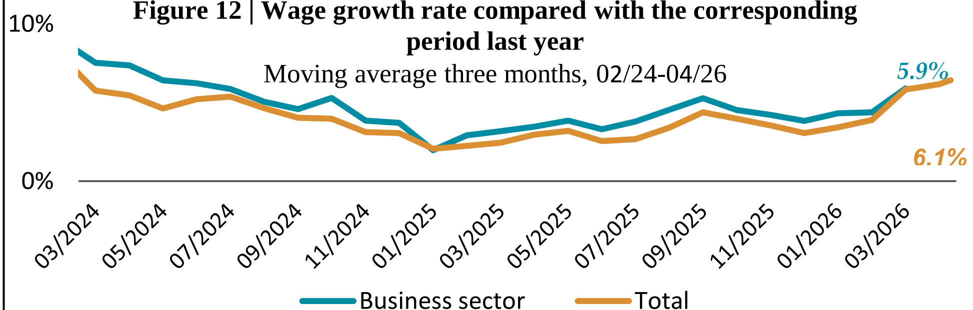


Figure 12 | Wage growth rate compared with the corresponding period last year

Moving average three months, 02/24-04/26



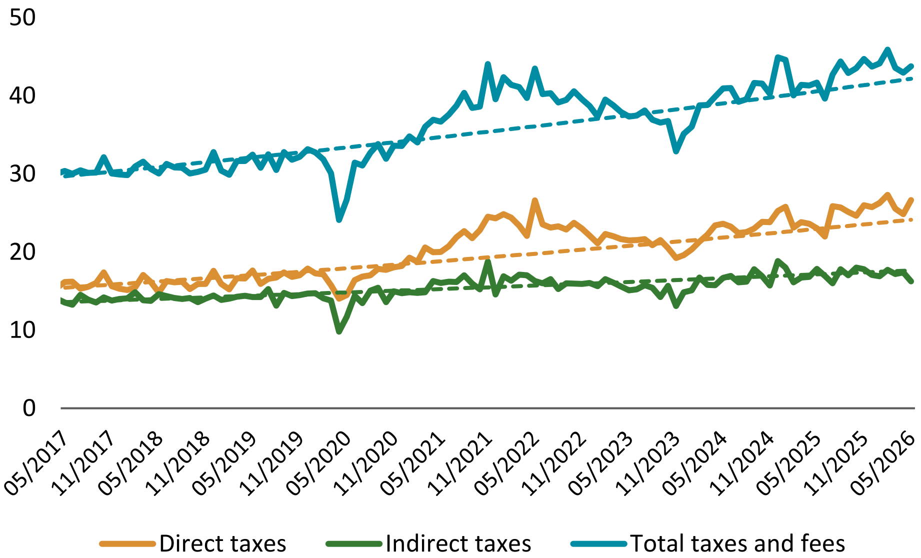
*Reserves data Oct 2023 to May 2026

SOURCE: Based on Central Bureau of Statistics

3. ADDITIONAL INDICATORS OF ECONOMIC ACTIVITY

Government tax revenues in recent months have ranged above the long term trend

Figure 13 | Israeli Government Tax Revenues
Seasonally adjusted, excluding legislation changes and extraordinary income, NIS billion, constant prices, dashed line - 2015-2019 trend, 05/17-05/26



SOURCE: BOI and Ministry of Finance.

Residential construction volume increased and for most of the year home prices declined

Figure 14 | Transactions of New and Existing Homes
Thousands, 3-month moving average, 03/16-04/26

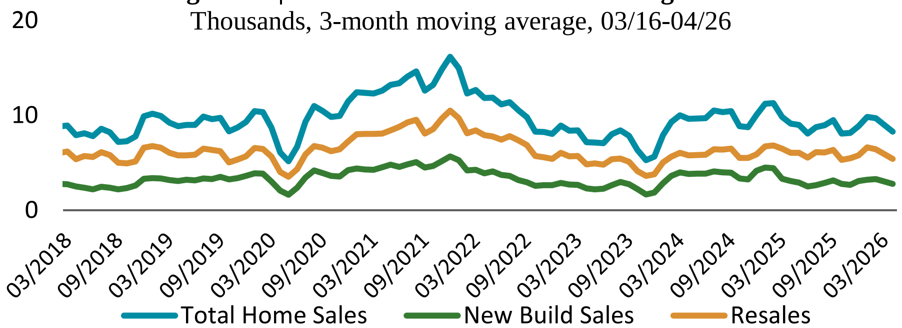


Figure 15 | Building starts, building completions, building permits and housing stock
Seasonally adjusted, thousands, 03/21-02/26

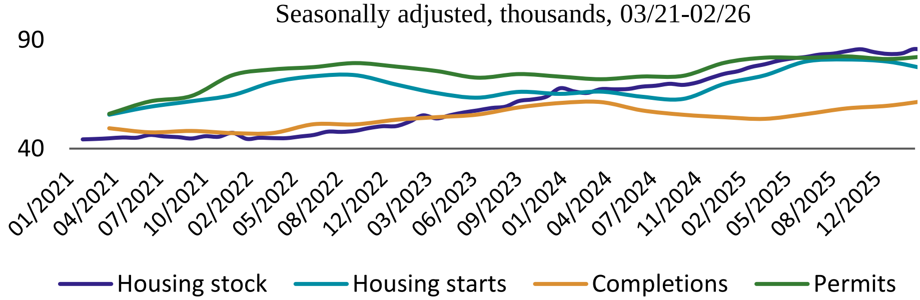
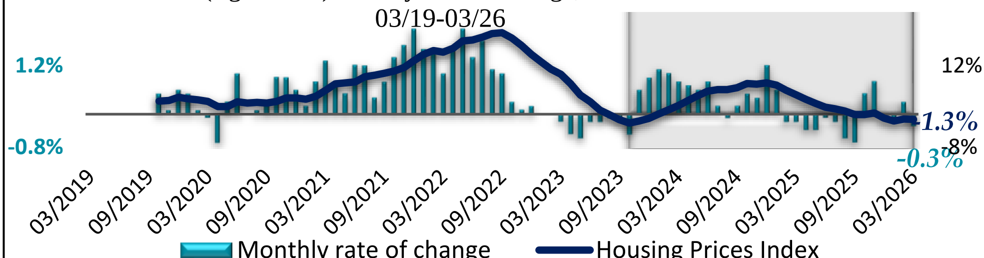


Figure 16 | Housing prices
Blue (left scale): Monthly rate of change,
Black (right scale): Yearly rate of change, Jan 2021 = 100
03/19-03/26



SOURCE: Based on Central Bureau of Statistics.

A sharp increase in goods exports was seen in the most recent data; there has been an increase in imports of raw materials and consumer goods since Operation “Rising Lion“

Figure 17 | Goods Imports to Israel
01/2023 – 04/2026

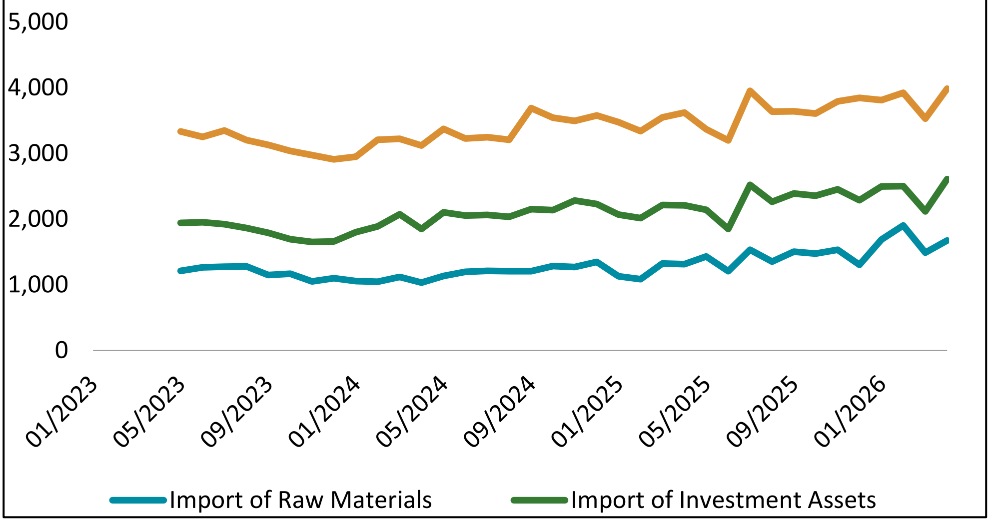
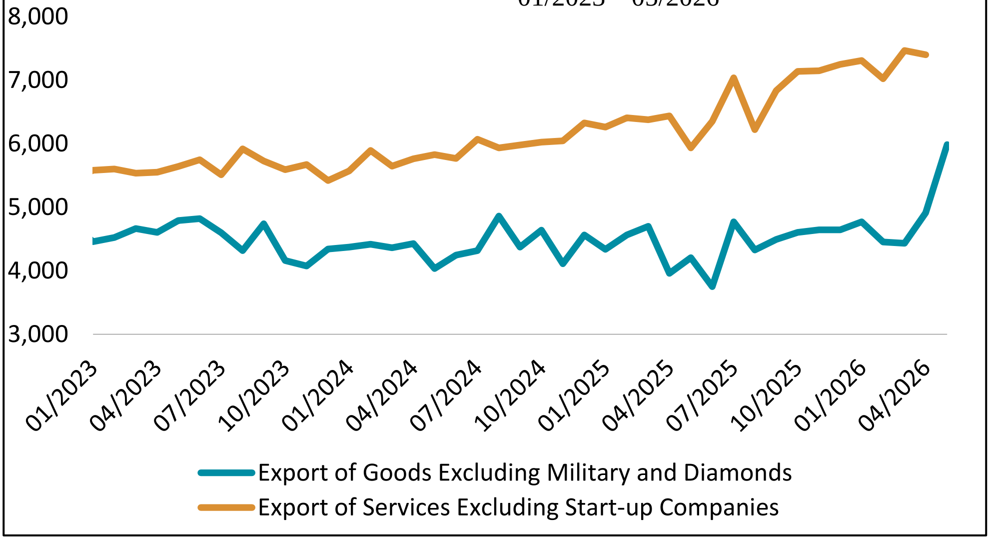


Figure 18 | Export of Goods and Services Exports
01/2023 – 05/2026



High tech has macroeconomic importance; funds raised declined but are at a high level

Figure 19

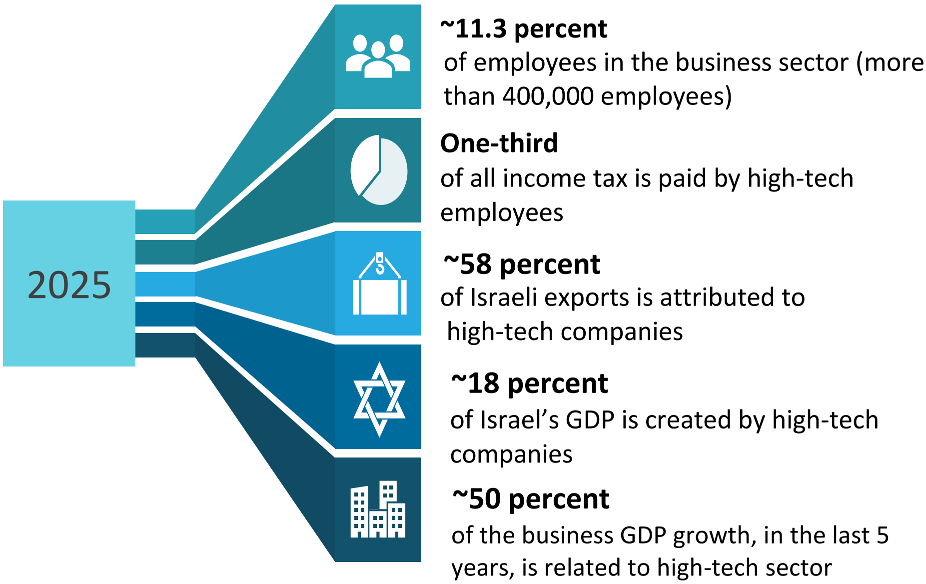
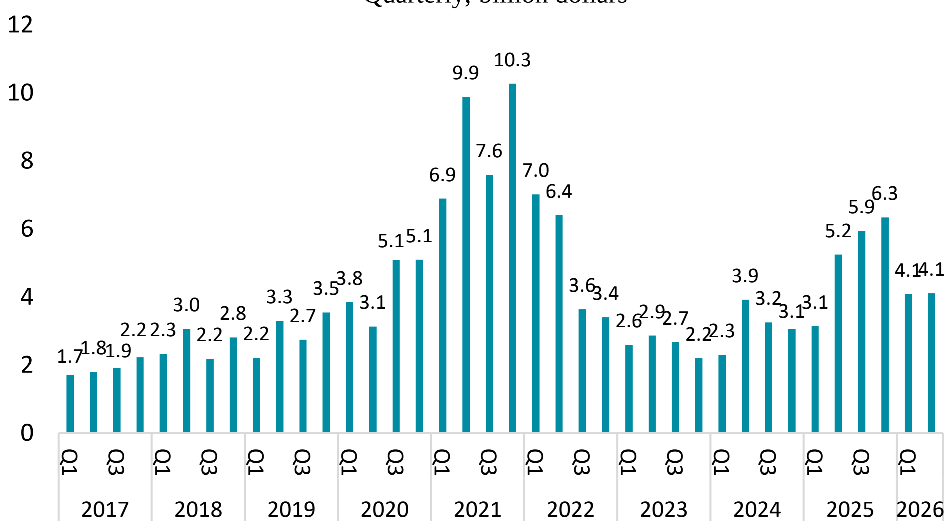


Figure 20 | Capital Raising of high-tech companies
Quarterly, billion dollars



4. FINANCIAL MARKETS

After the “beeper operation” and Operation Rising Lion, there was a sharp decline in the risk premium, to a level similar to that on the eve of October 7th 2023

Figure 21 | Selected equity market indices
as of 17/06, 02/10-06/26

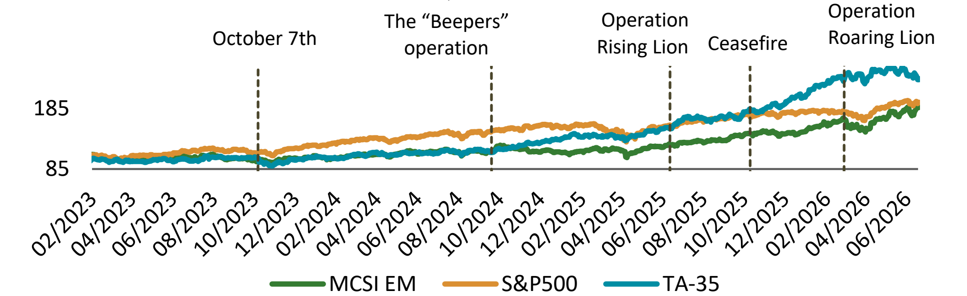


Figure 22 | CDS 5Y
as of 16/06, 02/10-06/26

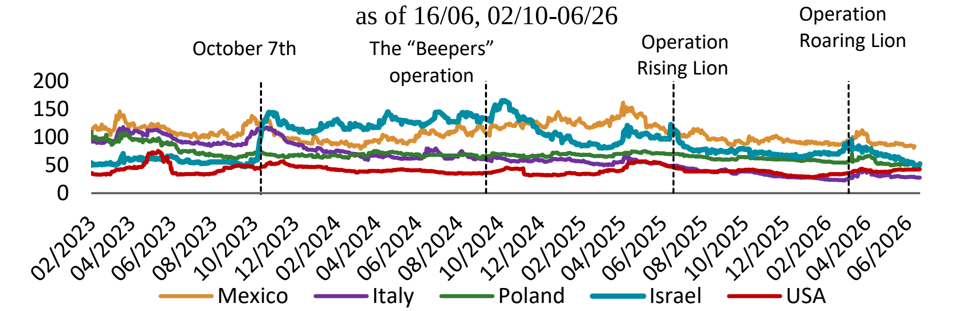
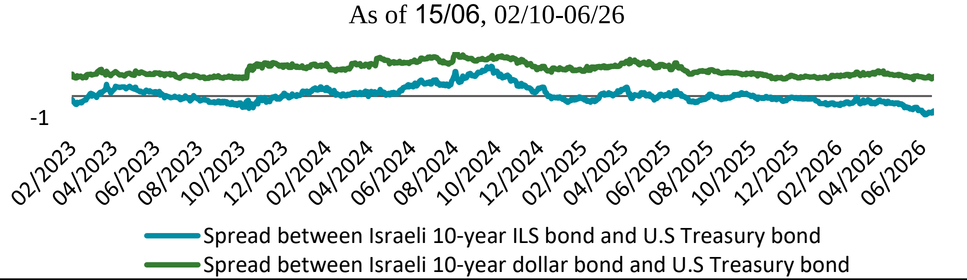


Figure 23 | Spread between Israeli 10-year bond and US Treasury Note
As of 15/06, 02/10-06/26



SOURCE: Based on Bloomberg data.

5. INTERIM SUMMARY

- Despite the negative impact of the war, the economy has demonstrated resilience and strength, including by historical comparison.

- The adverse impact on the economy has been reflected primarily in supply-side constraints in the labor market, and GDP remains below its long-term trend.

- The risk premium rose sharply at the outbreak of the war; moderated as the geopolitical situation improved, and is now similar to its prewar level. The performance of the Israeli stock market has been notable in comparison with global markets.

6. INFLATION AND THE EXCHANGE RATE

The shekel has appreciated sharply over the past 2 years, among other reasons in view of the decline in the risk premium, US stock market gains, and dollar weakness worldwide.

Figure 24 | The exchange rate of the ILS against US dollar and Israel CDS

5 year CDS, in percent as of 15/06, 10/20-06/26

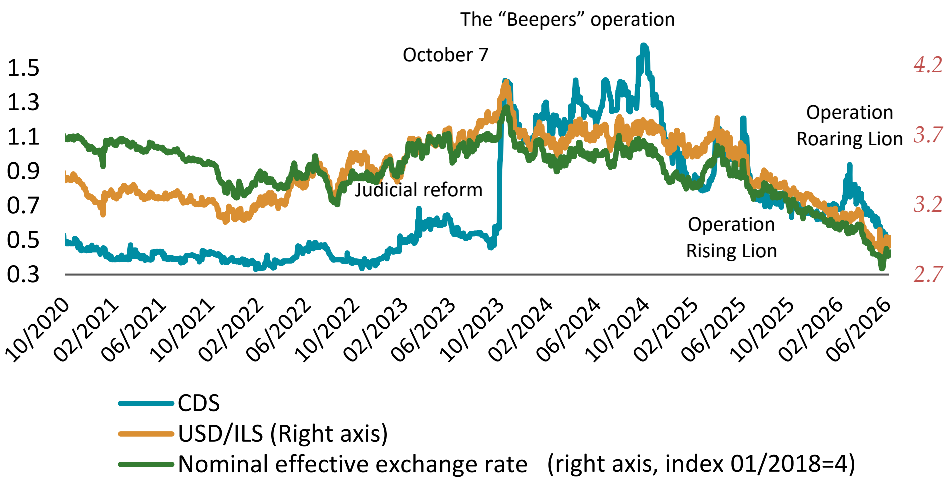
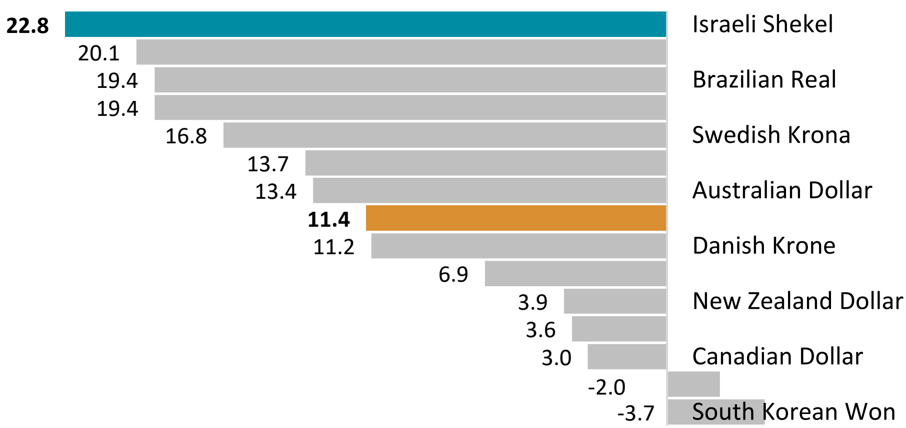


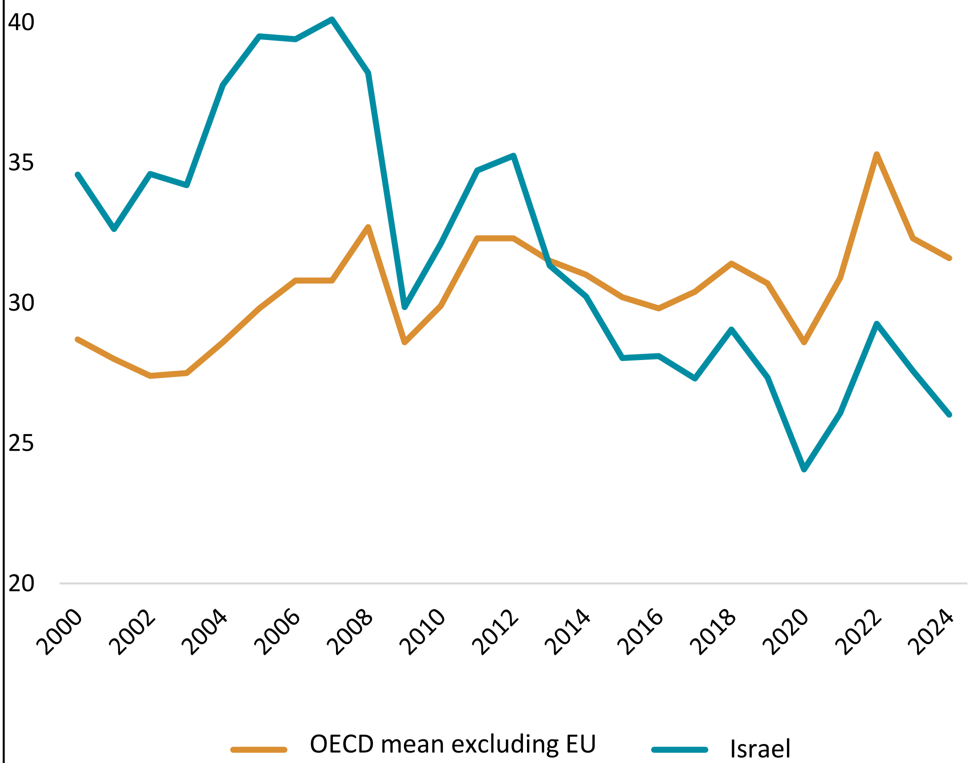
Figure 25 | Percentage change vs. the USD since 1/1/25



SOURCE: Based on Bloomberg data.

There is a surplus in the Current Account; there are import barriers, mainly in the food sector

Figure 26 | Imports into Israel
Percent of GDP



SOURCE: Based on OECD.

There has been an increase in the inflation rate and in the interest rate path worldwide; inflation in Israel is below the OECD median

Figure 27 | Inflation in Israel and OECD
1/21-5/26

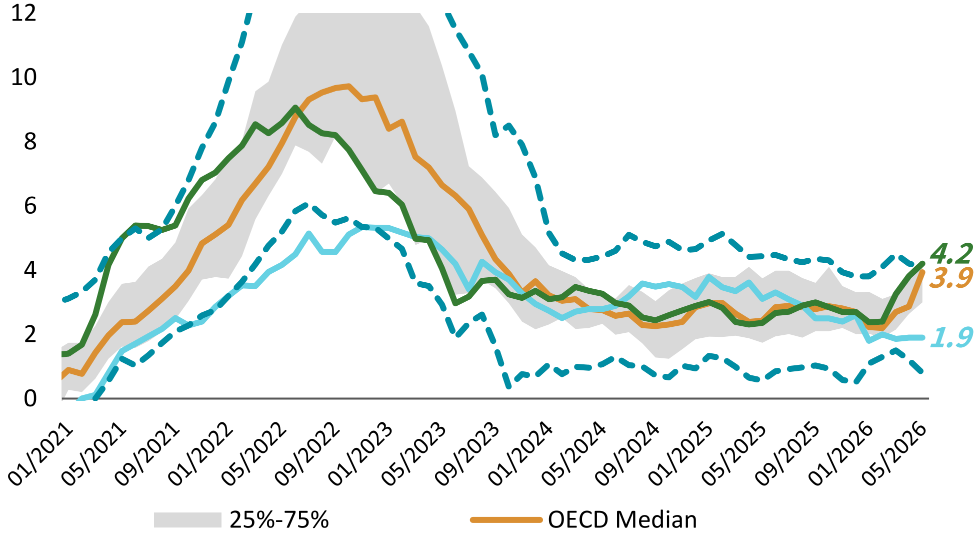
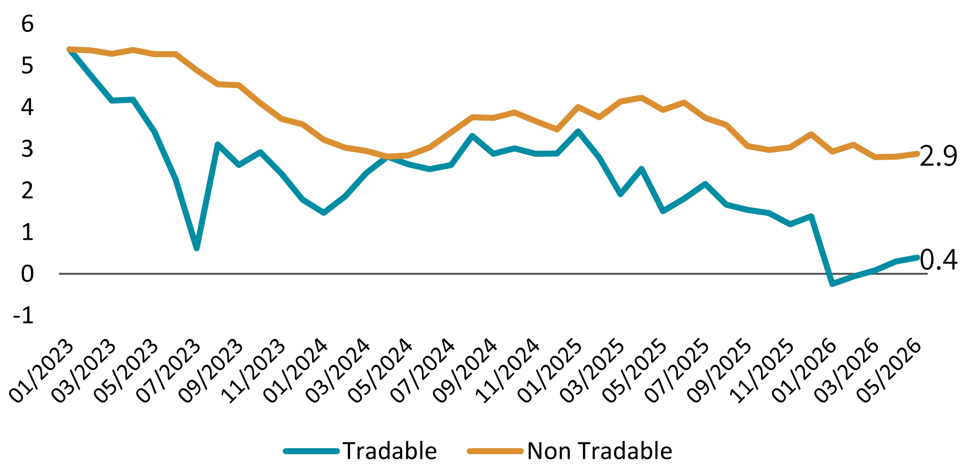


Figure 28 | Tradable and nontradable goods index
01/21-05/26



SOURCE: Based on FRED and ECB.

There is a strong connection between geopolitical events and monetary policy around the world

Figure 29 | US inflation and interest rates vis-à-vis the Global Supply Chain Pressure Index

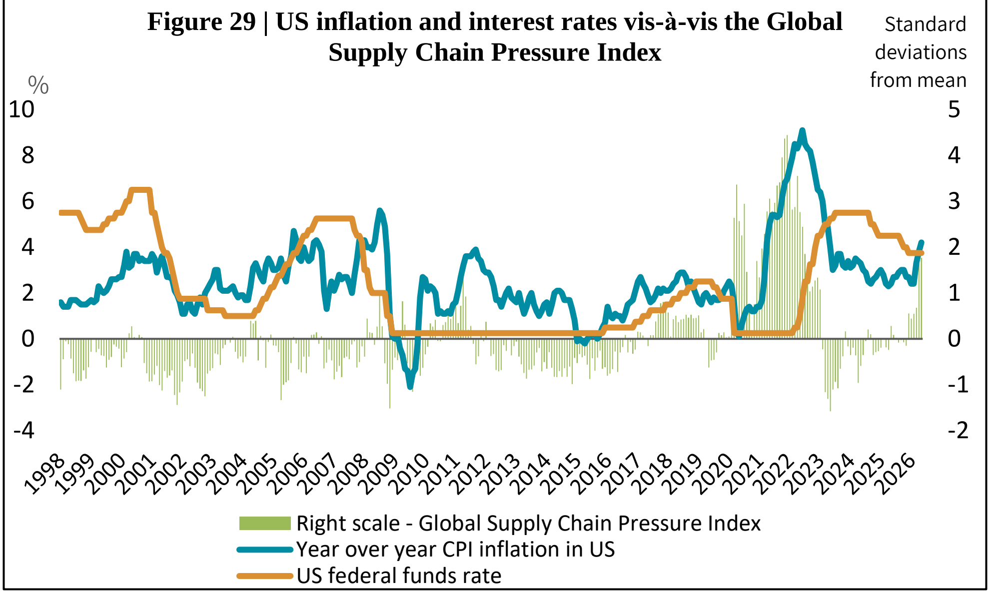
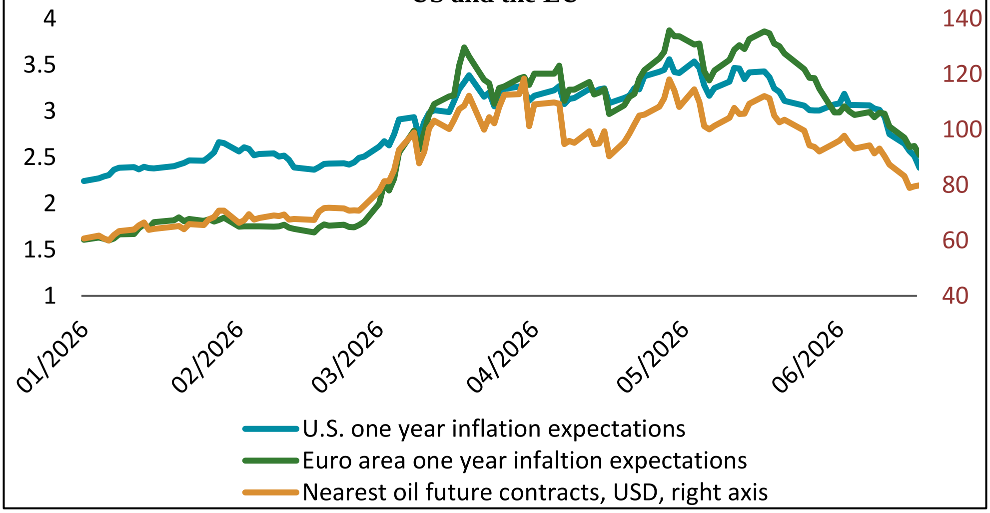


Figure 30 | Brent oil price vs. one-year inflation expectations in the US and the EU



SOURCE: Based on Bloomberg data.

The Fed’s interest rate path has increased since the conflict against Iran began, in parallel to an increase in oil prices

Figure 31 | ECB interest rates path

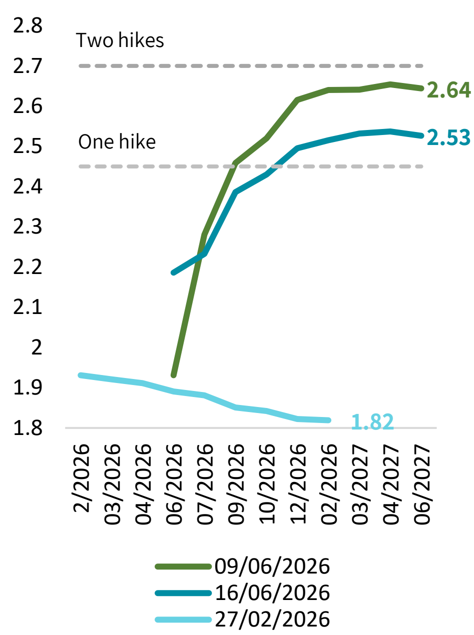


Figure 32 | The Fed’s interest rate path

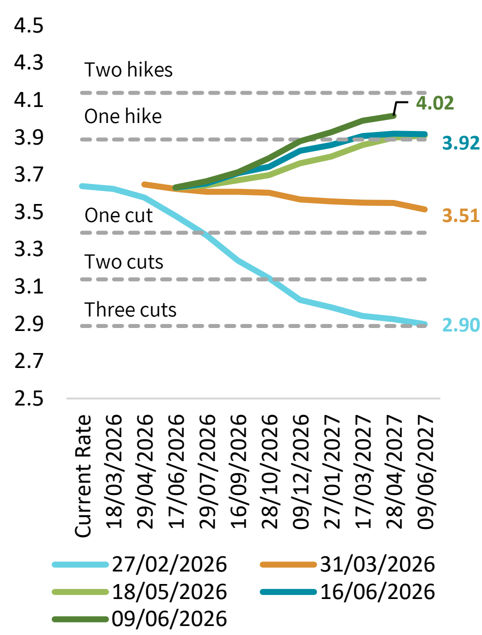
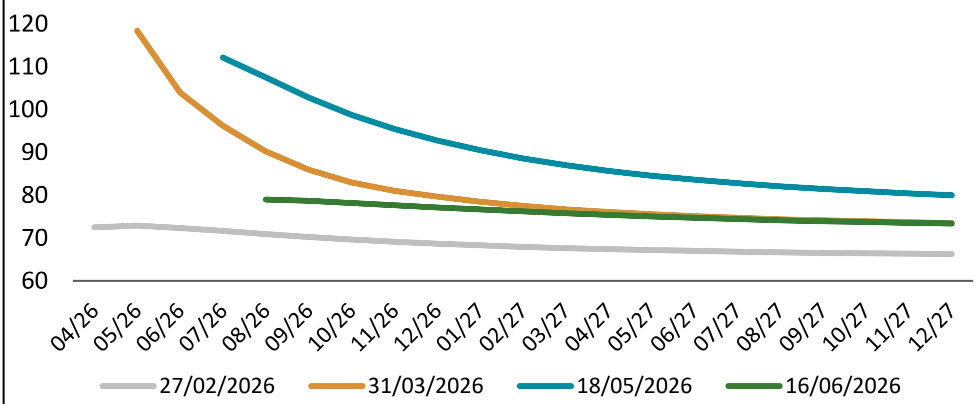


Figure 33 | Brent contracts curve



SOURCE: Based on Bank of Israel processing of Bloomberg data.

7. THE “FISCAL TRILEMMA”: PRINCIPLES FOR ECONOMIC POLICY IN THE COMING YEARS

The Fiscal Trilemma:
Declining debt to GDP path, high defense expenditures, low civilian investments

Figure 34 | Debt to GDP - various scenarios
As of April 2026

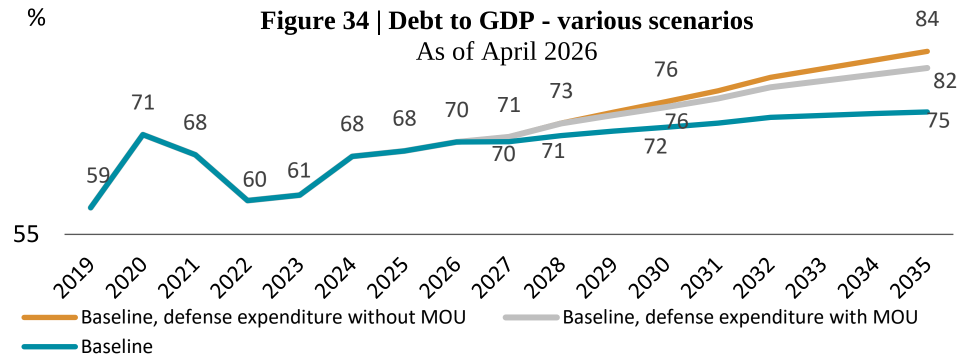


Figure 35 | Defense expenditure
2024, percent of GDP

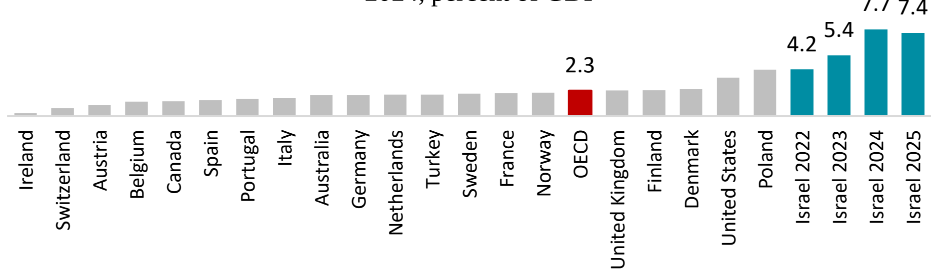
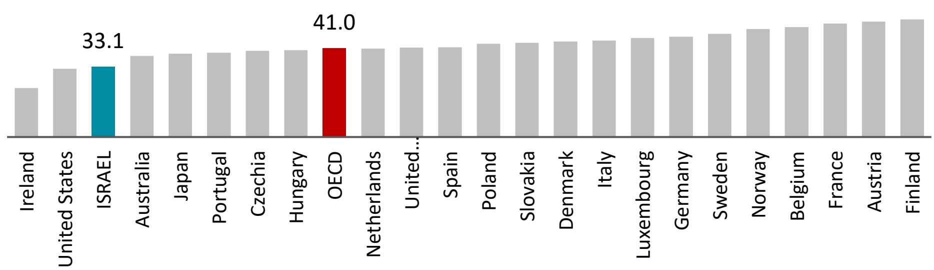


Figure 36 | Civilian public expenditure excluding interest
2024, percent of GDP



SOURCE: OECD.

Israel's interest payments increased in recent years; the tax burden in Israel is low compared to other OECD economies

Figure 37 | Israel's gross public debt compared to countries with similar debt levels in 2015 -2019

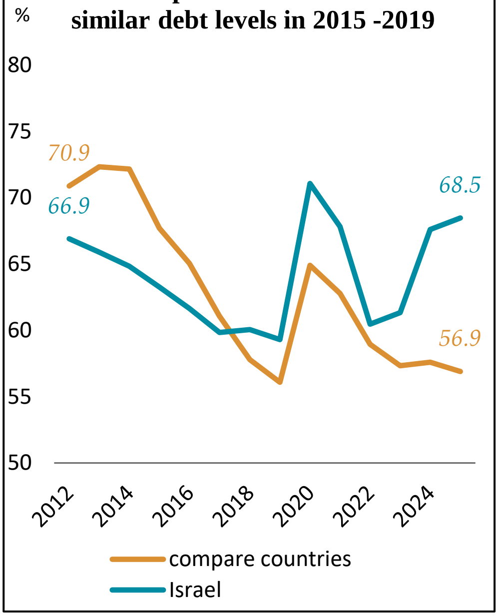


Figure 38 | Tax burden in Israel compared to OECD economies
Percentage of GDP, 2008-2025

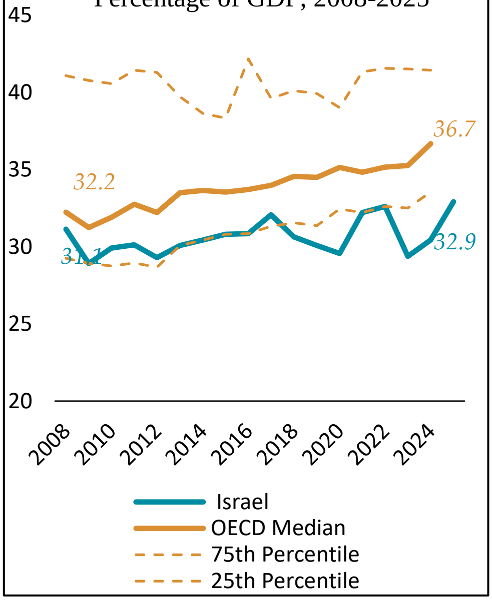
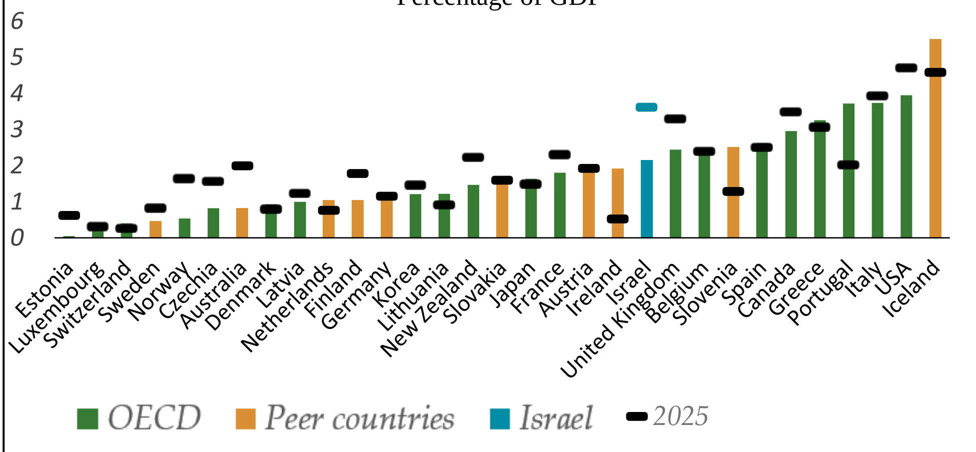


Figure 39 | Gross interest payments on debt
Percentage of GDP



SOURCE: OECD.

Public investment in Israel is similar to the OECD average, and population growth is the fastest

Figure 40 | Public investment
Net of defense investment, percent of GDP, 2019–2023 average

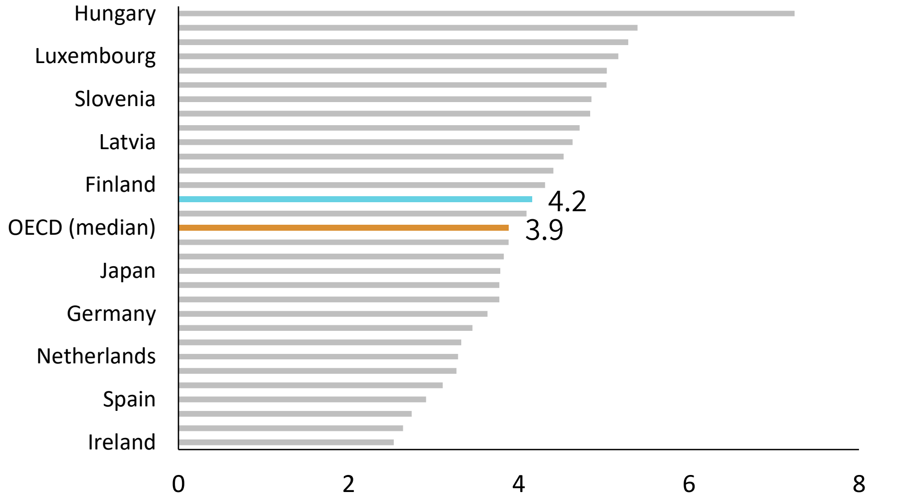
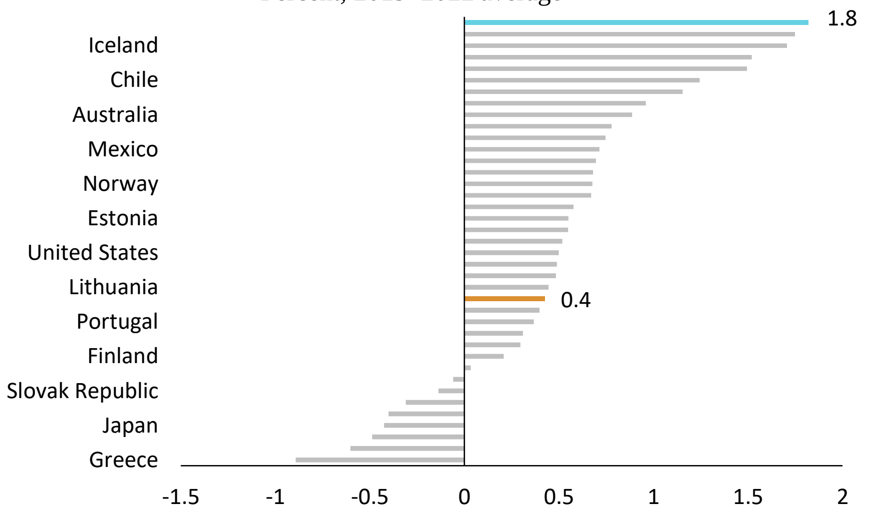


Figure 41 | Population growth
Percent, 2019–2022 average



SOURCE: Based on OECD.

Various segments of the public capital stock are in decline

Stock of fixed capital, public and private

Percent of GDP, fixed prices, 2000–24

Figure 42 | Fixed assets

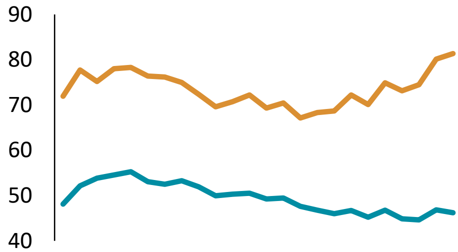


Figure 43 | Nonresidential properties

Figure 44 | Other construction

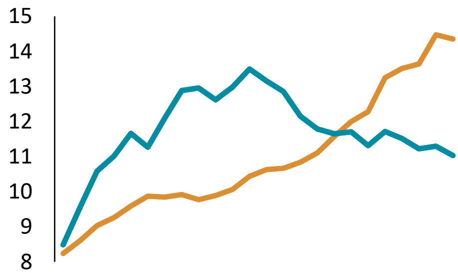


Figure 45 | Machinery and equipment

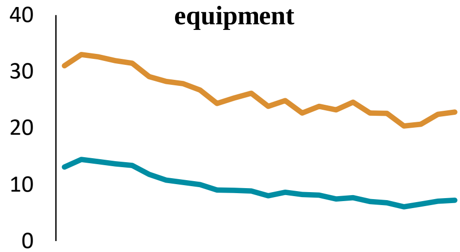


Figure 46 | Computer software and databases

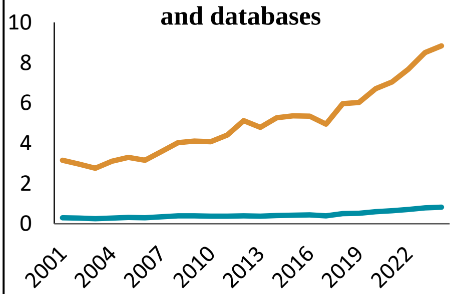
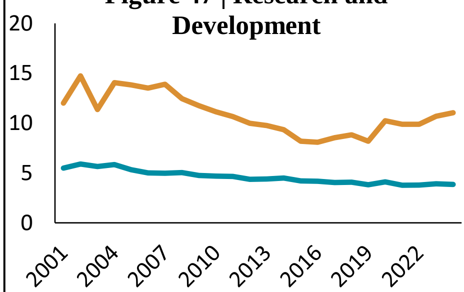


Figure 47 | Research and Development



Private Public

SOURCE: Based on Central Bureau of Statistics.

In summary, there is a fiscal trilemma: Declining debt to GDP path, high defense expenditures, low civilian investments.

Fiscal Trilemma

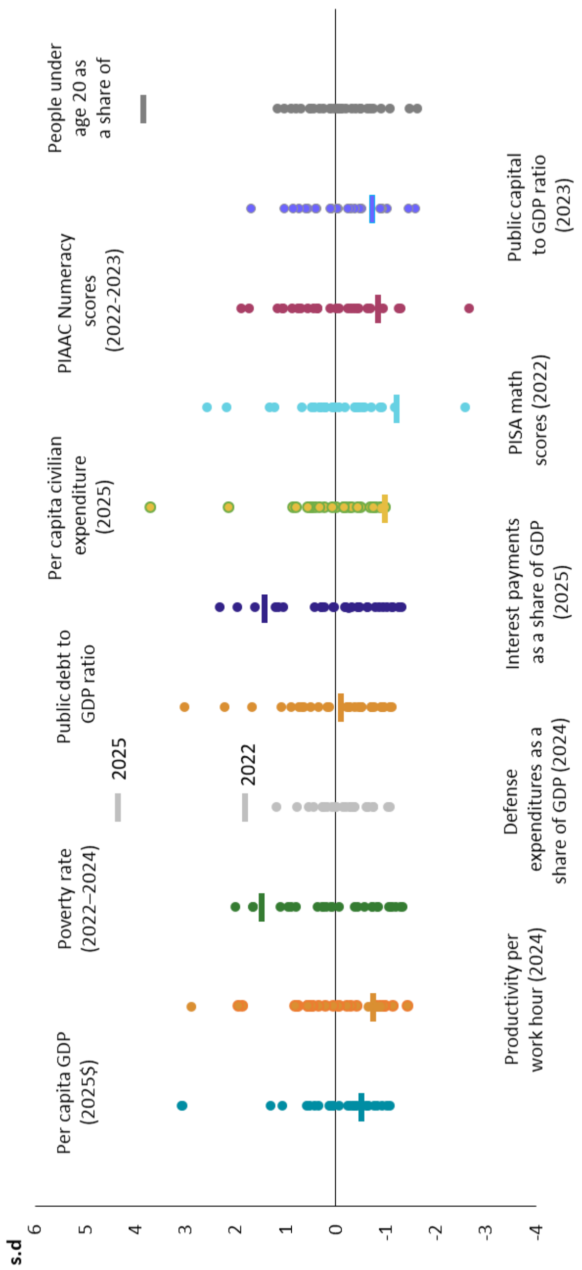
- Declining debt to GDP path.
- Financing defense needs.
- Investments in growth drivers.
- To achieve a deficit that will lead to a declining path of the debt to GDP ratio, it will be necessary to restrain defense expenditures to the extent possible while providing a response to future threats, and in line with finding alternative budget sources – cancellation of items that do not support growth drivers and at the same time adjustments on the revenue side.

SOURCE: Based on OECD, IES, and IMF.

Economic parameters: An overview of Israel

Figure 48 | Productivity, Human Capital, Public Capital, and Fiscal and Poverty Indices, Israel and Advanced OECD Economies

(Israel in blue bar, in standard deviation terms)



SOURCE: Based on OECD, IES, and IMF.

Employment rates for Arab women and ultra-Orthodox men are low. Among those working, there are significant wage gaps. The share of the ultra-Orthodox population is expected to grow markedly. Therefore, ensuring their meaningful and high-quality integration into the labor market is of critical importance.

Figure 49 | Share of various population groups in the prime working ages
Data for 2015 and forecast for 2040 and 2065

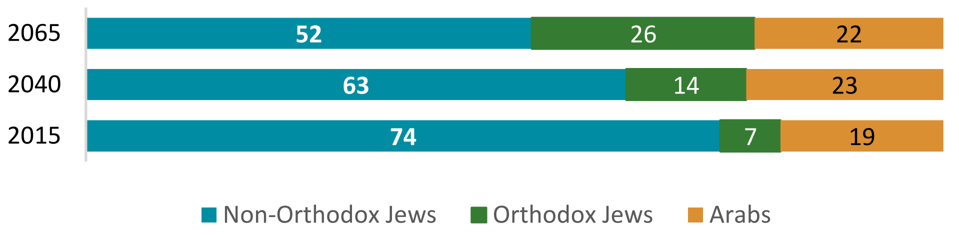


Figure 50 | Employment Rates by Population Group
percent

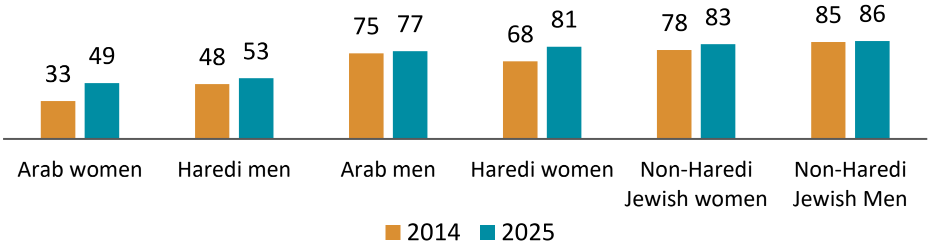
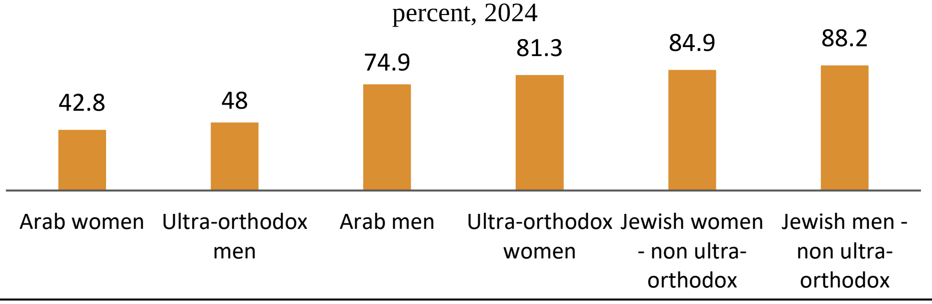


Figure 51 | Wages
percent, 2024



SOURCE: Based on IL and CBS.

8. IN CONCLUSION

Despite the adverse impact of the war, the economy has demonstrated resilience and robustness, including in historical comparison.

The risk premium rose sharply following the outbreak of the war. As the geopolitical situation improved, the premium moderated and has returned to a level broadly similar to that prevailing before the war. At the same time, the shekel appreciated and the Israeli stock market delivered strong performance.

Against the backdrop of the decline in the risk premium and the strengthening of the shekel, inflation expectations have decreased.

The key challenge facing any future government will be addressing the fiscal trilemma.