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Implications of Continuing the War on Israel's Economy—Three Scenarios

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In the tenth month of the Swords of Iron war, Israel stands at a crossroads in terms of the continued fighting in the Gaza Strip and the broader campaign against Iran and the "Axis of Resistance," which are directly involved in the conflict. Every decision about the future will undoubtedly have significant economic consequences, especially considering that the projected budget deficit for 2024 is expected to significantly exceed the forecast underlying the current state budget. This is further compounded by the impact of the war on defense spending, economic growth, foreign direct investment in Israel, its credit rating, and other critical parameters of economic resilience. This paper examines three scenarios: the continuation of the current situation, escalation on the northern front, and an agreement based on the proposed deal for the release of the hostages and cessation of fighting in Gaza. Among the conclusions of the comparative analysis of the scenarios is that Israel is expected to suffer long-term economic damage regardless of the outcome. The anticipated decline in growth rates in all scenarios compared to pre-war economic forecasts and the increase in defense expenditures could exacerbate the risk of a recession reminiscent of the lost decade following the Yom Kippur War. This situation will require further cuts in various government ministries and the allocation of funds to education, health, welfare, and infrastructure. When examining strategic alternatives, Israel must consider the expected heavy expenditures. Simply increasing the deficit could worsen the situation. In addition to raising taxes, which likely cannot be completely avoided, the government must reassess priorities and cut any unnecessary expenditures that do not support growth and the war effort.

Israel stands at a crossroads regarding the continuation of the war in the Gaza Strip and the broader campaign against Iran and the "Axis of Resistance," which are directly involved in the conflict. Every decision about the future will inevitably have major economic implications. This is especially critical given the starting point where the projected budget deficit for 2024 is expected to significantly exceed the forecast underlying the current state budget. This is further compounded by the war's impact on defense spending, economic growth, direct foreign investment in

Israel, its credit rating, and other critical parameters of economic resilience. This paper examines three scenarios:

1. Continuation of the Current Situation: Israel continues the war with varying intensity in the Gaza Strip while the fighting on the northern front continues in its current format—daily exchanges of fire, but without any major escalation.

2. Escalation in the North: This could lead to significant disruptions in the country. It is clear that it is difficult to predict where such an escalation, initiated by Israel, might lead. In a severe but plausible scenario, it could develop into a large-scale war on the northern front and even become multiple fronts, with involvement by Iran and other elements of the axis (proxy militias operating from Syria and Iraq, fire from Yemen, Iran, Iraq, and Syria, in addition to Hezbollah's missile and rocket arsenal, and of course, continued fighting in Gaza and daily activity in Judea and Samaria). However, for the purpose of analysis in this document, we assume a limited Israeli operation in the north, resulting in a high-intensity campaign lasting about a month against Hezbollah alone.

3. Agreement Based on the Proposed Deal for the Release of Hostages, Cessation of Fighting in Gaza in Its Current Format, and the Withdrawal of the IDF from the Strip: According to Hezbollah leader Hassan Nasrallah, this situation would also lead to a cessation of fighting on the northern border; in the short term afterward, an agreement might even be possible in which Hezbollah retreats beyond the Litani River, hopefully allowing residents of northern Israel to return to their homes.

Each of these scenarios has different strategic and economic implications. The analysis evaluates the economic implications of the fighting in each of the three scenarios, considering four key economic variables: economic growth (i.e., Israel's GDP growth rate); budget deficit; debt-to-GDP ratio; and risk premium, which represents the gap between the interest rate on Israeli government dollar bonds and the American equivalent. A larger spread indicates greater investor concern about Israel's ability to repay its debts. We will also try to estimate the growth, deficit, and debt-to-GDP ratio for 2025 in each scenario. The forecasts are presented in Table 1.

Table 1. Forecasts in the Three Different Scenarios (in percentages)

	Continuation of the current situation	**War in the North (one month of fighting)**	**Hostage deal and withdrawal from Gaza**
Growth rate 2024	1	Between -2 and -10	Between 1.5 and 2
Budget deficit 2024	8	Around 15	7
Debt-to-GDP ratio 2024	70	80–85	68–69
Risk premium	Between 1.75 to 2	Around 2.5	Between 1.3 to 1.5
Growth rate 2025	1	Between 5 to 7	4.6
Budget deficit 2025	6.5	10	6
Debt-to-GDP ratio 2025	74	Above 85	71

1. Continuation of the Current Situation

Before explaining our economic forecasts for the continuation of the current situation, Table 2 presents the forecasts for this scenario from the OECD, the Ministry of Finance, and the Bank of Israel.

Table 2. Growth and Deficit Forecasts from Various Economic Bodies Without War in the North (in Percentages)

	OECD (May)	**Ministry of Finance (June)**	**Bank of Israel (July)**
Growth rate 2024	1.9	1.9	1.5
Budget deficit 2024	6.6	5.2	6.6
Growth rate 2025	4.6	4.6	4.2
Budget deficit 2025	5.5	5.2	4

In light of the current situation, we anticipate only 1% GDP growth in 2024. (Given that Israel's population growth rate is 2%, a growth rate below this level implies a decrease in GDP per capita.) This growth rate is lower than the existing forecasts from the Bank of Israel, the Ministry of Finance, and international economic organizations. However, these organizations have recently been revising their forecasts downward on numerous occasions, so it is reasonable to cautiously expect this trend to continue. The same applies to the budget deficit and the debt-to-GDP ratio. We have taken additional precautions and initially estimated that these figures would be worse than those forecasts by various bodies. On this front, it appears that recent indicators regarding the deficit over the past 12 months, ten of which were during the war, align with the aforementioned forecast. At the time of writing, Israel's risk premium stands at 1.75**%**. The continuation of the current situation could further deteriorate the risk premium due to escalating security expenses, thereby increasing the deficit and the debt-to-GDP ratio. Israel's perception abroad will be that of an economically unstable country embroiled in an endless war, which will further diminish the appeal of Israeli risk assets.

The continuation of the current situation is expected to have negative consequences for 2025 as well. Growth is likely to remain low, around 1%, which still indicates negative per capita growth, while the budget deficit will continue to be high to fund security expenditures. These expenditures will negatively affect the debt-to-GDP ratio, which is expected to rise to 75%, potentially harming Israel's credit rating.

Additionally, the geopolitical and internal consequences of the ongoing state of war should be considered: Israel's international standing will continue to erode;

initiatives against it in international institutions will strengthen, along with fears of investing in Israel, especially in the sensitive high-tech sector. Internally, political and social disputes over the continuation of the war, the failure to return the hostages, and the lack of accountability of the political and military leadership for the October 7 disaster will intensify. As experienced during 2023, internal tensions will have a major impact on investors' readiness to invest in Israel, its credit rating, and the extent of Israelis leaving for abroad—many from sectors of high productivity with real and convenient options for working abroad.

Economic parameters should also include the effects of the strain on reserve soldiers, most of whom belong to productive sectors of the economy. Self-employed businesses will struggle to survive, employees may lose their jobs, and businesses will significantly decline in productivity due to the additional calls for reserve service, in addition to the many months reserve soldiers have served since the beginning of the war.

2. A Month of High-Intensity War in the North

It is difficult to predict how a high-intensity campaign against Hezbollah in Lebanon will develop and whether it can be contained to just one month and one arena. However, even a month of high-intensity warfare in the north against Hezbollah alone, with unprecedented intensive attacks on the Israeli home front, presents an unfamiliar scenario. Furthermore, predicting the consequences of such a war is challenging and depends on various factors.

One significant factor is how effectively Israel can intercept threats and minimize damage to the home front, especially strategic facilities and national infrastructure. Ukraine provides a recent example of a country experiencing ongoing damage to its home front during war. In the first year of the war that began in February 2022, Ukraine experienced a contraction of about 30% of its GDP. However, that war started in the first quarter of the year, continued throughout the year, and involved Russian military operations within Ukraine's territory.

In contrast, this analysis considers a war that would start in the third or fourth quarter of the year, with the ability to intercept some threats. Under these conditions, it is estimated that in the worst-case scenario of high-intensity warfare causing infrastructure damage, the Israeli economy could contract by up to 10% of GDP in 2024. In the best-case scenario, if Israel can neutralize a significant portion of the threats and minimize damage, the GDP could contract by about 2% (according to the Aaron Institute's forecast from December 2023).

It is easier to forecast the impacts on the budget deficit, debt-to-GDP ratio, and risk premium. The deficit would dramatically increase to about 15% to finance the war and support daily needs, including food and drink supply, transportation, and shelters. It should be noted that a contraction in GDP combined with large government expenditures will result in a debt-to-GDP ratio of around 80%–85%. The risk premium during a month of war is expected to surge to 2.5%, making fundraising more challenging. However, this is anticipated to change at the end of the war, depending on the outcomes.

Regarding the long-term economic consequences of a war in the north, it is important to emphasize the following:(1) Any increase in the risk premium leads to a significant rise in interest payments on Israel's public debt. For example, a permanent increase of one percentage point in the interest rate on public debt results in an additional payment of over 10 billion NIS per year (similar to the current welfare budget); (2) Reducing the debt-to-GDP ratio to the recommended level of 60% is a challenging task that could take more than a decade. The last time Israel's debt-to-GDP ratio exceeded 80% was during the Second Intifada when it reached 93% in 2003. The reduction of this ratio was slow, despite many years of accelerated growth, and it only reached 60% in 2017.

Looking ahead to 2025, we can expect significant growth due to two factors: increased government spending on reconstruction efforts and a return to normalcy, assuming that the conflicts in the south and north end and bring calm in 2025. Therefore, a double-digit deficit in that year should be viewed as a positive sign of government investment in construction and repairs, similar to the heavy public spending during the COVID-19 crisis, which resulted in a deficit of about 11% but led to substantial growth of 8.6%. However, it is important to note that some of the increase in public expenditure will come at the expense of private consumption, as the government will need to raise taxes, reduce direct support for various population groups, and the Bank of Israel will be expected to maintain high interest rates to combat inflation.

3. Hostage Deal and Withdrawal from Gaza with Calm on the Lebanon Border

Given that the war has been ongoing for eight months into 2024, an immediate withdrawal from Gaza will have a limited impact on the annual data. Nominal growth is expected to be around 2% of GDP, resulting in zero per capita growth. The budget deficit and debt-to-GDP ratio will slightly improve compared to continued fighting because security expenses are likely to remain high in the foreseeable future. Even with a ceasefire, the military will need to adjust its defense posture and build strength for potential future conflicts.

A hostage deal and withdrawal from Gaza are unlikely to bring Israel's risk premium back to pre-October 2023 levels. The understanding that Israel is less safe and stable than before the war will likely keep the risk premium between 1.3% and 1.5%, compared to the pre-war level of 0.8%. Assuming a deal is reached and the IDF exits Gaza, stability is expected to return in 2025, allowing for healthy growth of 4.6%, possibly even higher. This growth is necessary to recover from two consecutive years of negative per capita growth. However, the debt-to-GDP ratio is not expected to drop below 70% due to a large deficit in 2025, which will be allocated to rebuilding the south and north of the country and replenishing military supplies.

In the short term, the end of the war and a potential resolution in the north could lead to a more positive investment climate in Israel and the full return of many reservists to work, which may have a positive impact on growth. However, renewed internal political disputes, particularly regarding the accountability of senior military and political figures, may reintroduce internal instability, affecting economic activity.

Conclusions

1. No Significant Difference Between the Scenario of Continuing the Current Situation and the Scenario of Ending the War: Even if the war ends in the summer of 2024, we do not expect to see significant growth in GDP or a reduction in the deficit this year. The significant shift is expected in 2025, where the potential for growth, without ongoing conflict, is expected to improve substantially. However, the immediate economic effect of ending the fighting is likely to be seen mainly in the risk premium. International markets always penalize uncertainty and reward efforts to end conflict. Therefore, under the current situation, the risk premium is expected to be close to 2%, while ending the conflict should bring it below 1.5%. In contrast to these scenarios, a month-long war in Lebanon could dramatically affect all economic indicators.

2. Inability to Predict the Northern Front: The war scenario, assuming an optimistic outlook with threat neutralization and an end mechanism (as per the Aaron Institute scenario from December 2023), is fundamentally different from a pessimistic scenario involving difficulty maintaining routine in the home front and a lack of an end mechanism leading to a

prolonged war of attrition. The question arises: which scenario should decision-makers consider before deciding on a full-scale war in the north?

3. Israel's Risk Premium: Israel's risk premium has risen in a way that significantly increases the cost of raising capital. Even in the case of a hostage deal and a ceasefire in the north and south leading to total calm, it is difficult to envision a situation where Israel's risk premium returns to its pre-war levels. It will likely take Israel some time to bring the risk premium back to the levels of 0.7% that characterized recent years. This does not mean that Israel will be unable to raise funds in international markets—Israel still manages to attract investors. However, the cost Israel will have to pay to lenders for taking on risk has increased significantly and will raise the debt repayment item in the national budget in the coming years.

4. Long-Term Economic Damage: The expected reduction in growth across all scenarios, compared to pre-war economic forecasts, and increased security spending could exacerbate the risk of a recession, leading to economic problems reminiscent of the lost decade following the Yom Kippur War. This situation will require additional cuts in various government ministries, with reduced funding for education, health, welfare, and infrastructure, which are intended to improve economic productivity in Israel.

Recommendations

1. Long-Term Economic Preparation: Decision-makers preparing for strategic and political changes following the war must also anticipate a different economic reality. Long-term economic planning must consider a new economic reality characterized by lower growth, larger deficits, increased future debt payments, possible changes in international trade, changes in human capital due to more reserve duty days and potential brain drain, and lower tax revenues.

2. Assumptions for Northern War: It is important to consider severe conditions for a northern war. The risk of a multi-front war of attrition, where the opposing side has no incentive for a ceasefire, is the most serious. From an economic perspective, preparation cannot be based on familiar aspects of previous Israeli wars but must examine much more severe cases of economies severely impacted by domestic warfare. Additionally, it is not certain that the strategic benefits of such a war will outweigh the damage caused. Therefore,

from an economic standpoint, this scenario is undesirable, and alternative exit strategies should be preferred.

3. Funding Anticipated Heavy Expenses: It is crucial to start funding the anticipated heavy expenses alongside ongoing efforts now. Simply increasing the budget deficit could worsen the situation and should be combined with exploring other options before resorting to unavoidable tax increases. As a first step, the government should reassess its priorities and eliminate unnecessary spending that does not support growth and the war effort, starting with closing unnecessary government offices and canceling sectoral budget allocations that do not enhance labor productivity and economic growth.

4. Controlled Increase in Security Spending: Regardless of the scenario, we anticipate a significant increase in Israel's military expenditures in the foreseeable future. This increase must be controlled. Any substantial rise in the budget can easily become wasteful and inefficient. It is important that additional spending is directed toward the right needs. Therefore, meaningful discussions are needed among policymakers, generals, and economists, all aiming to achieve the best strategic benefit from the optimal use of resources.