

## The effects of the war on Israel's economy and the required policy measures

### Aaron Institute's position

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1. The murderous attack by Hamas and the war in Gaza fundamentally changed the economic conditions in Israel due to significant potential damage to local economic activity and exports and the emergency budgets required at this time. Coinciding significant increases in the government's expenses and a decrease in government income challenge economic stability. These developments threaten to divert the Israeli economy from the high growth trajectory of recent years.
2. To assess the economic impact of the war, we employed a scenario for the progression of the war constructed by the company Mind Israel, led by Amos Yadlin and Giora Eiland. This scenario considers ongoing high-intensity military actions against the Hamas organization in Gaza and military-security tensions on the northern border with Hezbollah. Based on this framework, we formulated macroeconomic forecasts, accompanied with immediate policy measures and recommendations for reconstructing the budget for 2024. Executing these measures will mitigate the economic damage to the greatest extent possible: upholding a responsible fiscal policy is crucial to sustain the confidence of financial markets, credit rating agencies, and high-tech investors in the economic resilience. Since the war commenced Israel's risk premium has surged, as reflected in the increase of CDS prices from 60 basis points to 140 basis points. This elevation in Israel's risk premium will result in more expensive future debt financing posing challenges for the economy to return to its previous growth trajectory.
3. The analyzed war scenario presupposes high intensity fighting in Gaza and security-military tensions marked by sporadic military activities on the northern front, until the end of 2023. This situation brings about disruptions in economic activity on the home front due to rocket fire, evacuation of cities and villages, partial functioning of the education system, and a sustained decline in the citizens' perception of personal security. The scale of the reserves deployed in the final quarter of 2023 is approximately 300,000 individuals, and starting from the first quarter of

2024, there would be a gradual reduction of reserves force will apply. According to military experts, this scenario is considered as optimistic.

4. In this scenario, considering a decline in employment rates, a projected 9% reduction in GDP is anticipated in the last quarter of 2023 compared to the preceding quarter. This decline translates into a forecasted GDP growth rate of 1.5% in 2023 signifying a decrease of approximately 0.5% in GDP per capita. Looking ahead to 2024, GDP growth rate is expected to decline to 0%-1% (contingent on the pace of the economy's returns to normalcy). This, in turn, implies a further reduction in GDP per capita of ranging from 1%-2%.
5. The foundational war scenario in the analysis takes into account various war expenses that include war-related expenditures, encompassing military costs, support for evacuees and the injured, and economic support for businesses and employees. These expenditures contribute to a projected 10% increase in the deficit during the years 2023-2024, resulting in an expected debt-to-GDP ratio of 68% by the end of 2024. **This is an upper threshold of the debt-to-GDP ratio that Israel can manage with without incurring a credit rating downgrade. It is essential to note that this assessment is built upon an optimistic scenario regarding the progression of the fighting and partial offsetting of expenses through American aid (NIS 20 billion per year).** Looking ahead to the years 2025 and beyond, Israel will be required to sustain a permanent increase in defense spending (between 0.5-1 percent of GDP) to upgrade the military infrastructure and reinstate the sense of security among its citizens.
6. Presently, the citizens of Israel face a profound crisis of trust in the government, coupled with a diminished sense of personal security. Government ministries exhibit limited and slow execution capacity, coupled with a low proficiency in effectively and professionally navigating the crisis, consequently adversely impacting economic activity and the social cohesion. The Prime Minister and the Minister of Finance must implement economic strategies that effectively communicate to citizens, investors, and credit rating agencies that the nation's decision-makers are responsibly steering the economy in line with the prevailing reality.
7. The resurgence of the economy towards a growth trajectory is intricately tied to the sense of personal security of the citizens. Achieving the objectives of the war - annihilating the military capabilities of the Hamas organization and especially the release of the abductees is pivotal for restoring the sense of personal security of the citizens and expediting their rapid return to economic activity.

8. The Prime Minister and the Minister of Finance must act immediately to enhance government execution capabilities, instill trust in governmental processes and bolster national security. Essential funds must be swiftly allocated to the evacuees and victims without bureaucracy hurdles. The transfer of coalition funds should be canceled immediately and funding of any non-essential activities and those that do not contribute to economic growth should be deferred. It is essential to form a **limited** economic cabinet immediately, tasked with establishing and implementing effective mechanisms for swift execution.
9. An immediate construction of a new budget for 2024 is paramount. This budget must support the government's heightened execution capacity and the necessary strengthened national security, incorporating growth-supporting reforms. This budget must embody the effectiveness of the public sector by reconstructing ministries. In particular, through the elimination of redundant ministries and enhanced inter-ministerial coordination. These adjustments are instrumental in promoting budgetary efficiency and, most importantly, optimizing government operations. Additionally, the budget must undergo necessary updates to address the evolving needs of the economy and incorporate permanent changes in security, health, welfare, and internal security. It is imperative for the government exercise fiscal responsibility, ensuring a deficit that does not surpass 5% of GDP.
10. It is crucial to note that unlike the global nature of the previous COVID-19 crisis, the current war is a localized event, prompting focused monitoring of Israel's activity. Therefore, responsible budgetary conduct is vital to maintaining investor confidence and trust. The economic recovery post-war will be different from the meteoric recovery from the COVID-19 crisis, which was due to the vaccinations, while the aftermath of the war is marked by considerable uncertainty, and the restoration of citizen's personal security and the full resumption of economy activity will be a protracted and gradual process. Another crucial aspect is the state of the high-tech industry, which is significantly different between the ongoing war and the COVID-19 pandemic. While the pandemic spurred global investments in digitization, benefiting the local high-tech industry sector, the current war, coupled with the global slowdown in high-tech is creating a disconcerting environment for investors. Notably, the initial three quarters of 2023 indicate a regression in investments to those observed in 2017-2019. Significant damage to the local high-tech industry poses a considerable threat to Israel's economic growth, given that this sector contributes 17% of the GDP.

11. In light of these challenges, including the significant apprehension that the objectives of the war will, including the full return of the abductees, may not be fully realized, it becomes crucial to underscore the necessity for adept responsible and professional economic management. This form of governance should surpass considerations confined to politics or specific sectors and actively contribute to fostering economic and social cohesion. Straying from such professional management immeasurably risks intensifying social and economic damage, diminishing public trust in the economy and off course that of investors, including credit rating agencies. A substantial decline in personal security, eroded public trust in state institutions, and a decline in the standard of living in Israel represent authentic threat to Israel's existence. These circumstances could prompt the departure of valuable human talent, posing the most significant risk to Israel's sustainability in the medium-to-long term, and it is imperative to take measures to eliminate this threat.