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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.

Professor Amir Yaron

A handwritten signature in blue ink that reads "A. Yaron". The signature is written in a cursive style with a large, stylized initial "A" and a long, sweeping underline.

Governor of the Bank of Israel

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Chapter 1

The Economy and Economic Policy During the War

- » The intensity of the military conflict declined in 2025 compared with 2024.¹
- » Gross Domestic Product (GDP) grew by 2.9 percent this year, marking an increase relative to the 1.0 percent growth recorded in 2024. The main factor restraining faster expansion was the labor supply constraint, although this eased over the course of the year, particularly following the ceasefire in Gaza.
- » The labor supply constraint—largely reflecting the high share of reservists and the absence of Palestinian labor—resulted in a tight labor market characterized by exceptionally low unemployment and a high number of job vacancies. Consequently, wages in the business sector rose at a rapid pace, and the GDP labor share increased.
- » Inflation moderated to 2.6 percent in 2025, within the target range and below the previous year’s level. The decline in inflation was supported by monetary policy measures and the appreciation of the shekel against the US dollar, which was largely supported by a reduction in Israel’s risk premium—mainly due to security developments and fiscal restraint—as well as by the global weakening of the dollar.
- » Given that inflation remained above target for much of the year, alongside supply constraints and heightened uncertainty surrounding the course of the conflict, the Bank of Israel maintained its policy interest rate until November.
- » In November, due to the moderation of inflation and inflation expectations, and in view of the ceasefire agreement in Gaza, the Monetary Committee reduced the interest rate to 4.25 percent. The appreciation of the shekel, continued security calm, and initial signs of easing in the tightness of the labor market led to a further reduction of the interest rate in January 2026 to 4.0 percent.
- » The reduction in the intensity of hostilities was accompanied by the Israeli equity market outperforming global markets, an increase in venture capital raised in the high-tech sector, narrowing corporate bond spreads, and an expansion of credit.
- » The government budget deficit narrowed during the year but remained elevated, reflected in a continued rise in the debt-to-GDP ratio, which reached 68.5 percent. The improvement in the deficit was made possible by tax increases and stronger-than-expected revenues from direct taxes.
- » The housing market was characterized by an expansion in supply alongside a decline in demand. Construction starts and land marketing activity were robust. Transaction volumes declined, and housing prices fell during most months of the year before rebounding toward the end of the year.
- » Given expectations that the economic impact of the war will persist even after its conclusion, it is essential that the government formulate a multiyear fiscal strategy aimed at reducing the debt-to-GDP ratio while adequately addressing growing security and civilian needs and supporting sustainable economic growth.

¹ Following the period covered by the Report, in February 2026, the intensity of combat again increased with the start of Operation Roaring Lion – a military operation carried out against Iran.

2.9%

GDP grew this year in view of the reduced intensity of the war

35
thousand shekels

Impact to per capita income as a result of two years of war



Nominal **business sector wage increased** by **4.2%**, in view of the tight labor market



Inflation declined this year to **2.6%**, within the target range

↑68.5%

The **debt to GDP ratio increased** for the third consecutive year



The **risk premium declined** during the year as the shekel appreciated

4.5%

The **interest rate remained unchanged** for most of the year, and was reduced following the ceasefire



Policy must combine reducing the debt ratio with a response to increased **civilian & defense needs**

1. MAIN POINTS AND ECONOMIC BACKGROUND CONDITIONS

a. Main domestic developments

The year 2025 marked the second year of the war that began on October 7, 2023. During the year, the intensity of the fighting subsided compared with the previous year. Following Operation Rising Lion² in June, and particularly after the ceasefire in Gaza that took effect in October, Israel's risk premium in financial markets declined to slightly above its prewar level. Likewise, the contraction in labor supply—which was largely due to the broad mobilization of reservists and the partial and gradual replacement of Palestinian laborers with foreign workers—moderated. These developments were reflected in an acceleration of GDP growth—especially in business-sector output—and in a moderation of inflation.

For the year as a whole, GDP grew by 2.9 percent, compared with 1.0 percent in the previous year, while annual inflation eased to 2.6 percent in December, within the target range, before declining further toward the midpoint of the target range in January 2026.

Due to the only moderate increase in labor supply, the labor market remained tight in 2025, characterized by low unemployment, a high number of job vacancies, and rapid wage growth in the business sector for most of the year. The economy's

Due to the slow growth in the labor supply, the labor market was tight in 2025 as well.

² The Israeli campaign against Iran that took place from June 13–25, 2025.

resilience was also evident in other indicators, including a notable increase in exports—particularly high-tech services exports—which grew at a strong pace and maintained a surplus in the goods and services account despite a significant rise in imports. The shekel appreciated markedly, and the Israeli stock market delivered outstanding performance relative to global markets. The credit market also expanded, both for households and businesses, while bond issuance spreads and the share of impaired credit remained low.

Alongside this resilience, the war continued to leave its mark on the economy. Overall GDP, and business sector output in particular, remained below their long-term trends (2014–2019), with the gap narrowing during the second half of 2025. The government deficit grew during the war, leading to a significant increase in the debt-to-GDP ratio. Beyond human physical and psychological injuries, the conflict also caused material damage in northern border areas and in the Gaza periphery, the costs of reconstruction of which will accompany the economy in the coming years.³

The economy's strong starting position—characterized by a moderate public debt-to-GDP ratio of 60 percent at the onset of the war, full employment, high foreign exchange reserves, inflation converging toward the target with well-anchored expectations, and financial robustness—enabled Israel to withstand the ongoing economic and security challenges. The debt-to-GDP ratio rose by more than eight percentage points during the war and the fiscal deficit surged—contributing to a credit rating downgrade in 2024 and, together with labor supply constraints, to a delay in returning inflation to its target. Yet despite these, and thanks to the economy's strong position at the outset of the war, the economy's underlying strength and the business sector's resilience, the Bank of Israel's policy actions since the outbreak of the war, and the government's fiscal consolidation measures in the 2025 budget, the financial market's confidence in the Israeli economy was preserved, particularly as hostilities subsided during 2025.

The economy's strong starting position enabled it to withstand the ongoing economic and security challenges.

b. The price of the war in terms of GDP and well-being

The economic and welfare cost of the war can be assessed by examining the deviation of output from the trend path that characterized the Israeli economy in the years preceding both the COVID-19 pandemic and the war—namely, 2014 to 2019. During those years, Israel did not experience a major macroeconomic shock such as a pandemic or large-scale conflict, and it is evident that following the disruption caused by COVID-19, the economy largely reconverged to that precrisis trajectory.⁴

In 2025 on average, the deviation of GDP from its trend line was -3.7 percent. The cumulative deviation since the beginning of the war totaled -8.6 percent of annual GDP (NIS -175 billion). In contrast, the deviation of business sector output (excluding

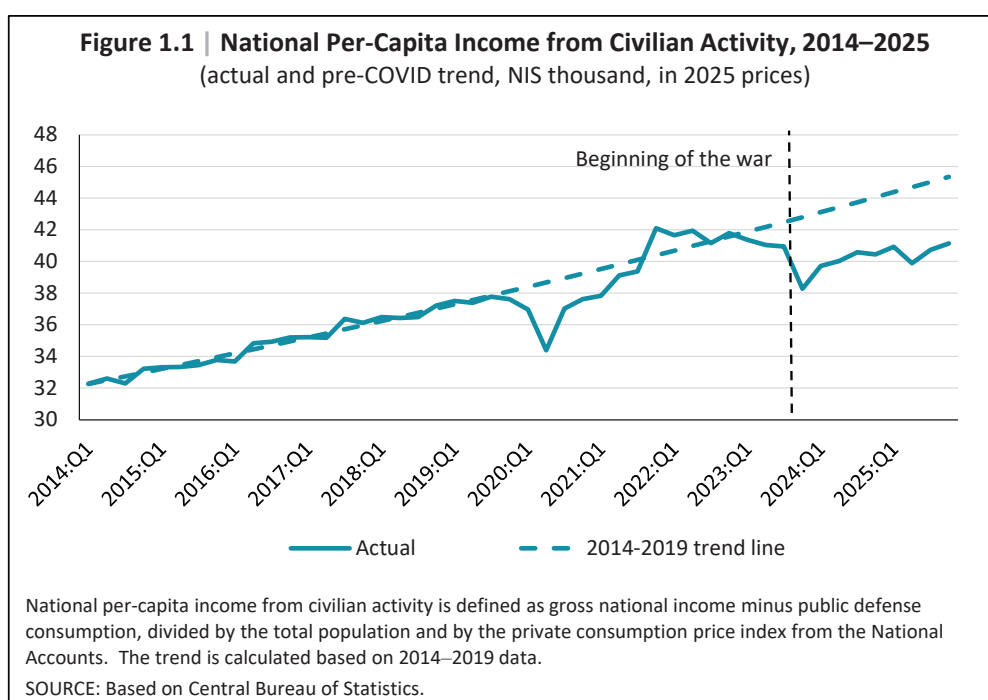
The cumulative deviation of GDP since the beginning of the war totaled -8.6 percent of annual GDP.

³ See, for example, the discussion on the increase in mental health needs due to the war in Chapter 7 of this Report, and the discussion on reconstruction expenditures in Chapter 6.

⁴ Between 2014 and 2019, average annual growth was 3.8 percent for GDP, 4.2 percent for business-sector output, and 1.8 percent for per capita GDP.

public activity—particularly defense) from its own trend line stood at -4.5 percent, and the cumulative deviation since the beginning of the war was -11.1 percent of annual business sector output (Figure 2.1 in Chapter 2 of this Report).

While the above estimates relate to the war’s impact on production—measured by Gross Domestic Product—the economic impact of the war can also be assessed from the perspective of citizens’ welfare. For this purpose, several adjustments are necessary relative to the GDP measure, as presented in Table 1.1 below. In order to obtain a proximate measure of the impact to civilian welfare, we use Gross National Income (GNI) instead of GDP. Unlike GDP, GNI does not include net payments to foreign factors of production, which increased during the reviewed period at a more rapid pace than GDP.⁵ We then subtract public defense consumption, which increased greatly during the war, from GNI. While public defense consumption is included in GDP and in income, the change in welfare value that results from comes directly the war itself. These two adjustments increase the measured impact relative to what is reflected by GDP, from NIS 175 billion to about NIS 375 billion over the nine quarters of the war.⁶



⁵ In contrast with GDP, GNI neutralizes the profits of multinational corporations operating in Israel, as well as payments to non-Israeli workers. Historically, the differences between these two measures have not been large. However, in the past two years, the level of activity of multinational firms in Israel has increased greatly.

⁶ For the purpose of this analysis, we move to real terms by dividing by the private consumption price index (from the National Accounts).

Table 1.1 | Economic Indicators by International Comparison, 2019–2025

	percent						
	2019	2020	2021	2022	2023	2024	2025
Global GDP (annual rate of change)	3.0	-2.7	6.6	3.8	3.5	3.3	3.3
World trade (annual rate of change)	0.5	1.1	7.0	-2.8	1.5	3.3	4.9
MSCI AWCI equities index	24.0	14.3	16.8	-19.8	20.1	15.7	20.6
a. US							
Per capita GDP (annual rate of change)	2.1	-2.6	5.9	1.9	2.0	1.8	1.6
Average annual unemployment rate	3.7	8.1	5.4	3.6	3.6	4.0	4.2
Inflation in December	2.3	1.4	7.0	6.5	3.4	2.9	2.7
Central bank interest rate in December	1.75	0.25	0.25	4.50	5.50	4.50	3.75
S&P 500 equities index	28.9	16.3	26.9	-19.4	24.2	23.3	16.4
b. Eurozone							
Per capita GDP (annual rate of change)	1.4	-6.2	6.4	3.4	0.0	0.5	1.3
Average annual unemployment rate	7.6	8.0	7.8	6.8	6.6	6.4	6.4
Inflation in December	1.3	-0.3	5.0	9.2	2.9	2.4	2.0
Central bank interest rate in December	-0.5	-0.5	-0.5	2.0	4.0	3.0	2.0
MSCI Europe equities index	22.2	-5.4	22.4	-11.9	12.7	5.8	16.3
c. Israel							
Per capita GDP (annual rate of change)	1.7	-3.4	7.6	4.4	0.1	-0.3	1.7
Average annual unemployment rate	3.8	4.4	5.0	3.8	3.4	3.0	3.0
Inflation in December	0.6	-0.7	2.8	5.3	3.0	3.2	2.6
Central bank interest rate in December	0.25	0.10	0.10	3.25	4.75	4.50	4.25
Tel Aviv 125 equities index	21.3	-3.0	31.1	-11.8	4.1	28.6	51.0

SOURCE: Based on Bloomberg and Central Bureau of Statistics.

Finally, in order to focus on civilian welfare, and due to the slowdown in the population increase compared with the baseline period (2014–2019), we work in per capita terms—hereinafter: “per capita income from civilian activity” (Figure 1.1). According to the indicator’s gap from its trend line, the loss of income reflecting a per capita welfare loss over the nine quarters of the war (up to the end of 2025) was about NIS 35,000 (an average of about NIS 3,900 per quarter). It is worth pointing out that this does not mean that every individual in the population paid this amount out of his or her pocket. Most of it was paid by the government (partly in payments to reservists) through an increase in public debt, which the public will need to repay in the future with interest.

The total welfare loss as a result of the war amounts to about NIS 35,000 per capita over 9 quarters.

c. Main global developments

Global GDP grew at a pace similar to last year, despite policy measures aimed at protecting domestic production.

The global economy maintained relative stability during the year. Global output grew at a pace similar to that of the previous year, while world trade accelerated (Table 1.1).⁷ This occurred despite the significant tariff increases introduced by the United States during the year, which led to volatility in world trade. At the same time, the global inflation environment moderated, prompting most central banks to lower their policy interest rates.

In addition, global equity markets continued to record substantial gains, extending the trend of the past two years, and there was a weakening trend of the US dollar globally.

2. THE MACROECONOMIC ENVIRONMENT

a. Macroeconomic activity during the year

Gross Domestic Product (GDP) grew by 2.9 percent this year, while business sector output expanded at a slightly faster pace of 3.2 percent. As in the previous year, the Israeli economy continued to operate below its past trends (Figure 2.1 in Chapter 2, orange line), which was also reflected in other indicators such as the tight labor market.

Despite a marked increase in imports, exports grew at a high rate, keeping the goods and services account in surplus.

Domestic uses grew at an annual rate of 3.7 percent this year. Given the prevailing supply constraints, much of the additional demand was met through a substantial increase in imports. This rise in imports was reflected in declines in the surplus in the goods and services account and in the current account of the balance of payments.

The labor market remained tight, with a low unemployment rate and a high number of job vacancies. These conditions resulted in an exceptionally high ratio of job vacancies to unemployed persons (Figure 1.2, grey line). Consequently, wages in the business sector rose rapidly, and the GDP labor share increased. (See Figure 5.13 in Chapter 5.)

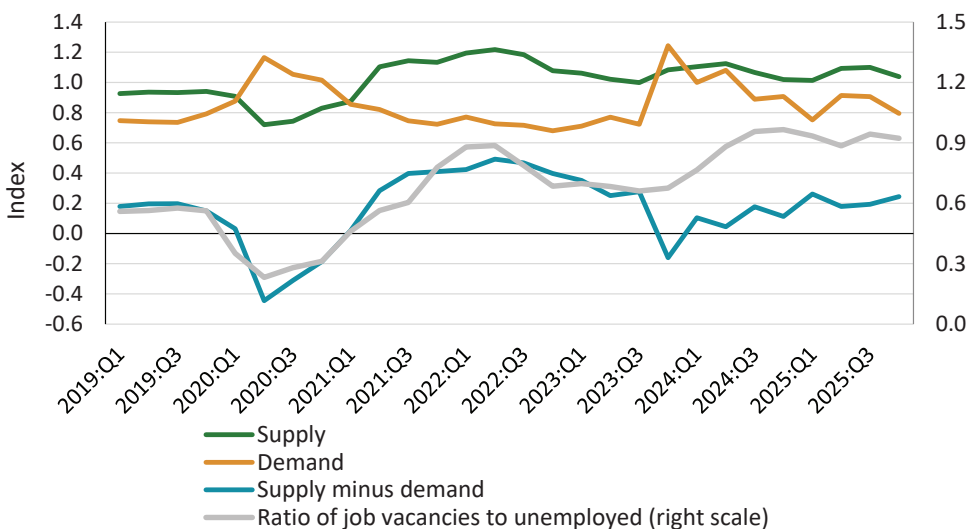
The twelve days of Operation Rising Lion led to a broad shutdown of economic activity, but the economy recovered swiftly.

The twelve days of Operation Rising Lion led to a broad shutdown of economic activity, and were reflected in negative growth during the second quarter. However, the economy recovered swiftly and expanded rapidly in the third quarter. Overall, this period of combat reduced annual growth by approximately 0.3 percentage points. (For details, see Box 2.3 in Chapter 2 of this Report.)

While total private consumption grew slightly less than GDP (Table 1.2) current consumption grew at a similar pace to GDP. Private consumption was positively affected by the sharp increase in the value of financial asset portfolios and the

⁷ An important—though not the main—component in the expansion of world trade this year was the increase in investments in high-tech and in chips—which is apparently connected to the development of AI.

Figure 1.2 | Supply and Demand Constraints, the Gap Between Them, and the Ratio of Job Vacancies to the Unemployed, 2019–2025



The constraint indices are based on the Central Bureau of Statistics Business Tendency Survey. The ratio of job vacancies to the unemployed is net of the 0.5 natural rate. The methodology is detailed in Ilek and Mazar (2025).

SOURCE: Based on Central Bureau of Statistics.

expansion of credit supply, but negatively influenced by the decline in disposable income due to higher tax rates and by the rise in real interest rates during the year.

Goods and services exports (excluding diamonds and startups) increased by 5.9 percent (Table 1.2). Goods and services imports (excluding defense, ships and aircraft) expanded at a rapid pace of about 8.8 percent, providing the sources needed to meet growing demand that could not be satisfied domestically due to supply constraints.

After two consecutive years of decline, fixed capital formation (excluding ships and aircraft) grew strongly by about 8.4 percent (Table 1.2). However, investment in business sector industries—excluding investments by the general government, which include defense equipment imports among other things—rose at a more moderate rate of only 3.8 percent. Despite the increase in investment this year, investment at the end of 2025 remained below its prewar level, mainly due to low investment in construction.

Table 1.2 | Main Developments, 2020–2025

	2015–2019 average	2020	2021	2022	2023	2024	2025
Population (yearly average, million)		9.2	9.4	9.6	9.8	10.0	10.1
Nominal GDP (NIS billion, current prices)		1,415	1,582	1,764	1,883	2,006	2,111
Per capita GDP (NIS thousand, current prices)		151.7	166.9	182.7	191.2	201.2	208.9
GDP (real rate of change, percent)	3.7	-1.8	9.3	6.4	2.1	1.0	3.1
Per capita GDP (real rate of change, percent)	1.9	-3.4	7.6	4.4	0.1	-0.3	1.7
Private consumption (real rate of change, percent)	4.2	-7.3	11.1	7.3	-0.6	3.9	2.6
Fixed Capital Formation (real rate of change, percent)	5.2	-2.5	13.6	11.1	-2.1	-5.5	8.1
Public consumption (real rate of change, percent) ^a	3.7	2.2	4.9	1.1	7.5	9.4	2.0
Goods and services exports (real rate of change, percent) ^b	3.6	-0.6	12.2	10.2	0.0	-3.7	6.1
Goods and services imports (real rate of change, percent) ^c	5.5	-5.2	18.0	12.4	-6.9	-2.2	8.2
Current account of the balance of payments (surplus, \$ billion)		15.6	15.1	14.4	16.1	15.8	8.9
Overall government deficit (percent of GDP) ^d	3.0	11.4	5.2	1.9	7.1	9.0	5.2
Gross Public debt (percent of GDP, end of year)	61.5	71.1	67.8	60.5	61.3	67.6	68.6
Employed Israelis aged 15+ (yearly average, rate of change, percent)	2.4	-1.3	1.1	5.8	3.3	1.2	1.5
Nominal wage per employee post (yearly average, rate of change, percent)	2.6	6.5	2.5	2.8	6.2	5.7	3.1
Unemployment rate, aged 15 and up (yearly average, percent)	4.7	4.4	5.0	3.8	3.4	3.0	3.0
Job vacancy rate (yearly average, percent)	3.4	2.4	4.5	4.8	3.8	4.4	4.4
Inflation (December compared to the previous December, percent)	0.1	-0.7	2.8	5.3	3.0	3.2	2.6
Bank of Israel interest rate (yearly average, percent)	0.2	0.14	0.10	1.25	4.50	4.50	4.48
Bank of Israel interest rate (last figure in the period, percent)	0.2	0.10	0.10	3.25	4.75	4.50	4.25
Real one-year interest rate (yearly average, percent)	-0.5	0.1	-1.9	-1.4	1.6	1.3	2.3
Real one-year interest rate (last figure in the year, percent)	-0.3	-0.5	-2.5	1.0	1.1	2.0	2.3
Nominal yield on 10-year government bonds (yearly average, percent)	2.0	0.8	1.2	2.6	3.9	4.7	4.3
Real yield on 10-year government bonds (yearly average, percent)	0.5	-0.5	-0.8	0.1	1.2	2.0	2.0
Real effective exchange rate (yearly average, percent rate of change) ^e		-3.6	-4.9	0.1	9.2	-0.5	-5.6
NIS/\$ exchange rate (yearly average)		3.44	3.23	3.36	3.69	3.70	3.45
Tel Aviv 125 index ^f	5.0	-3.0	31.1	-11.8	4.1	28.6	51.0
World Trade (rate of change, percent)	3.2	-8.3	10.8	5.8	1.0	3.6	4.1

^a Excluding defense imports.

^b Excluding diamonds and startups.

^c Excluding defense imports, ships, aircraft, and diamonds.

^d The broad government is comprised of the government itself, the National Insurance Institute, the national institutions, the local authorities, and nonprofit organizations whose main source of income is the government. Its activity is measured in accordance with National Accounts definitions, which differ from those used in the State budget.

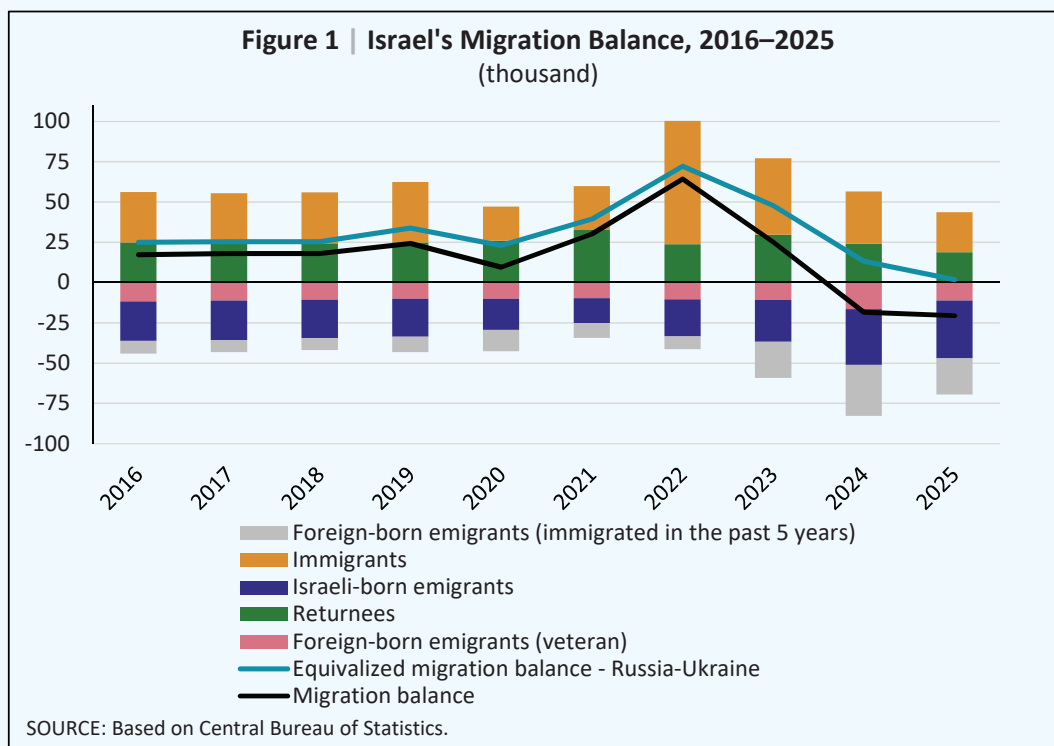
^e Relative to the same period in the previous year, (-) refers to depreciation of the shekel

^f Nominal rate of change - last day of December compared with the last day of the previous December

SOURCE: Based on Central Bureau of Statistics and International Monetary Fund.

BOX 1.1: THE BALANCE OF MIGRATION

During 2024–2025, the number of Israelis leaving the country¹ rose markedly, and the country’s migration balance turned negative—averaging around 20,000 people per year, compared with a positive migration balance averaging roughly 20,000 per year during 2016–2019, a difference of about 40,000 individuals (see Figure 1).



A significant portion of the increase in departures was due to the relatively rapid emigration of immigrants who had arrived in Israel due to the Russia–Ukraine war, many of whom viewed their stay as temporary refuge. Excluding short-term immigration of this kind, the gap between the 2016–2019 average and the past two years narrows to about 20,000: a positive migration balance of approximately 27,000 per year in 2016–2019, compared with an average of 7,500 in 2024–2025.

¹ According to the Central Bureau of Statistics (CBS), a resident is defined as having “left” the country if two conditions are met: (a) the individual remained abroad continuously for at least three months immediately following departure; and (b) the individual spent at least 275 days abroad within one year from the date of departure. The determination of migration status takes place one year after the initial departure or entry, and the date recorded refers to the determination of migration—not the initial departure. For example, the figures for 2025 refer to emigrants who actually left in 2024.

This reduction reflects an increase of roughly 10,000 in the number of native-born Israelis emigrating, alongside a decline of about 7,000 among immigrants and returning residents. It is still too early to determine whether the negative shift in the migration balance is a temporary phenomenon related to the war or indicative of more persistent factors.

From a labor market perspective, focusing on adult emigrants minus new immigrants (approximately 14,000), multiplied by the overall employment rate for individuals aged 15 and over (61.1 percent), yields an estimate of about 9,000 employed persons who left Israel, on average, in each of the past two years—beyond the average net outflow observed during 2016–2019 (for further details, see Chapter 5).

The negative migration balance also moderated housing demand, as roughly 10,000 more households (net) left Israel on average during 2024–2025 than during 2016–2019. (See Chapter 8 for details.)

b. The labor market

The supply constraints due to the war were reflected in a decline in labor force participation rates, in the high number of mobilized reservists, and in the low number of non-Israeli workers.

In 2025, as a result of increased demand for workers and persistent supply constraints resulting from the war, the labor market remained tight. These constraints were reflected in low labor force participation rates relative to the prewar period—partly attributable to the direct effects of the war⁸—and in a shortage of non-Israeli workers (Tables 1.2 and 1.3). Together, these factors accounted for approximately 70 percent of the total decline in employment. The absence of reservists from civilian work explains an additional 20 percent of the decline, with about 10 percent attributable to negative net migration.⁹

Table 1.3 | Labor Force Participation, Unemployment, and Employment Rates, 2019–2025

	2019	2020	2021	2022	2023 (prewar average)	2023 (4th quarter)	2024	2025	percent 2025 (4th quarter)
Ages 15+									
Labor force participati	63.5	61.8	61.8	63.3	63.8	62.6	62.7	62.7	62.9
Narrow unemploymer	3.8	4.4	5.0	3.8	3.8	3.2	3.0	2.9	3.1
Employment rate	61.1	59.1	58.7	60.9	61.4	60.6	60.8	60.9	61.0
Ages 25–64									
Labor force participati	80.4	79.2	79.4	81.2	81.6	80.6	80.7	81.0	81.3
Narrow unemploymer	3.4	3.8	4.6	3.3	3.1	2.7	2.8	2.7	2.8
Employment rate	77.7	76.2	75.7	78.6	79.1	78.4	78.4	78.8	79.0

SOURCE: Based on Central Bureau of Statistics Labor Force Survey.

⁸ As detailed in Chapter 5, part of the decline in participation reflects young people who transitioned directly from regular military service to reserve duty, spouses of mobilized soldiers, war casualties, and evacuees—all of whom reduced their labor supply as a result of the war.

⁹ For further details, see Table 5.2 in Chapter 5 of this Report.

The continued tightness in the labor market led to further wage increases for Israeli employees in the business sector in 2025. In the fourth quarter of 2025, wages were 4.6 percent higher in nominal terms and 2.0 percent higher in real terms compared with the same quarter of the previous year. Wage growth was broad-based across all industries within the business sector, and was particularly pronounced in industries where employment is concentrated among large employers (Figure 5.14 in Chapter 5). The high-tech sector stood out with especially strong wage gains.

Business sector wages increased by about 4.6 percent during the year.

Following a period of decline and stabilization in 2024, the GDP labor share in the business sector rose during 2025. While real wages in the business sector have cumulatively increased by about 18 percent since 2019, real wages in the public sector have remained at roughly their 2019 level. For a detailed discussion of the widening wage gap between the business and public sectors, see the section on this issue later in the chapter, as well as Chapters 5 and 6.

Real wages in the public sector remained at the 2019 level, while business sector wages have increased since then by 18 percent.

To analyze employment developments since the onset of the war, employee data can be separated into five categories: total employment, total employment in the business sector, total Israeli employment, and total Israeli and non-Israeli employment in the business sector. A comparison of these groups with the 2014–2019 trend lines indicates that in 2025, the main shortage of workers was concentrated in the business sector (Table 1.4).

Table 1.4 | Increase and Shortage in Employment, 2025

	2025 average compared to prewar level	Average annual growth rate, 2014–2019	2025 average ^a compared to trend line ^b
Total employed persons	0.9	2.1	-3.2
<i>of which:</i> Israeli	3.1	2.0	-1.2
Total employed in the business sector	-1.4	1.9	-5.0
<i>of which:</i> Israeli	0.8	2.0	-3.4

^a Average excluding 2025:Q2

^b The left column minus twice the middle column is approximately the right column.

SOURCE: Based on National Accounts data and the Labor Force Survey.

Compared with the development of business sector output, the shortage of employees was more pronounced. This is because non-Israeli workers—whose numbers declined significantly—tend, on average, to have lower labor productivity than Israeli workers.

Looking ahead, part of this shortage is expected to persist in the coming years, primarily due to reserve duty mobilization levels that are projected to remain elevated relative to the prewar period, as well as the reduced work capacity of the many individuals affected by the war.

c. Fiscal policy

The government deficit remained high and the debt-to-GDP ratio increased.

The budget deficit was similar to the original forecast, despite expenditure overruns.

Due to the continuation of the war and elevated defense expenditures¹⁰, the government deficit remained high in 2025, and the debt-to-GDP ratio increased for the third consecutive year. Public expenditure as a share of GDP was similar to that of 2024 and about 5 percentage points higher than its average during 2015–2019. Likewise, defense spending as a share of GDP remained broadly unchanged from last year, despite the decline in the intensity of the conflict.

The fiscal deficit in 2025 amounted to approximately 4.7 percent of GDP—two percentage points lower than in 2024. The deficit was broadly in line with the original forecast despite expenditure overruns, as these were offset by stronger-than-expected revenues. Despite the reduction in the deficit ratio relative to 2024, the debt-to-GDP ratio rose to 68.5 percent in 2025.

Israel entered the war with a debt-to-GDP ratio of 60 percent—a fiscal buffer that enabled the economy to withstand two years of conflict without losing market confidence. The sharp increase in the debt ratio during the war underscores the importance of maintaining fiscal space for emergency situations.

Compared with 2024, the main source of the deficit reduction this year was higher tax revenues. The tax-to-GDP ratio increased due to legislative changes and hikes in statutory tax rates introduced to help finance the war (estimated prior to the legislation at 1.5 percent of GDP¹¹), as well as an additional, unexpected increase of about one percent of GDP in direct tax receipts—much of it originating from the financial sector.

Despite the high level of the deficit, the adjustments the government made while the war was ongoing contributed to the reduction of the deficit relative to the previous year and to maintaining market confidence, and also supported the decline in Israel’s risk premium during the year, and contributed to the narrowing of bond yield spreads vis-à-vis the United States (Figure 1.4). This was largely because the magnitude of the permanent tax increases was in line with the expected rise in government expenditures in the coming years, following the end of the war.

Although the deficit declined relative to the previous year—implying that fiscal policy in 2025 was more contractionary than in 2024 (for details on the fiscal impulse and its contribution to growth, see Box 2.1)—the deficit nevertheless remained above the structural level that stabilizes the debt-to-GDP ratio (estimated at 3.2 percent) and above the prewar deficit. From this perspective, war-related expenditures continued to contribute to elevated domestic demand.

¹⁰ Additional government expenditures related to the war, according to the data available up to the end of 2025, are expected to total approximately NIS 350 billion over the years 2023–2026. (See Table 6.2 for details.)

¹¹ For further discussion of the distributional impact of the statutory tax rate increases across household income groups, see Box 6.2 in Chapter 6 of this Report.

d. Inflation and the exchange rate

In 2025, the Consumer Price Index (CPI) rose by 2.6 percent (Figure 1.3), compared with 3.2 percent in 2024. The CPI excluding the effects of taxation and regulation—mainly the one-percentage-point increase in the VAT rate at the beginning of the year—and in the CPI excluding energy, fruit, and vegetables also moderated.

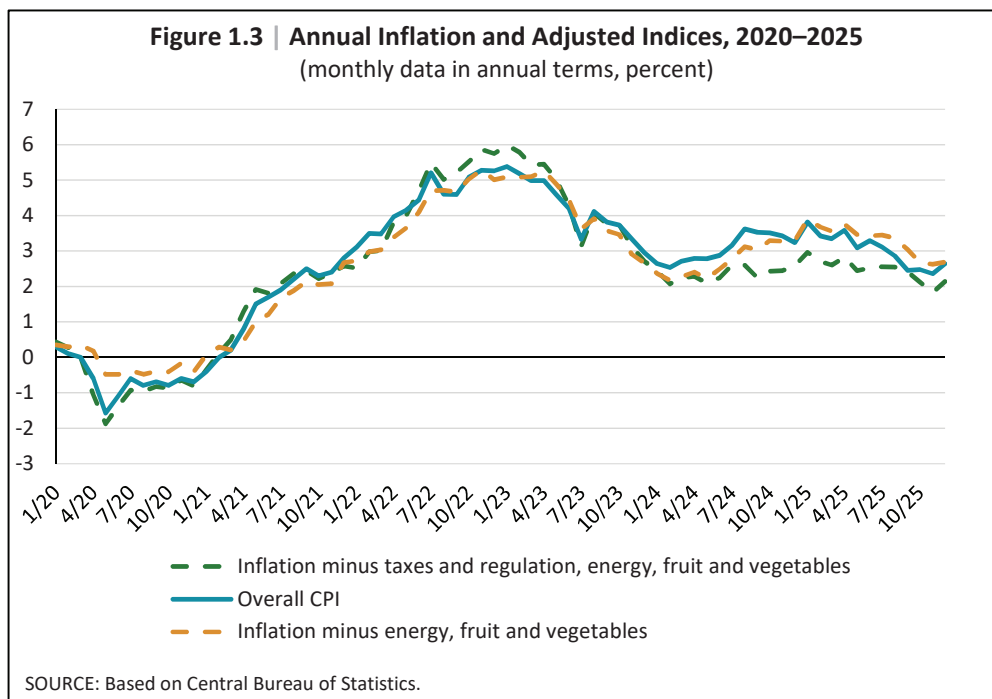
During the year, the inflation rate gradually declined, with volatility, converging into the target range with the August CPI reading that was published in mid-September. This development occurred against the backdrop of reduced combat intensity, a significant appreciation of the shekel, and a restrictive monetary policy stance that helped anchor inflation expectations and moderate demand pressures.

The sharp appreciation of the shekel—11 percent against the US dollar and 8 percent in terms of the nominal effective exchange rate (December 2024 average compared with December 2025)—occurred alongside a decline in Israel’s risk premium, which stabilized and even accelerated following Operation Rising Lion (Figure 1.4). This appreciation was a key factor contributing to the moderation of inflation during the year.

Although at the end of 2025 the risk premium remained slightly above its prewar level (prior to October 7, 2023), it had fallen substantially from its peak. Accordingly, the rate of increase in the tradable component of the CPI slowed to 1.4 percent, compared with 2.9 percent in 2024, leading the overall moderation of inflation. (For further discussion, see Chapter 3.)

During the year, the inflation rate gradually declined, converging into the target range in August.

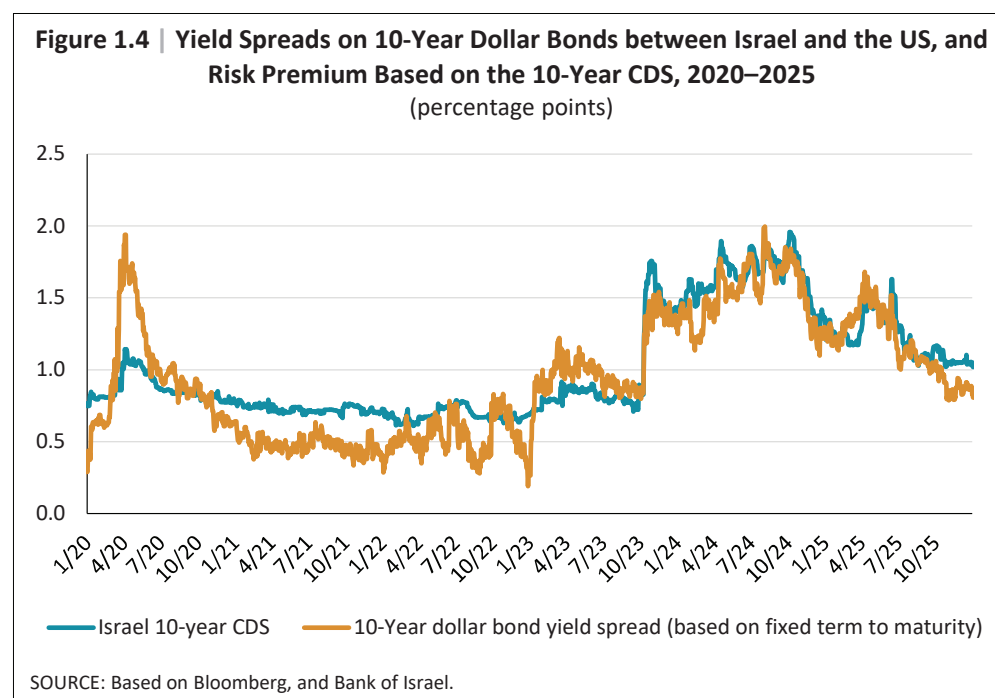
The sharp appreciation of the shekel was a key factor in the moderation of inflation during the year.



An analysis conducted by the Bank of Israel Research Department indicates that the appreciation of the shekel in 2025 was largely driven by the domestic component of the exchange rate—reflecting Israel-specific factors such as the risk premium—and captured the evolving effects of the war. From the outbreak of the conflict until Operation Northern Arrows on the Lebanese front in late 2024, the domestic component contributed to depreciation, and thereafter to appreciation.

Throughout most of the year, the global component—reflecting the worldwide weakening of the US dollar—also contributed to the shekel’s appreciation, particularly following the announcement of the US administration’s tariff policy in April 2025. (For further details, see Box 3.1 in this report.)

In 2025, inflation in Israel moderated at a faster pace than global inflation. This development was the reverse of the previous year, when domestic inflation exceeded global inflation due to supply constraints in the labor market and the lagged impact of the sharp depreciation of the shekel that occurred at the onset of the war. (See Chapters 1 and 3 of the Bank of Israel Annual Report for 2024).



Alongside the moderation in overall inflation, domestic price pressures persisted. The decline in the intensity of the fighting, the increase in exports, particularly services exports, and the fiscal impulse all supported demand, while the limited labor supply—due to the ongoing war—continued to constrain production capacity. As a result, the nontradable component of the Consumer Price Index, which accounts for about two-thirds of the index, rose by 3.4 percent in 2025, similar to the 3.5 percent increase recorded in the previous year. (See Figure 3.1 in Chapter 3 of this Report.)

The moderation of inflation during 2025 was accompanied by a significant decline in inflation expectations across all horizons. One-year-ahead expectations, which had hovered near the upper bound of the target range throughout 2024, gradually eased toward the midpoint of the range and, by year-end, fell slightly below it. This process—likely supported by expectations of a calmer geopolitical environment and by monetary policy—helped moderate actual inflation through the influence of expectations on price- and wage-setting behavior.

Long-term inflation expectations also declined markedly. After remaining elevated around 2.9 percent in 2024, they fell during 2025 to around 2.5 percent—close to their long-term average. With the easing of inflationary pressures and the signing of the ceasefire agreement, the likelihood that the market attributed to an interest rate cut increased, as reflected in the expected policy rate path.

e. Monetary policy

For most of the year, inflation was above the target range, and the interest rate remained unchanged. Since for most of 2025, the Israeli economy continued to face labor supply constraints, a reduction in the policy interest rate would have stimulated demand and intensified inflationary pressures, while contributing only marginally—if at all—to real activity. Therefore, in view of the high uncertainty and prevailing geopolitical risks, the policy rate was kept unchanged for most of the year.

Toward the end of the year, conditions matured for a monetary policy rate reduction. This was due to the further decline in inflation. Actual inflation continued to moderate, and one-year-ahead inflation expectations from various sources fell to around the midpoint of the target range. These developments were supported by the ceasefire in Gaza, which contributed to a decline in the risk premium and to an intensification of the shekel's appreciation. In view of these developments, the monetary interest rate was lowered in November by 0.25 percentage points. In the January 2026 interest rate decision, the interest rate was lowered again, to 4 percent. The most recent reduction in the interest rate was also supported by initial indications of an easing of the labor supply constraint. The labor force participation rate increased in November, the absentee rate due to reserve mobilization declined, and the pace of wage increases in the business sector moderated slightly.

In view of the continuation of the war and the high level of uncertainty, monetary policy in 2025 was characterized by caution and risk management. The Monetary Committee's decision to maintain the policy rate at 4.5 percent until November did not reflect inaction, but rather a consistent stance aimed at anchoring inflation expectations during a period of supply constraints and exceptional geopolitical uncertainty. Under these conditions, a rate cut was expected to make a limited contribution—if any—to activity and employment, while potentially intensifying inflationary pressures—among other things, by supporting domestic demand and possibly weakening the shekel.

An early reduction in the policy interest rate would have intensified inflationary pressures, while contributing only marginally—if at all—to activity.

Following the ceasefire in Gaza and the convergence of the inflation environment to the target range, the economic conditions became suitable for reducing the interest rate.

In practice, maintaining a stable nominal interest rate contributed to a restrictive policy stance in view of declining inflation expectations. This was reflected in an increase in the real interest rate, which helped moderate the pace of private consumption growth and encouraged a shift from consumption to savings. At the same time, credit expanded rapidly, and—alongside the fiscal impulse—supported GDP growth. The fact that growth was led mainly by the producing segment is consistent with the assessment that monetary policy was calibrated to the economy’s limited supply capacity during wartime, while maintaining price stability.

The effects of monetary policy were also evident in the composition of inflation and in the pace of its convergence to the target.

1. The nontradable component of the CPI remained elevated at 3.4 percent in 2025, similar to 3.5 percent in the previous year, reflecting a tight labor market and domestic demand pressures resulting from supply constraints during the war. This dynamic—typically more persistent than the tradable component and indicative of underlying wage and price pressures—supported the decision to maintain a restrictive policy stance for most of the year to mitigate the risk of entrenched and even accelerated inflation above the target.
2. The moderation in inflation was driven mainly by the tradable component, which rose by 1.4 percent in 2025 compared with 2.9 percent in 2024, and by just 0.6 percent excluding the airfares component, which is volatile. A key factor behind this was the significant appreciation of the shekel, largely reflecting the decline in Israel’s risk premium and supported by the global weakening of the US dollar. Monetary policy contributed to this outcome by keeping the interest rate steady for most of the year.

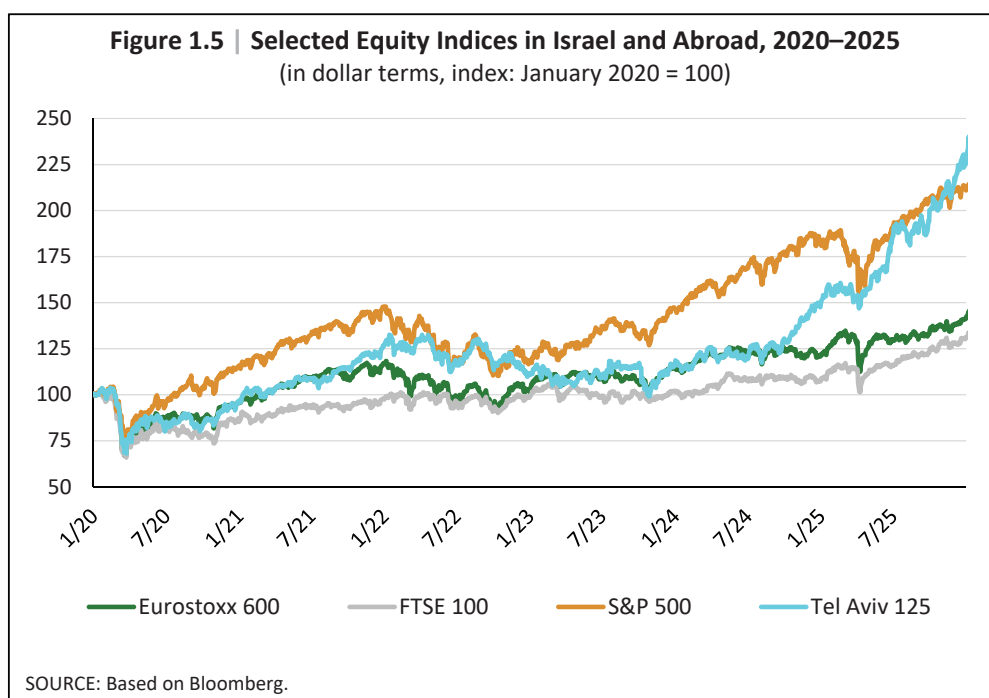
f. The financial markets

Due to the improvement in the geopolitical environment, the recovery in the domestic financial markets intensified.

Evidence of the economy’s resilience and the continued confidence of investors emerged clearly from developments in the capital markets. Despite the ongoing war, for a second consecutive year, there was a continued—and even intensified—recovery in domestic financial markets, supported by the improvement in the security situation.

The Tel Aviv 125 Index surged by approximately 50 percent during the year—an exceptional increase compared with global trends, where major equity indices rose more moderately, by 16–23 percent (Figure 1.5). Following Operation Northern Arrows in Lebanon in October 2024, and even more so after Operation Rising Lion and the ceasefire, net inflows into mutual funds increased sharply, particularly into funds specializing in equities, in parallel with the significant rise in share prices.

These trends reflected a combination of relative domestic economic recovery and continued positive momentum in global capital markets. In November, with the improvement in the security environment, the S&P credit rating agency revised Israel’s sovereign credit outlook from “negative” to “stable”, and at the end of January 2026, Moody’s followed suit with a similar revision.



The year 2025 was also marked by robust activity in the corporate bond market. The outstanding balance of corporate bonds reached approximately NIS 330 billion—an increase of about 9 percent compared with the previous year. After a temporary rise in yields at the outbreak of the war, this trend was followed by a sustained decline in yield spreads to historically low levels, similar to global patterns, which contributed to an expansion in credit supply.

Issuance activity was particularly strong in the financial services and construction and real estate industries. Financing needs in the construction and real estate industries increased due to the rise in housing starts, prolonged construction and more expensive construction inputs resulting from the cessation of employment of Palestinian workers since the beginning of the war, and the decline in transaction volumes during the conflict. (For further details, see Chapter 8 of this Report.)

g. The housing market

Against the backdrop of the ongoing war, housing demand moderated for most of 2025, while the supply of housing expanded, creating conditions that supported a decline in prices. Following the ceasefire in October, there was some recovery in activity, and prices began to rise.

A notable increase was recorded in housing starts, which reached approximately 80,000 units. Through an increase in the number of Israeli and foreign workers, the shortage of construction workers that had emerged at the onset of the war narrowed during the year. (For further details, see Chapters 5 and 8 of this Report.) However,

The moderation of housing demand alongside the expansion of supply created an environment that supported lower home prices.

given the extensive scale of construction and renovation activity, a shortage of workers in the construction industry persisted, as reflected in firms' reports of growing recruitment difficulties. The increase in housing starts was made possible by a shift of resources from nonresidential to residential construction, as well as by the continued increase in building permits and land marketing in previous years. (See Chapter 8 of this Report.)

Several factors contributed to the moderation in demand: a relatively high interest rate environment (although mortgage rates began to decline gradually in the second half of the year—see Chapter 4, The Mortgage Market); Bank of Israel restrictions on financing campaigns for new homes; a slower pace of population growth; and heightened geopolitical uncertainty.¹² All these factors led to a decline in transactions for new dwellings and stability in the volume of transactions for secondhand homes.

In 2025, the rental market was affected by a combination of supply-side shocks—a temporary reduction in the effective housing stock due to evacuations in the north and south and Operation Rising Lion—alongside weaker demand, partly in view of a negative migration balance. During the year, some evacuees returned to their homes, while others were accommodated in hotels—developments that helped ease pressures in the rental market. In view of these developments, rental prices rose by 3.2 percent—a rate slightly below that of 2024 (4.0 percent; see Chapter 8 for details).

The evacuation of localities in the north and in the south affected the rental market.

EXPANDED ISSUE: THE CHALLENGES OF MACROECONOMIC POLICY AFTER TWO YEARS OF WAR

a. Introduction

Even prior to the outbreak of the war, Israel faced significant macroeconomic challenges as part of its long-term aspiration to raise living standards and converge toward the per capita GDP levels of advanced economies. Achieving this goal required sustained growth through higher labor productivity, addressing demographic trends—including the need to integrate additional population groups into the economy and promote their advancement—and managing the economy within a persistently unstable security environment. These challenges were reflected in infrastructure and human capital gaps relative to other advanced economies.

The prolonged war has posed new and weighty challenges for Israel's macroeconomic policy. These include the expected increase in defense needs over the coming years, a sharp rise in the debt-to-GDP ratio, and the necessity of providing assistance to those physically, psychologically, and economically harmed by the

The prolonged war has posed new and weighty challenges for Israel's macroeconomic policy.

¹² According to the Consumer Confidence Survey (September 2025), about 95 percent of households estimated that they would not purchase a home in 2026—significantly higher than the historical average of 89 percent during 2011–2019. (See the Bank of Israel's 2025 Financial Stability Report for details.)

war.¹³ In addition to the domestic transformations brought about by the war, there have also been notable global developments in recent years that are reshaping the conditions for long-term growth. These include the rapid advancement of artificial intelligence, and growing fragmentation in the global economic system manifested, inter alia, in protectionist measures (most prominently, the American tariff policy) and restrictions on cross-border technology transfers.

These challenges and transformations create a multidimensional challenge for the government, which includes and intergenerational implications: the need to reduce the debt-to-GDP ratio while simultaneously expanding the defense budget; to address the economy's development needs; and to maintain the population's current standard of living and the quality of public services.

This multidimensional challenge raises several key questions: Should short-term living standards be lowered in order to achieve the long-term objectives outlined above? If so, to what extent should this be pursued—through higher tax rates or reduced public expenditure? Is it possible to advance structural reforms that could accelerate growth and thereby expand the tax base, and if so, how should policymakers address the impacts of policy on various population groups? How can a balance between defense and civilian spending be achieved so that both security needs and essential investments in physical infrastructure and human capital are adequately met? And finally, how can these needs be addressed while rebuilding the fiscal space necessary for the government to support the economy in the face of future shocks?

The government will continue to face these challenges, and it is therefore essential to formulate a multiyear strategic framework that defines future objectives and sets out the policy paths for achieving them. Such a framework would also provide a roadmap enabling the business sector to plan its activities with greater certainty.

The purpose of this section is to present a comprehensive picture of the Israeli economy—its strengths and weaknesses—and, based on this assessment, to outline several medium-term policy directions that merit consideration. Some of these recommendations have already been reflected in strategic plans submitted by the Bank of Israel to incoming governments, the most recent of which was presented in January 2023.¹⁴

Previous challenges and the transformations induced by the war create multidimensional challenges for the government.

¹³ See, for example, the discussion of increased healthcare needs resulting from the war in Chapter 7 of this Report, and the economy's rehabilitation requirements in Chapter 7 of the Bank of Israel Annual Report for 2023.

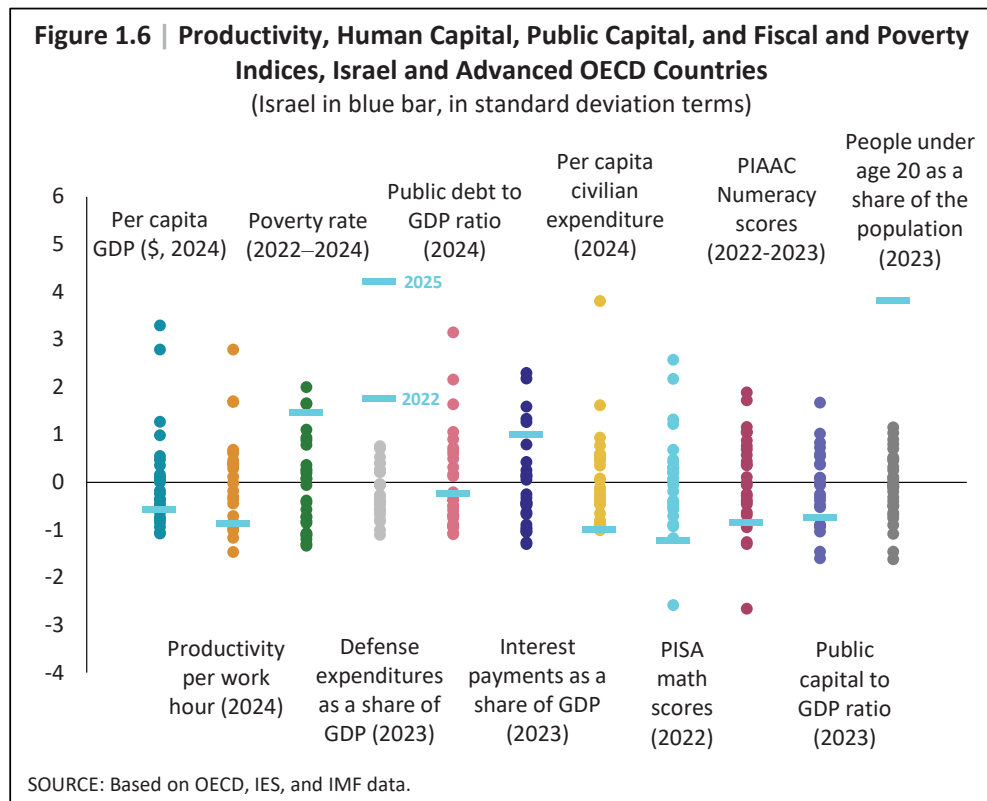
¹⁴ See: Recommended Strategic Pillars of Action for the Government, Bank of Israel (2023).

b. Components of the multidimensional challenge facing the government

(1) Reducing the Debt-to-GDP Ratio

Israel's debt-to-GDP ratio—68.5 percent—is above the OECD median.

While the debt-to-GDP ratio in Israel, which increased over the past three years—from approximately 60 percent to 68.5 percent—is not exceptionally high, it now exceeds the median level among OECD countries and among those classified as advanced economies.¹⁵ (See Figure 1.6, as well as Figures 6.1 and 6.10 in Chapter 6 of this Report.)¹⁶ Moreover, in most advanced OECD economies where the debt-to-GDP ratio was similar to Israel's prior to the war, the ratio has remained stable or even declined in recent years.



Israel bears a heavy interest burden on its public debt: 3.1 percent of GDP.

In addition, Israel bears a heavy interest burden on its public debt—3.1 percent of GDP, compared with an average of 1.9 percent of GDP in advanced OECD economies, and compared with a similar rate that Israel would pay if its interest rate on public

¹⁵ The 31 OECD countries (out of the 38 in the organization) that are classified by the International Monetary Fund as “Advanced Economies.”

¹⁶ Among the OECD countries shown in Figure 1.6, 14 have a higher debt-to-GDP ratio than Israel, while 17 have a lower ratio.

debt were similar to countries with comparable debt levels.¹⁷ This is partly due to a higher risk premium attributed to Israel in view of geopolitical uncertainty.

Given the geopolitical risks, and particularly based on past experience, it is essential that Israel reduce its debt-to-GDP ratio in the coming years. There are several key arguments supporting this necessity:

1. A higher debt level leads to higher long-term interest rates (with an estimated elasticity of 0.1¹⁸), which in turn crowd out investment in the economy, results in a lower capital-to-labor ratio at equilibrium, and reduces the potential growth rate of the economy. An analysis by Brand and Katz (2026)¹⁹ found that the estimated adverse impact of an actual increase in the debt-to-GDP ratio is expected—through this transmission channel alone—to significantly slow the economy’s growth rate and, in the long run, reduce potential output by approximately 2 to 3 percent. Moreover, an increase in the debt-to-GDP ratio brings with it the risk of a sharp increase in financing costs, which do not increase proportionally from a certain level that is difficult to estimate in advance.
2. Interest payments on public debt crowd out other fiscal uses, as they limit the government’s ability to expand civilian expenditures or reduce taxes, and may eventually necessitate future tax increases to finance them.
3. The risk of another security-related confrontation in Israel’s region is higher than in most other countries (as we have seen with Operation Roaring Lion in March 2026). Accordingly, larger fiscal buffers are required to cope with such events. The experience of the COVID-19 crisis and of the war has underscored the importance of maintaining such buffers. It is not coincidental that international economic organizations and credit rating agencies view the debt-to-GDP ratio as a key parameter reflecting a country’s capacity to withstand economic and fiscal challenges.
4. The global economy is currently in a period of higher interest rates, making debt financing more expensive today than during previous crises.

The structural budget deficit is currently estimated at 3.7 percent of GDP, even after a structural increase of approximately 1.5 percent of GDP in the tax burden implemented over the past year. (See Chapter 6 of this report for further details.) To ensure a stable debt-to-GDP trajectory, the structural deficit must be reduced by at least half a percent of GDP, and a larger reduction in the structural deficit would be required to achieve a downward path in the debt-to-GDP ratio.

¹⁷ Based on a linear regression among advanced OECD economies (excluding Japan) between public debt as a share of GDP and interest payments as a percentage of GDP. The regression has an explanatory power (R^2) of 0.55.

¹⁸ A. Brender and S. Ribon (2015). “The Effect of Fiscal and Monetary Policies and the Global Economy on Real Yields of Israel Government Bonds”, Discussion Papers Series 2015.02, Bank of Israel Research Department.

¹⁹ G. Brand and G. Katz (2026), “The Implications of Stabilizing Versus Reducing a High Debt-to-GDP Ratio.” Chief Economist, Ministry of Finance.

It is essential that Israel reduce its debt-to-GDP ratio in the coming years.

To stabilize the debt-to-GDP ratio, the structural deficit must be reduced by at least half a percent of GDP.

(2) Increasing the Defense Budget

Defense expenditure as a share of GDP increased during the war, and is expected to remain high.

Defense expenditure as a share of GDP was already significantly higher than the average among advanced OECD economies prior to the war (Figure 1.6). It surged during the war, and is expected to remain elevated relative to its prewar level in the coming years.

The government appointed the “Committee to Examine the Defense Budget and Force Building” (the Nagel Committee), which recommended a multiyear budgetary framework beginning in 2025. However, the government did not adopt these recommendations. In November 2025, the Prime Minister instructed that the defense budget be increased by NIS 250–350 billion over the next decade—an amount exceeding the committee’s recommendation—though this directive has not yet been formalized as a government decision. (See Chapter 6, Section 3a of this Report for further details.) These developments indicate an assessment that the defense budget will continue to expand substantially in the coming years relative to its prewar level.

In contrast, between 1995 and the eve of the war, defense expenditure as a share of GDP declined at a rate of roughly one percentage point every five years.²⁰ This consistent decline supported both the reduction of the debt-to-GDP ratio and the lowering of the tax burden (taxes as a share of GDP), while primary civilian expenditure as a share of GDP remained largely unchanged.²¹

(3) Investment in Sustainable Economic Growth

GDP per hour worked in Israel is lower than in most advanced OECD countries.

Relative to the OECD economies defined as “advanced”, Israel ranks near the upper end of the lower third in terms of per capita GDP (an indicator of living standards) and GDP per hour worked (an indicator of labor productivity) (Figure 1.6). Israel’s per capita GDP is also significantly below that of benchmark countries²²—approximately two-thirds of their average level. Moreover, Israel’s poverty rate is nearly double the OECD average, indicating that a substantial portion of the population lives at particularly low income levels compared with other advanced economies. Across these three indicators, Israel’s relative position has shown little improvement over the past decade.

²⁰ For further discussion of past defense expenditure trends and future alternatives, see Box 6.1 in the Bank of Israel Annual Report 2023.

²¹ Civilian expenditure as a share of GDP declined slightly in the early 2000s and rose modestly toward the end of the previous decade.

²² Benchmark countries are small OECD economies with relatively high labor productivity: Austria, Ireland, Belgium, Denmark, the Netherlands, Finland, and Sweden.

Various analyses have identified two principal drivers of productivity growth: the quality of human capital and its implications for labor market outcomes and welfare, and the level of physical capital.²³

The level of Israel’s physical capital—particularly its stock of public capital²⁴ and the quality of public infrastructure—lags considerably behind the levels that are common in benchmark countries (Figure 1.6). For instance, the gap in transportation infrastructure is reflected in limited connectivity between and within localities and in severe road congestion, which harm quality of life, constrain leisure consumption, and lead to significant wasting of resources and time. These phenomena directly hinder economic growth and living standards.

The shortage of infrastructure is compounded by Israel’s rapid population growth, which generates higher demand for public infrastructure expansion than in other advanced OECD economies. To merely maintain Israel’s current relative position in terms of the physical capital-to-GDP ratio compared with countries experiencing more moderate population growth, annual infrastructure investment must be approximately 40 percent higher than what is common in those countries²⁵, which the Bank of Israel indicated in previous publications.²⁶

A recent example of the potential benefits of public infrastructure investment can be found in the field of artificial intelligence, as discussed in Box 1.2.

The stock of public capital and the quality of public infrastructure are lower than the acceptable levels.

The rapid growth of Israel’s population creates greater demand for expanded public infrastructure.

²³ See also: Raising the Standard of Living in Israel by Increasing Labor Productivity, Bank of Israel Research Department (2019); and Recommended Strategic Pillars of Action for the Government, Bank of Israel (2023).

²⁴ The stock of public capital refers to the total physical assets and resources owned by the state or local authorities that support economic and social activity. These include infrastructure such as roads, bridges, ports, airports, water and sewage systems, schools, hospitals, and cultural and sports facilities. Public capital is critical for economic development and public welfare, as it provides the foundation for essential services and business activity. Investment in public capital can stimulate private sector investment, enhance quality of life, increase productivity, and foster long-term economic growth.

²⁵ The relatively simple development of a steady-state capital accumulation model suggests that $K/GDP = I/GDP \cdot (1+g)/(g+\delta)$, where g is the GDP growth rate and δ is the depreciation of the capital. We position g as 1.1% economic growth for OECD countries and 3% for Israel (the average growth rate between 1999 and 2019). We assuming $\delta = 3\%$. If other countries invest X percent of GDP in infrastructure, Israel must invest $1.4X$. Given that Israel currently invests about 4.2 percent of GDP annually in infrastructure, maintaining its relative capital-to-GDP ratio would require an additional investment of roughly 1.5 percent of GDP per year.

²⁶ See: Recommended Strategic Pillars of Action for the Government, Bank of Israel (2023).

BOX 1.2: ISSUE IN ECONOMIC STRATEGY – THE NATIONAL ARTIFICIAL INTELLIGENCE (AI) INFRASTRUCTURE

- The field of artificial intelligence (AI)¹ is developing rapidly, and its economic implications are already evident. The potential economic impact of AI is extensive, particularly in its capacity to significantly affect employment and enhance labor productivity.
- At the end of 2025, the National AI Directorate was established within the Prime Minister's Office to coordinate government activity related to the economic implications of AI. In February 2026, the government approved a decision to promote the establishment of data centers and to define them as national infrastructure.
- Formulating and implementing a national policy to advance AI infrastructure—so that the Israeli economy in general, and the Israeli high-tech industry in particular, are well integrated into the global AI infrastructure value chain—can contribute meaningfully to Israel's growth potential.
- Israel's high-tech ecosystem hosts numerous R&D centers of multinational corporations engaged in AI development. These centers contribute to entrepreneurship and infrastructure building in the field. In addition, Israel ranks highly internationally in both the number of newly established AI-focused companies and the quality of research in the discipline.

The AI sector is expanding at an accelerated pace, and its economic effects are already visible in surging global demand for semiconductors and computing power, large-scale investments in model development and AI data centers, and corporate reports of AI integration into work processes, among other things. Various estimates suggest that AI's potential economic impact is broad and likely to intensify in the future. In particular, it may significantly influence growth rates, income distribution, labor productivity, and the structure of the economy's comparative advantages.² Forecasts indicate that the adoption of AI could add between 0.1 and 1.5 percentage points to annual productivity growth in advanced economies over the coming decade—a wide range reflecting uncertainty and dependence on adoption rates, usage intensity, and the economic model's assumptions.³

Given its industrial composition, the Israeli economy belongs to the group of countries that are highly exposed to the AI's positive impacts on growth trajectories, for example via international trade (Filippucci et al., 2026).

In 2024, Israel ranked 10th globally in private AI investment and 11th in the number of newly established AI companies. Cumulatively between 2013 and 2024, Israel ranked 4th worldwide in the number of companies established—a high position given the economy's size. Israeli-affiliated researchers

¹ The terms AI and artificial intelligence are used interchangeably in this document.

² Box 5.1 in the Bank of Israel Annual Report for 2024 dealt with the expected impact of generative artificial intelligence on workers.

³ An OECD report quotes estimates of a wide range of potential productivity growth for the US and G7 economies (through increased labor productivity and TFP)—from 0.1 percentage points annually (Acemoglu, 2025), through 1.0 (Aghion and Bunel, 2024), to very optimistic assessments of 1.5 percentage points (Goldman Sachs, 2023). See also Chaar et al. (2025) for these findings and a calculation for the G7 countries.

were among the top ten globally in citations in the AI field (in 2023).⁴ The Israeli high-tech ecosystem contains numerous R&D centers attached to multinational corporations developing AI technologies. These centers also contribute to encouraging entrepreneurship in the field.

Due to the rapid developments in AI technologies, to realize this potential, Israel requires a comprehensive policy to promote AI infrastructure. Such a policy should include accessible computing and data resources for academia and the business sector, cultivation of human capital, integration of AI technologies in the public sector, and the establishment of an appropriate regulatory framework.

As an economy-wide technological and computational infrastructure, AI is expected to improve processes across the manufacturing and services industries, the public sector, and research institutions. Fully leveraging these opportunities requires substantial investment in high-performance computing infrastructure that is accessible to all sectors. Recognizing this need, the National R&D Infrastructure Program for Artificial Intelligence was launched in 2021 with a budgetary investment of NIS 1 billion for 2021–2026.⁵

A key achievement of this program is the establishment of Israel’s first national supercomputer, which began operating in early 2026 to train large-scale models, cofunded with Nebius. The supercomputer serves high-tech companies and academic researchers with limited access to such resources. Its computing capacity—1,000 GPUs—is provided at subsidized rates, supported by a government investment of NIS 160 million and a private investment three times larger to add 3,000 GPUs available on the open market.⁶

Following assessments by a joint team from the Ministry of Finance and academic institutions that this capacity will be insufficient within five years, the 2026 budget proposal includes a plan to provide additional supercomputing services totaling up to 5,000 GPUs for academic use under competitive criteria, with a NIS 1.3 billion budget over five years. Alongside government investment, private sector initiatives are also underway to establish additional computing units for use by Israeli researchers and companies.

Beyond the supercomputer, the National R&D Infrastructure Program for Artificial Intelligence has advanced other infrastructure issues, including physical infrastructure (such as establishing supercomputing and AI technology laboratories), human capital (scholarships for advanced degrees and recruitment of leading international AI faculty), data infrastructure, regulation, and technology adoption.⁷

⁴ See Figures 4.3.8, 4.3.12, and 1.1.11 in Artificial Intelligence Index Report 2025, Stanford University.

⁵ The program was initiated by the Telem Forum (National Infrastructure for R&D), a voluntary coordination and resource pooling framework among national research bodies that can be served by a large research infrastructure. The forum’s members include the Planning and Budgeting Committee (PBC), the Ministry of Defense (MAFAT), the Ministry of Innovation, Science and Technology, the Ministry of Finance, and the Israel Innovation Authority.

⁶ Prior to the establishment of the national supercomputer, Israel had private AI computing infrastructure, but it was not highly accessible to some companies and researchers.

⁷ For details, see “The National Artificial Intelligence Program – Status Report 2025”, Israel Innovation Authority: <https://innovationisrael.org.il/document/ai-national-program-2025> (in Hebrew).

In August 2025, the Nagel Committee⁸—the National Committee to Accelerate the Field of Artificial Intelligence—submitted its findings. The committee emphasized that Israel’s AI infrastructure needs far exceed current capacity, even with the planned national supercomputer still under development at the time. The committee highlighted the urgent need to leverage Israel’s distinct advantages—high-quality human capital, a vibrant startup ecosystem, and significant multinational R&D presence—through extensive national investment in high-performance computing, secure data systems, enabling regulation, and broad human capital training.

The committee’s proposed plan outlines a five-year national initiative totaling with a budget of about NIS 25 billion, carrying both a of promise and considerable uncertainty, given the difficulty of predicting the depth of technology adoption, long-term usage patterns, and the required level of public sector involvement.⁹

Formulating Israel’s national AI policy requires a cost-benefit assessment across a spectrum of options:

Establishing a comprehensive national infrastructure ensuring strategic independence and data security (“computing sovereignty”);

Adopting a leaner model, using national infrastructure only for sensitive needs while relying on private (including international) infrastructure for nonsensitive applications—thus optimizing public expenditure.

A broad national infrastructure offers strategic advantages, positioning Israel at the forefront of the global “AI arms race.” However, it entails substantial costs—not only for establishment but also for ongoing maintenance amid rapidly evolving technology. Moreover, it is not certain that a national entity would have a comparative advantage in building and operating such a project relative to outsourcing to private or international providers, with subsidized access aligned to national priorities.

AI computing infrastructure consumes significant energy, posing a potential challenge to Israel’s electricity system in the medium-to-long term. This demand is expected to rise sharply as private sector AI usage expands.¹⁰ Therefore, decisions regarding the scale of computing infrastructure must be synchronized with energy sector planning—expanding energy sources and adapting the electricity grid.

To strengthen Israel’s position in AI infrastructure, on February 22, 2026, the government approved Resolution No. 3907, promoting the establishment of advanced data centers. The resolution defines approval procedures for new data centers, removes planning and construction barriers, addresses energy-use constraints, and establishes a government coordination mechanism for energy and environmental considerations. However, the decision does not include an expansion of overall electricity production capacity.

⁸ Report of the National Committee to Accelerate the Field of Artificial Intelligence, chaired by Prof. Yaakov Nagel (submitted August 2025).

⁹ The proposed budget significantly exceeds that of the previous AI program under the Israel Innovation Authority. The allocation includes NIS 18 billion for computing, energy, and operations; NIS 3 billion for academic and training programs; and the remainder for national “moonshot” initiatives and the establishment of a National AI Institute.

¹⁰ According to the Electricity Authority’s estimates presented to the Knesset Subcommittee on Artificial Intelligence and Advanced Technologies (November 25, 2025), data centers accounted for about 0.5% of total electricity consumption in 2024, with that usage projected to rise to 5–7% by 2030.

In parallel, an interministerial task force published an interim report on “Energy for Data Centers.”¹¹ The team’s goal is to enable the development of the data center sector while maintaining the stability and reliability of the national electricity system. In the short term, the team recommended locating new data centers outside high-load areas of the grid, emphasizing regions with greater potential for renewable energy use. In the long term, it advised a comprehensive review of the need to expand Israel’s electricity production capacity, including alternative energy sources, to ensure uninterrupted supply for all consumers.

Within the range of options for implementing a national AI infrastructure, the central policy objective is to ensure that the Israeli economy—and particularly its technology industry—integrates effectively into the global AI infrastructure value chain. Such integration is essential to maintaining Israel’s relevance and leadership in global technology. In this context, Israel’s accession to the “Pax Silica” initiative¹² in December 2025—a US-led alliance of Western technology powers to secure advanced technology supply chains—represents a significant strategic signal of Israel’s role as a key player in the global technological partnership.

Alongside rapid developments in the technology sector, it is crucial to prepare for AI’s broader impacts on government and business activity. AI is expected to have far-reaching effects on employment, education, healthcare, and other areas. Government policy must anticipate these changes to harness opportunities and mitigate risks. It is equally important to advance regulation that facilitates AI adoption while addressing potential complexities and risks inherent in its applications.

In conclusion, realizing the growth potential inherent in artificial intelligence requires coordinated investment in physical infrastructure (computing and energy), human capital development, enabling regulation, and the preservation of Israel’s international standing. Following the submission of the Nagel Committee report, the National AI Directorate was established in the Prime Minister’s Office in September 2025, with a defined need for multiyear budgeting—though funding levels have yet to be determined.¹³ Participation in the accelerating global AI race, as a driver of economic growth, must become a central component of Israel’s economic policy in the coming years.

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Chaar. T. , F. Filippucci, C. Jona-Lasinio, and G. Nicoletti (2025), “AI and the Global Productivity Divide: Fuel for the Fast or a Lift for the Laggards?”, *OECD Artificial Intelligence Papers*, No. 51.1

¹¹ The task force included representatives from the Ministry of Finance, the National AI Directorate, the Ministry of Energy, the Electricity Authority, the Innovation Authority, the Ministry of Environmental Protection, and the Planning Administration. Interim findings (in Hebrew) are available at: https://www.gov.il/he/pages/press_190226.

¹² A strategic US-led initiative to form an alliance among Western technology powers to ensure the resilience of advanced technology supply chains, including AI and semiconductors.

¹³ Government Resolution No. 3375 (September 2025) established the National AI Directorate in the Prime Minister’s Office.

Filippucci, F. P. Gal K. Laengle, M. Schief and M.A. Yildirim (2026), "AI Meets Trade: Global Linkages and the Cross-Country Distribution of the Gains from AI", OECD Artificial Intelligence Papers No. 57.7

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<https://innovationisrael.org.il/document/ai-national-program-20255>.

Student achievement and workers' skill levels in Israel are low by international comparison.

Student achievement levels in Israel are low by international comparison (Figure 1.6), a finding that points to insufficient quality in the education system. These gaps are subsequently reflected in the labor market, where the skill levels of Israeli workers are relatively low (Figure 1.6) and exhibit exceptionally high variance compared with other countries.²⁷ Low skill levels contribute to Israel's low labor productivity²⁸, which remains the principal factor constraining living standards and contributing to the high cost of living.

Educational needs in Israel are particularly extensive, since the country has a high proportion of students relative to its population.

Educational needs in Israel are particularly extensive, as the country has a high proportion of students relative to its population.²⁹ Moreover, Israel's education policy has historically evolved to accommodate the ethnic and cultural diversity of its population through multiple educational streams. Alongside the state education system, there are separate *Haredi* (ultra-Orthodox) school networks, the scope of which is already substantial and continues to expand. These networks also maintain gender segregation, and many of their institutions—particularly those for boys—do not teach core subjects essential for participation in the labor market. A separate (state) education stream also exists in the Arab sector, where student achievement levels in both local and international assessments are particularly low. Furthermore, even within the state education system, there is a division between secular and religious state education, the latter also characterized by gender segregation. This

²⁷ For further analysis of adult skill levels in the second wave of the PIAAC survey and comparison with the first wave, see: S. Bachar and E. Demalach (2024), "Skills of Israel's Population by International Comparison: Initial Findings of the 2022–2023 PIAAC Survey," Research and Policy Analysis Notes Series, No. 2024.03, Bank of Israel Research Department.

²⁸ See, for example, Bank of Israel Annual Report 2018, Chapter 5, which found that raising the average skill level of Israeli workers to the OECD average could increase labor productivity by nearly 3 percent.

²⁹ Israel's fertility rate stands at 2.9 births per woman, compared with an OECD average of 1.5—the highest among all advanced OECD economies.

multiplicity of educational streams significantly increases system costs and makes reform and improvement efforts especially challenging.

Nevertheless, improving and streamlining the education system offers high returns, even if the results are not immediately visible.³⁰ Improving the education system is particularly critical in view of the technological transformations expected in the coming years, as students lacking basic skills will be unable to leverage these changes to raise productivity once they enter the labor market. At the same time, technological advances also present opportunities to improve the education system itself, potentially at lower cost.

The relatively low skill levels among Israeli adults are also evident in the labor market. Beyond the low productivity mentioned above, Israel has one of the highest shares of low-wage workers³¹ among advanced OECD economies—ranking second—with nearly one-quarter of workers earning low wages, compared with an average of 15 percent in other countries. There is also a strong correlation between low skill levels and low wages and the population groups to which these workers belong, particularly the *Haredi* and Arab communities. This is reflected in their under-representation in advanced economic industries, most notably high-tech (see discussion below). Consequently, improving educational outcomes among these populations holds significant potential both for increasing Israel’s potential output and for reducing poverty rates in the longer term.³²

Another factor limiting Israel’s per capita output due to under-utilization of human capital is the low employment rate among two population groups. In 2025, employment rates among *Haredi* men (53 percent) and Arab women (49 percent) remained very low compared with the rest of the population. While Arab women have shown a clear upward trend over time (a positive cohort effect), primarily reflecting their rising education levels, progress among *Haredi* men has been slow and has stalled in recent years. (See Chapter 7 of the Bank of Israel Annual Report for 2022 for further discussion.)

Israel’s high-tech sector is a global leader and attracts the most skilled workers. The sector’s share of employment (11 percent of total employees)³³ is significantly higher than in other advanced OECD economies, and the sector is responsible for more than

Improvement and streamlining of the education system will bring a high return in the long run.

The relatively low skill levels of Israeli adults are evident in the labor market.

The employment rates of *Haredi* men and of Arab women are very low compared with the rest of the population.

³⁰ The high estimated return on additional investment in education is based primarily on the Bank of Israel’s long-term growth model and extensive international literature. See discussion in the Bank of Israel Research Department’s Special Report: Raising the Standard of Living in Israel by Increasing Labor Productivity (2019).

³¹ Less than two-thirds of the median wage, equivalized to the scope of employment.

³² For example, the increase in labor supply among *Haredi* women over the past two decades has led *Haredi* households to record the largest average market-income growth compared with non-*Haredi* Jewish and Arab households.

³³ For international comparisons of Israel’s high-tech sector, see: G. Brand, E. Demalach, and Y. Peterfreund (2025), “The Composition of Human Capital and the Wage Premium in the Israeli High-Tech Sector,” Research and Policy Analysis Notes Series No. 2025.07, Bank of Israel Research Department; and the Governor’s presentation at the conference “50 Years of the Government Companies Authority: Leading Tomorrow’s Economy.”

40 percent of the growth in business-sector output in recent years. Skill gaps between high-tech workers and the other workers in the economy are exceptionally large by international comparison, and these gaps are reflected in wage disparities between the two groups. These wage gaps have widened further over the past decade and are among the highest in the OECD.³⁴

The Arab and Haredi populations are strongly under-represented in the high-tech sector.

Certain population segments remain underrepresented in the high-tech sector, perpetuating social disparities and potentially limiting the sector's growth potential. In recent years, the share of Arab workers in high-tech employment has not increased, despite a substantial rise in the share of Arab graduates in high-tech-related fields. Young *Haredi* men have also continued to account for a very low share of those employed in high-tech throughout the past decade, despite the establishment of dedicated preparatory programs and specialized campuses.

Conversely, *Haredi* women account for an increasing share of those employed in high-tech over the past decade, with the share approaching their proportion in the general population. This trend reflects the opening of nonacademic software engineering tracks under the supervision of the Government Institute for Technological Training (MAHAT) in the Beit Yaakov seminar network, which has facilitated the integration of young *Haredi* women into high-tech employment. However, their wages remain relatively low compared with other technological occupations in the sector, primarily because their representation in core high-tech roles is limited—a situation likely reflecting the lower quality of the educational institutions they typically attend relative to universities.³⁵

In contrast to the high-tech sector, other industries—such as construction³⁶, trade, and certain manufacturing subindustries—suffer from low labor productivity, limited worker skills, and a low propensity for innovation.

Despite an increase in real per-student expenditure, educational achievements have shown only limited improvement in international assessments.

Addressing the economy's development needs, including narrowing productivity gaps relative to other advanced economies, requires both structural reforms and substantial public resources. The Bank of Israel Research Department's special report on raising the standard of living (2019) estimated the necessary investment at approximately 3 percent of GDP per year. However, resource allocation alone is insufficient. For example, despite a significant 40 percent increase in real per-student expenditure over the past decade, educational achievements have shown only limited improvement, as reflected in international assessments. Similarly, infrastructure investment should focus on projects with the highest returns to the economy. Resource allocation must therefore be accompanied by programs aimed at improving system effectiveness and optimizing operational processes.

³⁴ Brand, Demalach, and Peterfreund (2025), *ibid.*

³⁵ E. Demalach and Y. Sade (2025), "Integration of the Arab and *Haredi* Populations into Israel's High-Tech Sector," Research and Policy Analysis Notes Series, Bank of Israel, Research Department.

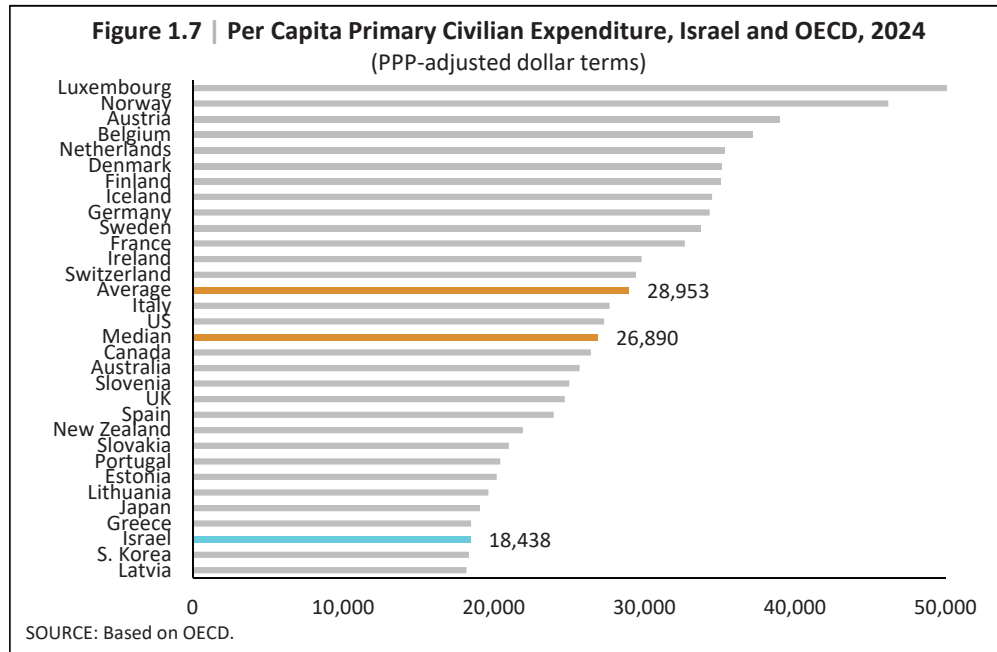
³⁶ The construction industry exhibits a significant productivity gap compared with benchmark countries. Improving worker skills and expanding the use of advanced technologies in construction are expected to help close this gap.

(4) Maintaining the Public’s Current Living Standards and the Quality of Public Services

The discussion of policy challenges in the preceding sections highlights the substantial benefits the economy could derive from increased investment in infrastructure and human capital, as well as from building fiscal buffers to strengthen resilience against future shocks. Alongside the anticipated rise in defense expenditures in the near term—based on decisions currently under consideration—it appears that, at present, resources used for other purposes in the economy will need to be reallocated, with an associated reduction in living standards, to finance these expenditures.

The composition of this adjustment depends on each country’s needs and preferences, but international comparisons of per capita civilian public expenditure (Figures 1.6 and 1.7) and Israel’s relatively low tax burden (see Chapter 5, Figure 5.1) provide useful context. In 2024, Israel’s per capita primary civilian expenditure amounted to only two-thirds of the average among advanced OECD economies (Figure 1.7), while its per capita GDP stood at 78 percent of the average in those countries.

Per capita primary civilian expenditure amounted to only two-thirds of the average among advanced OECD economies.



One of the key components underlying Israel's low civilian public expenditure—and its stabilization at low levels in recent years—is the relatively low wage level in the public sector. The ongoing erosion of public sector wages continued this year, while wages in the business sector rose at a faster pace (see Figure 6.5 in Chapter 6 of this Report). According to wage regression analysis, which takes into account workers' characteristics and their measurable qualifications, the relative erosion has already exceeded 10 percent.

The erosion of public sector wages is reflected in a notable decline in the skill levels of public sector employees.

This erosion is also reflected in a notable decline in the skill levels of public sector employees, particularly among young men, both by international comparison and relative to workers in the business sector³⁷, with potential negative implications for the quality of public services, including in areas critical to economic growth. Consequently, continued relative wage erosion in the public sector is unlikely to serve as a significant source for reducing public expenditure in the future.

Moreover, narrowing the wage gap in the public sector entails costs of a macroeconomic scale. Each percentage point increase in public sector wages carries a net budgetary cost of approximately NIS 1 billion per year.³⁸ It is therefore important that upcoming public sector wage agreements include measures to improve efficiency—such as through technological means—as well as alternative ways to enhance the sector's attractiveness that involve relatively low ongoing fiscal costs.

Israel's low level of civilian expenditure creates a genuine difficulty in reducing it as a means of financing defense needs, investments, and debt reduction. Evidence of this challenge emerged over the past two years, during which, despite the exceptional increase in defense spending and the need to finance it, other civilian expenditures did not decline—even amid a public sector wage freeze (see Figure 6.4 in Chapter 6 of this Report).

An international comparison indicates that taxes in Israel, particularly direct taxes, are low compared to the advanced OECD countries.

The difficulty in reducing expenditures underscores the importance of the alternative of increasing revenue sources to finance defense needs, investments, and debt reduction. While raising taxes and eliminating tax exemptions means reducing living standards in the short term, international comparisons indicate that Israel's tax levels—particularly direct taxes—are low relative to advanced OECD economies (see Figure 6.1 and Box 6.2 in Chapter 6 of this report, which show that, by international comparison, tax as a share of household income is particularly low in the middle of the household income distribution).

³⁷ Y. Mazar (2025), "The Quality of Human Capital Among Young Public Sector Employees," Research and Policy Analysis Notes Series No. 2025.04, Bank of Israel Research Department.

³⁸ After accounting for income tax offsets.

c. Policy Recommendations for Addressing Macroeconomic Challenges

The analysis above indicates that gaps in infrastructure and human capital relative to other advanced economies hinder Israel’s long-term growth potential. Given the substantial defense expenditures expected in the coming years, the economy is likely to face difficulties in bringing public debt back onto a downward trajectory and maintaining sustainable growth while narrowing the gap in the standard of living between Israel and the OECD benchmark countries—unless there is a significant increase in tax revenues. Addressing these challenges requires a multidimensional policy approach that combines targeted fiscal measures with long-term structural reforms. It is essential that the 2027–2028 budgets include a strategic plan designed to confront the challenges outlined above. The following recommendations aim to provide an integrated response that will lay the foundation for sustainable growth.

(1) Implementing a Fiscal Path to Reduce the Deficit and Debt-to-GDP Ratio

First and foremost, the government should restore sound budgetary procedures and redefine credible multiyear fiscal targets (see Section 1 in Chapter 6 of this Report).³⁹ This requires establishing expenditure and revenue trajectories that ensure a gradual reduction of the structural deficit and a return to a declining debt-to-GDP ratio beginning in 2027. This step is crucial in view of the sharp increase in the debt ratio following the war, the relatively high interest rate Israel pays on its debt compared with most advanced economies, and the need to rebuild fiscal buffers.

Given the expected rise in defense expenditure as a share of GDP relative to prewar projections, the government faces an intensified challenge in identifying sources that will enable both debt reduction and the necessary investments to support sustained economic growth. Infrastructure and human capital gaps relative to other advanced economies continue to constrain Israel’s long-term growth potential.

Accordingly, this fiscal path will require the inclusion of revenue increases—through higher tax rates and broadening the tax base (eliminating exemptions). It would be appropriate to begin with taxes addressing negative externalities affecting quality of life and the environment, such as congestion charges, carbon taxes, mileage-based levies, taxes on disposable plastics, and taxes on behaviors that lead to public costs, such as the tax on sugary drinks. In addition, it is worth conducting a comprehensive examination of the entire tax structure, for instance through a public committee, which has also been recommended by the International Monetary Fund⁴⁰ and in the OECD’s review on Israel.⁴¹

The government must formulate expenditure and revenue paths that ensure a return to a declining debt-to-GDP ratio beginning in 2027.

³⁹ While fiscal rule relaxation during wartime is generally understood by markets, returning to peacetime requires renewed fiscal discipline—particularly following a prolonged period of escalation on the security front and weakened budgetary control.

⁴⁰ IMF initial report, February 2026.

⁴¹ OECD Economic Surveys: Israel 2025.

Since civilian expenditure is low in Israel, it is difficult to reduce it as a tool to finance defense needs.

It is also important to reorient expenditure composition toward growth-supportive spending. Policies that increase labor market participation among Arab women and, in particular, *Haredi* men would contribute to increasing the potential growth rate. Much of this policy could be financed by reallocating existing budgetary resources that currently discourage employment. Expanding output through investments and incentives such as those that would increase productivity and labor supply will, in the medium term, also help reduce the debt-to-GDP ratio. However, the ways to implement policy components that are based on increasing investments in the short term will need to take into account changes in the balance of risks due to the narrowing of fiscal buffers in recent years.

(2) Establishing a Multiyear Framework for Sustainable Defense Expenditure

The government must adopt a clear and credible defense expenditure path.

A clear and credible trajectory for defense spending should be adopted—one that meets security needs while leaving room for additional investment in civilian infrastructure. A definitive government decision is required regarding the medium-term defense budget, based on an assessment of geopolitical risks. This decision should serve as a shared foundation for multiyear fiscal planning, taking into account the economic and social implications of crowding out civilian budgets or raising taxes, as well as uncertainty regarding the scope of future US defense assistance.

(3) Large-Scale Investment in Public Infrastructure

The lag in the scope and quality of infrastructure necessitates a significant leap in public investment.

The lag in the scope and quality of infrastructure necessitates a significant leap in public investment—particularly in mass transit systems such as railways, buses, and metro lines, as well as in communications, artificial intelligence, and energy infrastructure—to narrow gaps with benchmark countries and accommodate Israel's rapid population growth.

Some of these investments require substantial budgetary allocations, while others can be implemented through private sector participation but will need regulatory and planning support from the public sector. Such investments will improve labor productivity, reduce congestion, and increase potential growth. It is recommended that part of the financing be achieved through a combination of public budgets and private sector involvement, especially in large-scale projects whose benefits are concentrated among specific populations, such as the metro project.

(4) The Education System

Alongside the attendant challenges, Israel’s rapidly growing population and its unusually high share of young people (Figure 1.6) present significant potential for innovation-driven growth.⁴² However, given the expected increase in the share of *Haredi* men of working age—projected to double by 2047—without changes in their employment trajectory and earning capacity, which depend on acquiring education that is relevant for the labor market (primarily mathematics, English, and science at adequate levels), this opportunity could be missed and instead become an obstacle.

Such a scenario would likely impede potential growth and leave the Israeli economy behind.⁴³ Therefore, public funding for educational systems should be conditioned primarily on the teaching of core subjects—mathematics, English, and science—that enable integration into the modern economy. This must be accompanied by effective enforcement to ensure compliance at an appropriate level. This is a critical step for harnessing Israel’s demographic potential and ensuring sustainable growth.

Regular identification of key barriers within the education system, whether in how new technologies are implemented, the high number of students per classroom, the low quality of teachers, or collective agreements that make it difficult to implement important reforms, is essential for improving student achievement, enhancing future employee skills, and addressing forthcoming technological changes.

(5) Advancing a New Five-Year Plan for the Arab Population

The five-year plans for the Arab population (Plan 922 for 2016–2021 and Plan 550 for 2022–2026) have proven to be central and effective tools for reducing gaps between the Arab and non-*Haredi* Jewish populations in areas such as education, higher education, employment, infrastructure, transportation, and housing.⁴⁴ Despite

Public funding for educational systems should be conditioned on the teaching of core subjects, and this condition should be enforced.

It is recommended to formulate a new five-year plan for Arab society, with similar objectives to the previous one.

⁴² An increase of one standard deviation in median age reduces the likelihood of entrepreneurship by 2.5 percentage points—about 40 percent of the average entrepreneurship rate. See: James Liang, Hui Wang, and Edward P. Lazear (2018), “Demographics and Entrepreneurship,” *Journal of Political Economy* 126, pp. 140–176. Israel’s high entrepreneurship rate relative to other advanced OECD economies and benchmark countries (<https://www.gemconsortium.org>) is explained by its younger median age and extended military service. Moreover, PIAAC survey data show that younger individuals exhibit stronger technological orientation and learning capacity. Labor Force Survey data indicate that young people spend less time job searching, are more educated, and are more likely to work in high-tech.

⁴³ The loss of per capita output resulting from nonconvergence of *Haredi* men’s employment and education levels to those of non-*Haredi* Jews is projected to reach about 6 percent by 2065. See: Governor’s presentation at the release of the Bank of Israel Annual Report, 2023.

⁴⁴ Bachar, Demalach, and Miari (2024) found that during the implementation of the previous five-year plan for the Arab population (922), significant progress was achieved in key areas: improved educational outcomes (Meitzav and matriculation rates), higher academic attainment, a substantial rise in female employment, advances in urban planning and master plans, expanded transportation infrastructure, and reduced education funding gaps. See: S. Bachar, E. Demalach, and S. Miari (2024), “Analysis of the Implementation of the Five-Year Economic Development Plan for the Arab Society under Government Resolution 922: Budgets, Achievements, and Barriers,” Bank of Israel, Periodic Papers.

this progress, significant disparities remain between Jews and Arabs across many dimensions.⁴⁵

The current five-year plan (550), which will expire next year, was designed to preserve and expand the achievements of the previous plan. Given the contribution of these programs to narrowing gaps and strengthening human capital in the Arab sector—and research findings indicating that such investments tend to yield returns that exceed their cost through their contribution to growth—it is recommended to formulate a new five-year plan with similar objectives.

(6) Expanding Participation in Military Service

Expanding the circle of participation in military service will lower economic costs.

In view of the expected increase in the IDF's manpower needs in the medium term, as part of the effects of the war, expanding the circle of military service carries increased macroeconomic importance. It would reduce labor market distortions by lowering the need for extensive reserve mobilization. The economic cost of one month of reserve duty for a 30-year-old is approximately NIS 38,000, and is much higher than the economic cost of a soldier in compulsory service. A significant increase in the enlistment of *Haredi* men could substantially reduce the national and personal economic burden associated with heavy reliance on reservists.

For example, increasing annual enlistment cohorts by about 7,500 *Haredi* men (resulting in approximately 20,000 additional conscripts once the process matures) would enable a considerable reduction in reserve service, lowering the annual economic cost by at least NIS 9 billion (0.4 percent of GDP). This is an example of a policy measure that promotes growth and development, imposes no fiscal cost (and may even reduce it), and helps free resources for defense needs.

It is essential that any future legislative arrangement regarding the conscription of *Haredi* youth be designed to meet the army's needs while establishing effective positive and negative incentives.⁴⁶

⁴⁵ In 2024, Jews maintained a clear advantage over Arabs across most quality-of-life indicators in Israel, including employment quality, material living standards, and personal security. See: Central Bureau of Statistics (Press Release, 2026), "Gaps Between Jews and Arabs in Well-Being Indicators in Israel."

⁴⁶ For further discussion and reference to the proposed amendment to the Defense Service Law ("Draft Law") debated this year in the Knesset Foreign Affairs and Defense Committee, see: Bank of Israel (2026), "Comments on the Draft Law and the Economic Cost of Non-Enlistment of *Haredim* in the IDF."

Chapter 2

Growth and Aggregate Activity

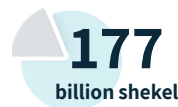
- » The war continued to weigh on economic activity in Israel this year, mainly through its adverse effect on labor supply. GDP grew by 2.9 percent—below its long-term growth trend. Business sector output also grew below its prewar trend. The cumulative loss of output from the beginning of the war through the end of 2025 totaled 8.6 percent of annual GDP (about NIS 177 billion).
- » The labor market remained tight in 2025. Unemployment was low and labor supply remained constrained due to reserve mobilization, a decline in the number of non-Israeli workers, and a lower labor force participation rate. Demand for workers remained high.
- » Investment increased rapidly, but by the end of 2025 it was still 1.7 percent below its prewar level—particularly due to low investment in construction. The rapid increase in investment in machinery and equipment came mainly from defense-related investment, and its contribution to expanding productive capacity in the business sector was therefore limited.
- » Public consumption—both defense and civilian—remained high.
- » The fiscal impulse moderated this year due to higher taxation, but remained stronger than before the war. The impulse was mainly due to wage payments to reservists and domestic defense procurement. Signs of crowding out of civilian business activity are evident.
- » In 2025, both goods exports and services exports increased rapidly. This increase was concentrated mainly toward the end of the year, whereas until then exports grew moderately. An examination of Israeli exports to the European Union points to a relative decline in exports to countries that are critical of Israel.
- » Throughout the year, imports increased at a high rate and provided sources for demand, in view of domestic supply constraints.
- » The impact on annual growth resulting from Operation “Rising Lion” was about 0.3 percent of GDP, including the offsetting recovery in subsequent quarters. That is, even excluding the effect of Operation “Rising Lion”, annual growth in 2025 still remained slightly below the economy’s previous growth trend.



GDP growth was below the pre-COVID trend



Imports grew rapidly responding to supply constraints



Loss of GDP during the war



Investment expanded, but remained **lower** than before the war

1. MAIN DEVELOPMENTS

GDP grew by 2.9 percent in 2025. The growth rate and level of GDP remained below the pre-COVID-19 trends.

In 2025, GDP grew by 2.9 percent, and its level remained below the long-term growth trend that had characterized the economy prior to the COVID-19 crisis and the war. The main events affecting economic activity during the year were security-related: the continuation of the war at varying intensity throughout the year, Operation “Rising Lion” in June, and the ceasefire agreement in October. These events constrained labor supply to the business sector. Business sector output grew at a slightly faster rate than total GDP, but this rate was also below the trend that had characterized the business sector prior to the war.

Throughout 2025, the labor market remained tight. On average, about 30,000 workers were absent from their jobs due to reserve duty. The labor force participation rate declined, partly due to war-related effects, such as reservists being outside the labor market and war casualties. In addition, although the number of non-Israeli workers increased gradually, it remained below its prewar level. All these factors constrained labor supply, such that the unemployment rate remained low. Demand for workers was even stronger, as reflected in the high level of job vacancies and rising wages in the business sector. This situation indicates that the constraint on economic activity in 2025 was primarily the result of supply-side limitations. (For further details on the labor market, see Chapter 5 of this Report.)

Government demand increased during the war and crowded out civilian demand.

During the war, the public sector’s contribution to demand increased. Defense wage expenditures rose sharply in order to finance wages and grants for the many reservists who were mobilized. At the same time, defense purchases of equipment, logistics services, and supplies from domestic producers and from imports increased. This expansion in government defense activity crowded out civilian demand for the same workers and factors of production. This was reflected, for example, in private consumption, which grew in 2025 and throughout the war at a more moderate pace than previously.

Fixed capital formation increased rapidly in 2025, but remained below its prewar level due to the low investment in construction, which was a result of the ban on the entry of Palestinian workers into Israel since the beginning of the war. The ban continues to constrain activity in the sector even now, despite partial replacement through foreign workers and increased employment of Israeli workers in the sector. Nevertheless, the number of housing starts increased rapidly this year, partly due to the reallocation of production factors away from nonresidential construction. (For details, see Chapter 8 of this Report.)

As a result of these supply constraints, and in response to increased demand, the economy turned to imports. After the initial decline in imports and exports at the beginning of the war, the export surplus began to narrow from mid-2024 onward, due to a rapid increase in imports. At the end of 2025, the export surplus increased due to a surge in exports in that quarter.

2. AGGREGATE ACTIVITY

a. GDP

In 2025, GDP increased by 2.9 percent—below the average growth rate in the past (Table 2.1). Even excluding the effects of Operation “Rising Lion”, GDP grew by only 3.2 percent (see Box 2.3 in this chapter). Accordingly, during the war a gap opened up between actual GDP and the trend that had characterized the years preceding the COVID-19 pandemic and the war.¹ This deviation from trend reflects damage to the economy’s productive capacity, in particular a contraction in labor supply due to extensive reserve mobilization and prolonged absences, alongside disruptions to activity in various industries. To estimate the loss of output resulting from the war, we compared actual output during the war period with the trend (Figure 2.1).² According to this estimate, the cumulative loss of output from 2023:Q4 through 2025:Q4 totaled 8.6 percent of annual GDP, and the loss of business sector output totaled about 11 percent of business sector output.³ A return of GDP to its trend would signal the end of the war’s impact, but would not compensate for the accumulated loss. Such compensation would occur only if GDP were to rise above the trend for a prolonged period—something not anticipated in the prevailing forecasts at this time.

The cumulative loss of GDP during the war was 8.6 percent of annual GDP.

¹ The economy’s productive capacity under “normal” circumstances is represented by the GDP growth trend. This trend is calculated on the basis of GDP in 2014–2019, years in which average growth was about 3.8 percent.

² The loss of output represents an estimate of the value (at 2025 prices) of domestic production (goods and services) that did not take place during the war period. It focuses on the utilization of productive capacity rather than on the welfare of Israeli citizens (as reflected in the estimate in Chapter 1) or on the share financed by the public sector (as reflected in Chapter 6).

³ Business sector output is the output of the entire economy excluding the output of the government sector, nonprofit institutions serving households, and owner-occupied housing services. The loss of business sector output, measured in percentage terms, is larger because total output includes government sector output, which increased during the war as defense expenditures rose, thereby partially moderating the loss in total output.

Table 2.1 | Selected indices of economic activity, 2009–2025

	annual rates of change, percent					Change during the war ^b
	2009–2022 ^a	2022	2023	2024	2025	
Gross domestic product	4.1	6.4	2.1	1.0	2.9	1.7
Per capita GDP	2.2	4.4	0.1	-0.3	1.6	0.4
Business sector output	4.7	7.6	1.1	-0.4	3.2	1.2
Exports (excluding diamonds and startups)	5.5	10.2	0.0	-3.7	5.9	2.1
Domestic uses (excl. inventory)	4.1	6.7	0.7	2.8	3.7	2.5
Unemployment rate (ages 25–64, avg. level)	4.9	3.3	3.0	2.8	2.8	0.1
Real wages per employee post	1.8	-1.5	2.0	2.5	0.1	2.1
Current account surplus (percent of GDP)	2.7	2.7	3.1	2.9	1.5	-0.5
Real effective exchange rate ^c	-1.7	0.1	9.2	-0.5	-5.6	-5.0

^a Average annual rate of change or average annual level, as relevant.

^b Average annual rate of change between 2023:Q3 and the most recent quarterly figure, or the difference in levels between the most recent quarter and 2023:Q3, as relevant.

^c An increase means depreciation.

SOURCE: Based on Central Bureau of Statistics.

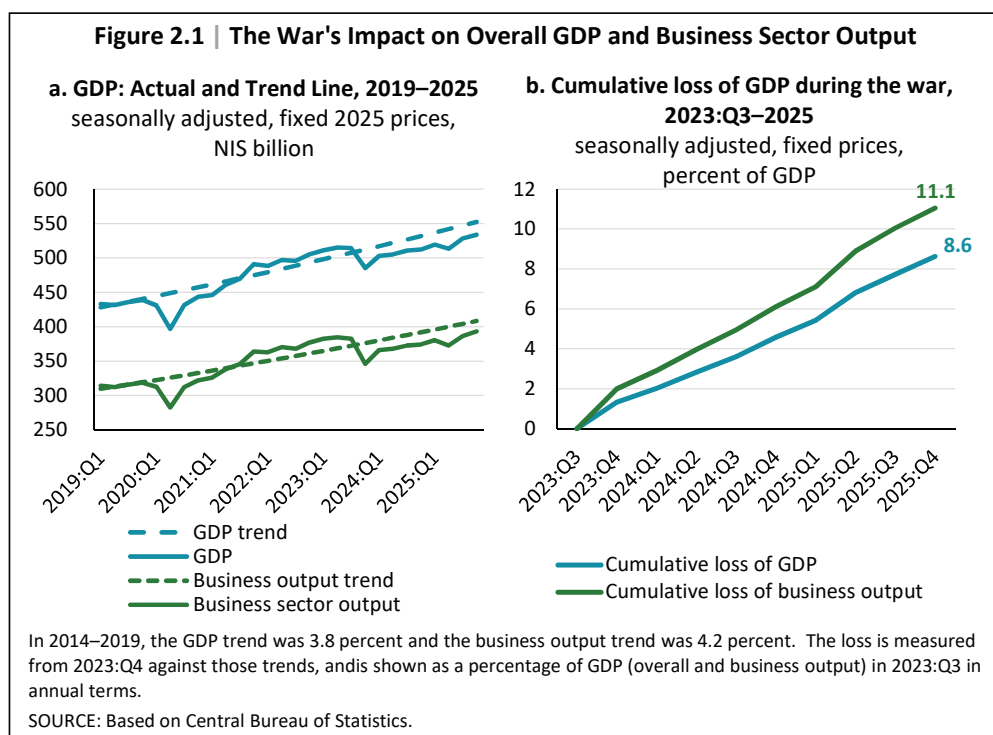


Table 2.2 | Sources and uses, 2009–2025

	annual rates of change, percent					Change during the war ^b
	2009–2022 ^a	2022	2023	2024	2025	
GDP	4.1	6.4	2.1	1.0	2.9	1.7
Imports (excluding ships, aircraft, diamonds, and defense imports)	6.1	12.4	-6.9	-2.2	8.8	3.4
Domestic uses (excl. inventory)	4.1	6.7	0.7	2.8	3.7	2.5
<i>of which</i> : Private consumption	3.8	7.3	-0.6	3.9	2.6	2.6
Fixed capital formation (excluding ships and aircraft)	5.6	11.5	-2.6	-5.5	8.5	-1.4
Investment in inventory (excluding diamonds and startups, percent of GDP)	0.2	0.2	0.2	0.0	-0.1	
Public consumption (excluding defense imports)	3.2	1.1	7.5	9.4	2.0	7.4
Startup companies output	12.2	22.3	-23.3	-48.1	-0.1	-24.2
Exports (excluding diamonds and startups)	5.5	10.2	0.0	-3.7	5.9	2.1

^a Average annual rate of change or average annual level, as relevant.

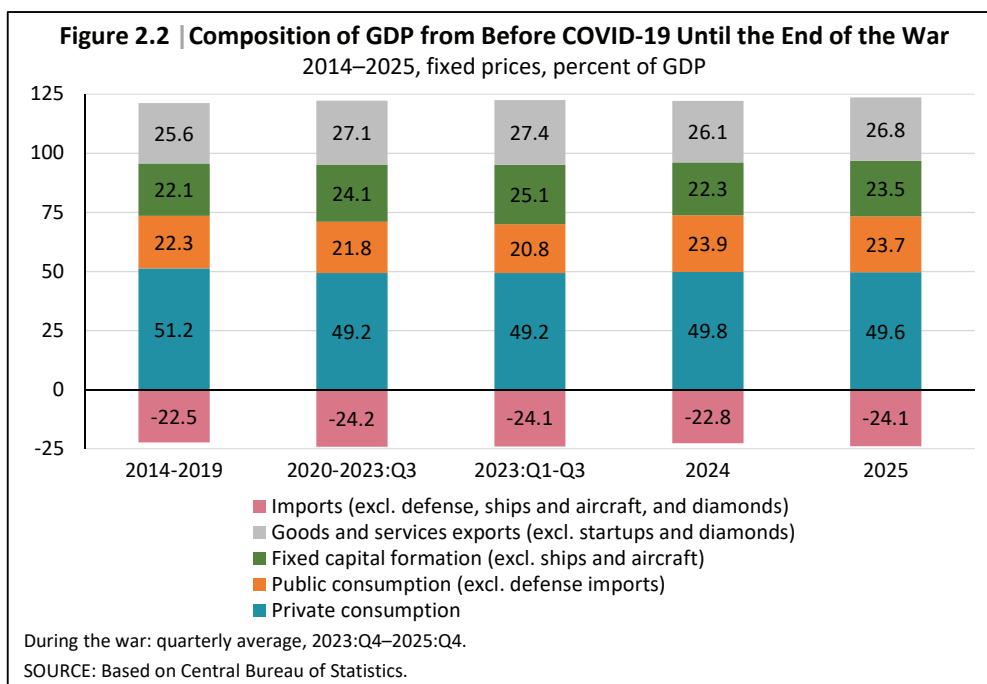
^b Average annual rate of change between 2023:Q3 and the most recent quarterly figure, or the difference in levels between the most recent quarter and 2023:Q3, as relevant.

SOURCE: Based on Central Bureau of Statistics.

b. Uses

In 2025, domestic uses (excluding inventories) grew faster than GDP—an expression of the economy’s constrained productive capacity (Table 2.2). All the main components increased.⁴ Figure 2.2 presents the changes in the composition of GDP from the pre-COVID period through 2025. At the beginning of the decade, exports and investment grew faster than private and public consumption, and their share in uses increased. Since the beginning of the war, this pattern has partially reversed due to the surge in public consumption, the decline in activity in the construction industry (investment), and the relative resilience of private consumption.

Domestic uses grew faster than GDP this year, reflecting supply constraints.



⁴ Startup output remained about 0.8 percent of GDP, similar to its level in 2024 and about half its prewar size.

c. Private Consumption

Total private consumption grew moderately, but consumption excluding durables grew faster than GDP.

In 2025, private consumption grew at a moderate pace due to a decline in purchases of durable goods, the consumption of which is volatile, while consumption excluding durables increased at a rate slightly higher than GDP (Table 2.3). Over the war period as a whole, private consumption grew more moderately than in the past, but still faster than GDP, and its share in GDP therefore increased (Figure 2.2). The increase in private consumption was supported by the sharp rise in the value of households' net financial asset portfolios and by the expansion of consumer credit.⁵ Although private disposable income declined, the decline was apparently influenced by a reduction in the operating surplus of the business sector, while net wages increased and supported higher consumption.⁶ The rise in real interest rates moderated private consumption (Table 2.3).

Table 2.3 | Domestic demand: Background conditions and main indicators of its development, 2009–2025

	annual rate of change, percent					Change during the war ^b
	2009–2022 ^a	2022	2023	2024	2025	
Private consumption	3.8	7.3	-0.6	3.9	2.6	2.6
<i>of which</i> : Consumption excl. durables	3.4	7.1	0.2	3.4	3.6	3.3
Durable goods consumption	7.1	8.9	-9.1	9.3	-8.6	-0.5
Gross private disposable income from all sources	4.3	3.9	4.8	2.1	-1.5	1.6
Net wages+ transfer payments ^c	4.4	4.1	3.1	4.5	2.2	
Business sector's operating surplus ^d	5.3	3.4	4.4	1.0	-0.8	
Credit to households	7.2	14.9	5.5	3.9	7.0	5.8
<i>of which</i> : Nonhousing credit	5.3	12.1	0.8	0.4	4.9	3.7
Real 1-year yield (government bonds, average level)	-0.4	-1.4	1.6	1.3	2.3	0.4
Value of the public's financial assets portfolio	7.0	5.4	2.8	10.8	13.4	12.8
Fixed capital formation (excluding ships and aircraft)	5.6	11.5	-2.6	-5.5	8.5	-1.4
Credit to the business sector	4.0	14.6	8.9	4.7	8.3	7.0
Real 10-year yield (government bonds, average level)	0.9	0.1	1.2	2.0	2.0	0.6
Public consumption excluding defense imports	3.2	1.1	7.5	9.4	2.0	7.4
Defense consumption excluding imports	1.7	-2.0	20.9	27.2	-0.6	19.4
Total taxes	29.1	32.6	29.4	30.4	32.9	
General government budget deficit ^e	4.3	1.9	7.1	9.0	6.4	

^a Average annual rate of change or average annual level, as relevant.

^b Average annual rate of change between 2023:Q3 and the most recent quarterly figure, or the difference in levels between the most recent quarter and 2023:Q3, as relevant.

^c GDP labor share (including imputation to self-employed) plus current transfer payments from the government to the public, minus income tax, National Insurance, and health tax payments.

^d Total profits of business sector firms after current expenses and before interest and tax payments.

^e As a percentage of GDP.

SOURCE: Based on Central Bureau of Statistics.

⁵ For a discussion of the factors affecting the growth of private consumption in Israel, see: Arnon Barak (2017), "The Private Consumption Function in Israel", Discussion Paper 2017.04, Bank of Israel. According to this model, the sharp increase in the value of the public's net asset portfolio in 2025 increased private consumption by 1.7 percentage points.

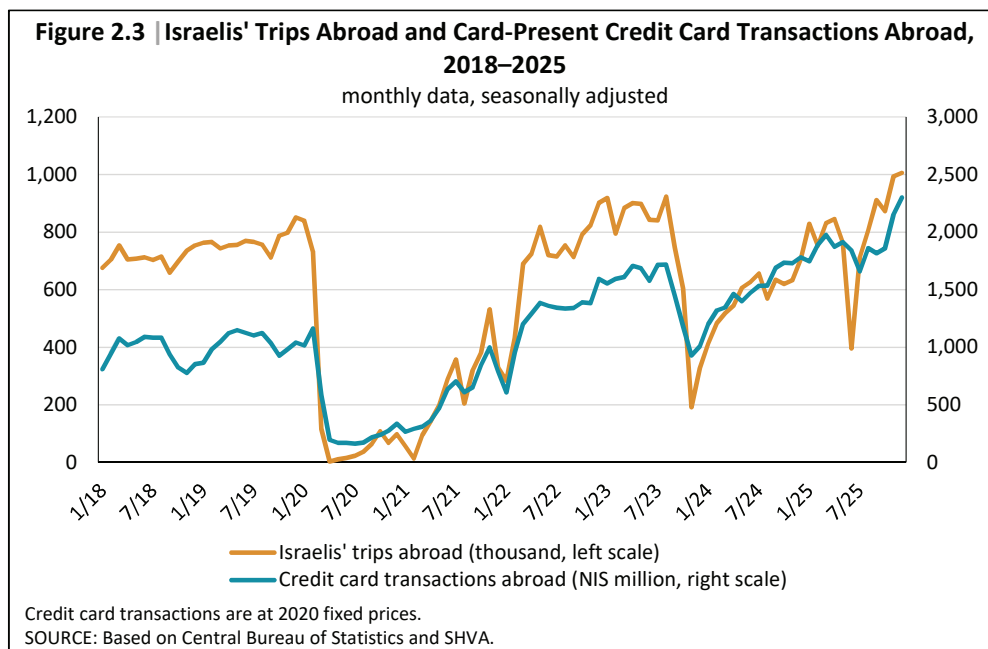
⁶ For a discussion of disposable income and consumption, see the section on savings later in this chapter.

At the beginning of the war, outbound tourism declined, partly due to constraints on flight supply by foreign airlines, but within a short time it resumed rising and strengthened further after the ceasefire in the north in 2024. By the end of 2025, the number of Israelis traveling abroad had reached a new peak, and Israelis' consumption abroad exceeded its prewar level (Figure 2.3). This is evidence of underlying household demand for private expenditure.

d. Public Consumption

During the war, the government's share in GDP increased significantly. Expenditure on public consumption (excluding defense imports) rose from 21.8 percent of GDP in 2023 before the war to 26 percent of GDP with the outbreak of the war in the fourth quarter of 2023. As the war continued, the share of public expenditure declined, but it remained high relative to the prewar period (Table 2.3).⁷ A 50 percent increase in defense consumption (excluding defense imports) was the main reason for this higher level. This increase in government activity increased aggregate demand, exerting a positive fiscal impulse on the economy (see Box 2.1 in this chapter). At the beginning of the war, this impulse increased total uses. As the war continued, however, the high level of government demand likely crowded out business activity. This can be seen in the high rate of job vacancies during the war period, when tens of thousands of reservists were mobilized. (Another example appears in the investment section of this chapter.)

The government's share of GDP increased greatly during the war, due to increased defense consumption.



⁷ Public consumption does not include transfer payments and compensation, since these are used by recipients for private consumption. These payments are, however, included in government expenditure (see Chapter 6 of this Report).

During the war, the extensive reserve mobilization led to an average increase of 52 percent (1.0 percent of GDP) in defense wage expenditures, and demand for military and logistical equipment led to a 90 percent (0.8 percent of GDP) increase in domestic defense procurement. This was in addition to the even sharper increase in defense imports during the same period. During this period, civilian public consumption also increased by about 6 percent, partly due to war-related expenditures.

BOX 2.1. THE FISCAL IMPULSE DURING THE WAR

- With the outbreak of the war, the sharp increase in domestic defense consumption led to a marked rise in the fiscal impulse, reflecting a positive effect of fiscal policy on aggregate demand.
- In 2025, the impulse moderated relative to its level at the beginning of the war, mainly due to the tax increases decided on by the government, but it remained positive relative to its level prior to the war.

a. Background

The term “fiscal impulse” reflects the direction and intensity of the effect of fiscal policy on aggregate demand. This box uses the Brookings Institution’s Fiscal Impact Measure (FIM) (Sheiner et al., 2021), which makes it possible to assess how changes in public consumption, transfer payments, government investment, and taxes affect changes in aggregate demand. The analysis focuses on the recent crises—the COVID-19 pandemic and the war that began on October 7, 2023—during which the government implemented fiscal adjustments in line with the unique geopolitical and macroeconomic circumstances.

b. Methodology

The FIM calculates the contribution of fiscal policy to aggregate demand relative to a “neutral” policy—namely, a situation in which expenditure and taxes change at the same rate as potential GDP growth. Any increase in expenditure or reduction in taxes beyond the neutral path represents fiscal expansion, whereas any reduction in expenditure or tax increase is considered fiscal restraint. The FIM focuses only on the initial effect of fiscal measures on aggregate demand and does not take into account fiscal multipliers or other indirect effects. In addition, the FIM reflects not only active government policy, but also the operation of the automatic stabilizers when output grows below or above potential. The overall FIM is calculated as the sum of the contributions of public consumption, transfer payments, taxes, and government investment.

In the case of public consumption, the measure compares the actual level of real public consumption with the level that would have prevailed had public consumption grown at the rate of potential GDP growth. A positive gap represents fiscal expansion, whereas a negative gap represents restraint. The

gap is expressed as a percentage of GDP in the previous quarter.¹ The public investment component is calculated similarly.

Likewise, for taxes and transfer payments, the measure assesses how changes in these items affect private demand. For each component, a neutral revenue level is defined—that is, the level that would have prevailed had it changed in line with the rate of potential GDP growth. The gap between the actual level and the neutral level is then measured, taking into account that each component affects private consumption over several quarters in accordance with its characteristic marginal propensity to consume.² Taxes lower than the neutral value, or transfer payments higher than the neutral value, increase demand and constitute expansion, and vice-versa. The total contribution of taxes and transfer payments is expressed as a percentage of GDP in the previous quarter, similar to the calculation for public consumption.³ Summing all the contributions yields the overall FIM, which provides a comprehensive presentation of the effect of all fiscal measures on aggregate demand relative to a neutral policy.⁴

c. Results

Figure 1 presents the level of the fiscal impulse relative to the period prior to the COVID-19 pandemic, and Figure 2 presents the level of the fiscal impulse relative to the period prior to the war. In these years, fiscal expansion was high relative to earlier years. This was made possible partly by the “fiscal buffers” accumulated before the crises, which gave the government room to maneuver (International Monetary Fund, 2026). Whereas during the COVID-19 pandemic (Figure 1) the impulse was driven mainly by transfer payments and faded rapidly with the termination of the assistance packages, during the war period (Figure 2) it rested on public consumption, mainly defense-related, which is characterized by a high multiplier but also by considerable volatility. In 2025, the fiscal impulse moderated, mainly due to the implementation of adjustment measures on the revenue side, particularly tax increases.

¹ Equation for the public consumption component: $FIM_t^G = \frac{G_t - (1+\mu) \times G_{t-1}}{Y_{t-1}}$ where G_t is real public consumption excluding defense imports, seasonally adjusted, in quarter t ; μ is the growth rate of real potential output; and Y_t is seasonally adjusted GDP in quarter t . A different growth rate is used for each period: for 2020:Q1–2023:Q3, an annual growth rate of 3.9 percent; for 2023:Q4–2025:Q4, an annual growth rate of 3.5 percent, in line with the assessments of the Bank of Israel Research Department.

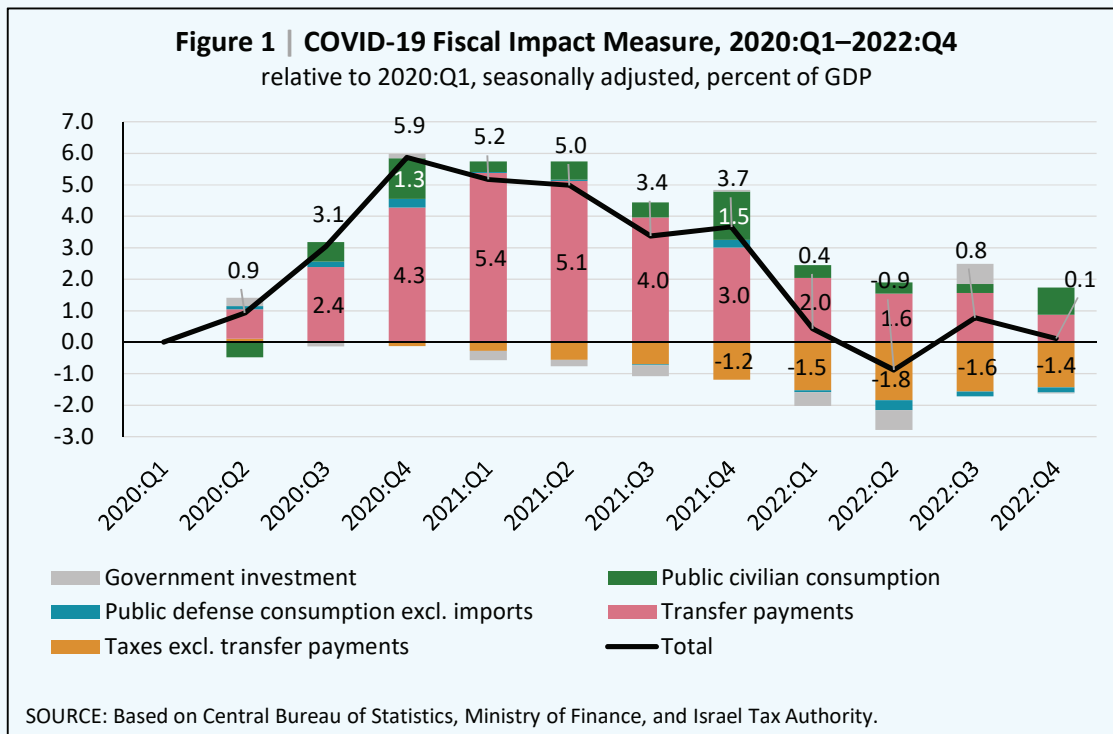
² We use the multipliers and marginal propensities to consume appearing in the Brookings Institution paper: 0.9 for transfer payments, with full effect within one year; -0.6 for income tax (excluding corporate tax) and indirect taxes, with full effect within two years; and -0.4 for corporate tax, with full effect within three years. For public consumption and investment, we assume a multiplier of 1. The literature presents a wide range of multipliers and marginal propensities to consume, and we use values that lie within that range. It should be noted that this is an assumption, and the results may vary depending on the multipliers used. However, sensitivity tests show that although the levels themselves change, the dynamics across periods remain similar.

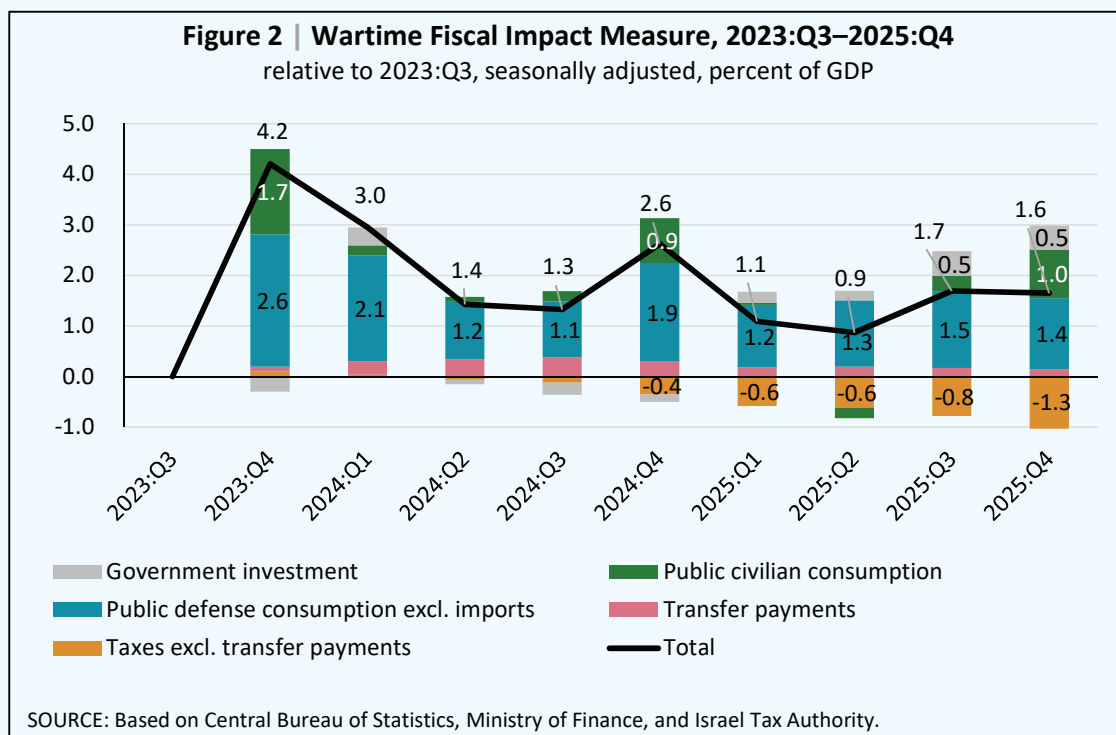
³ Equations for the tax and transfer payment components: Neutral level: $\tilde{T}_{j,t} = T_{j,t-1}(1 + \mu)$. Overall effect of taxes and transfer payments: $T_t^C = \sum_{j=1}^3 \sum_{i=0}^n MPC_{j,t-i} * (T_{j,t-i} - \tilde{T}_{j,t-i})$. Contribution of taxes and transfer payments relative to GDP in the previous quarter: $FIM_t^T = \frac{T_t^C}{Y_{t-1}}$, where: j is the type of tax/transfer payment. Taxes are divided as follows: (1) income tax excluding corporate tax, together with indirect taxes; (2) corporate tax; (3) transfer payments also include National Insurance transfers and subsidies for domestic production. The data are in real terms and seasonally adjusted. i is the number of quarters backward, and $MPC_{j,t-i}$ is the marginal propensity to consume, specific to component j and time $t - i$.

⁴ Equation for the overall measure: $FIM_t = FIM_t^G + FIM_t^I + FIM_t^T$.

The high fiscal impulse in recent years may have helped narrow the gap between actual GDP and the trend line, although the strength of the effect is not unequivocal and depends to a considerable extent on the cyclical position of the economy. To the extent that the economy is in an environment of full employment or under supply constraints—as was the case during the war period—the fiscal impulse may be reflected in changes in the composition of demand, price increases, or an increase in imports.

Moreover, a large share of the fiscal impulse during the war period was due to expenditure on reserve service. This component is similar to other government expenditures in terms of generating demand, but differs from it in the manner in which demand is created: It does not rely on market mechanisms (recruiting workers by offering wages), but rather on a binding order. The employer of a reservist is required to preserve the employee’s position, which increases the tendency to crowd out other business activity and to reduce supply in the business sector.





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e. Investment

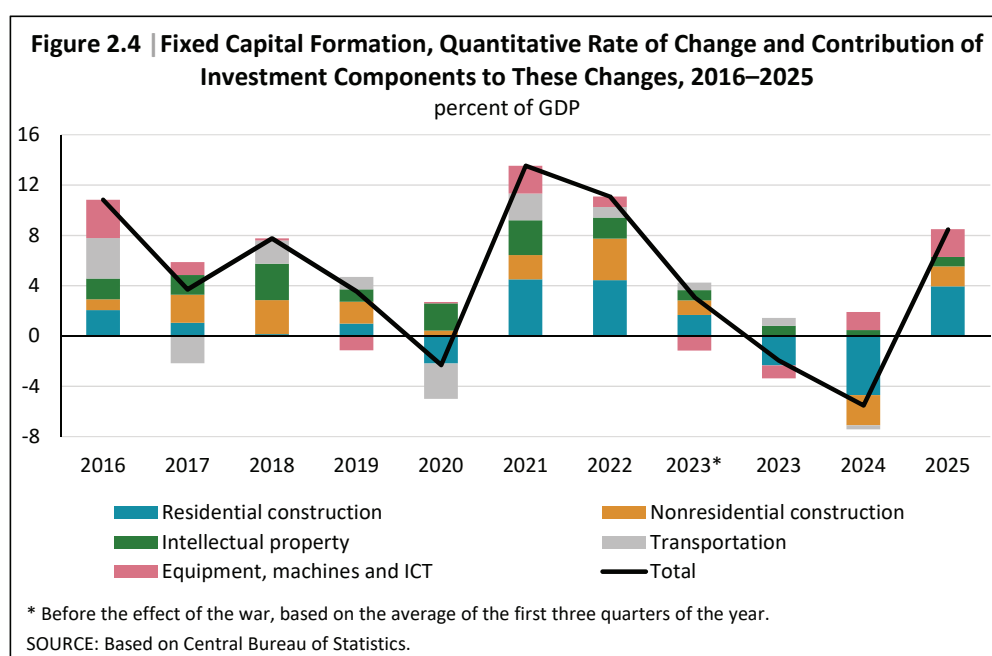
In 2025, fixed capital formation (excluding ships and aircraft) increased by 8.5 percent, but due to its decline in previous years, its level at the end of 2025 remained lower than in 2023 before the war. The components of investment can be divided into two groups that developed differently: investment in construction and investment in machinery and equipment (Figure 2.4).

Investment in construction (both residential and nonresidential) increased by 11.6 percent in 2025, but this followed two years of sharp declines, and by the end of 2025 it still remained 13.8 percent below its prewar level. The cumulative loss in construction investment during the war period amounted to about NIS 141 billion (at

Investment grew rapidly this year, but its level remains lower than before the war.

Construction investment was the component of aggregate uses most severely affected by the war.

2025 prices)⁸—a substantial share of the output loss described above. Construction investment was the component of aggregate uses most severely affected by the war. This is because, on the eve of the war, about 30 percent of the workforce in the construction industry consisted of Palestinian workers, and from the beginning of the war almost all of these workers were barred from working in Israel. As a result, in 2024 the number of employed persons in the industry averaged only about 82 percent of its prewar level. Since then, employment in the industry has increased, and by the end of 2025 it had returned to approximately its prewar level.⁹ Nevertheless, the increase in housing starts points to a stronger recovery in this segment, partly at the expense of nonresidential construction, but the labor shortage led to a lengthening of construction times (see Chapter 8 of this Report).



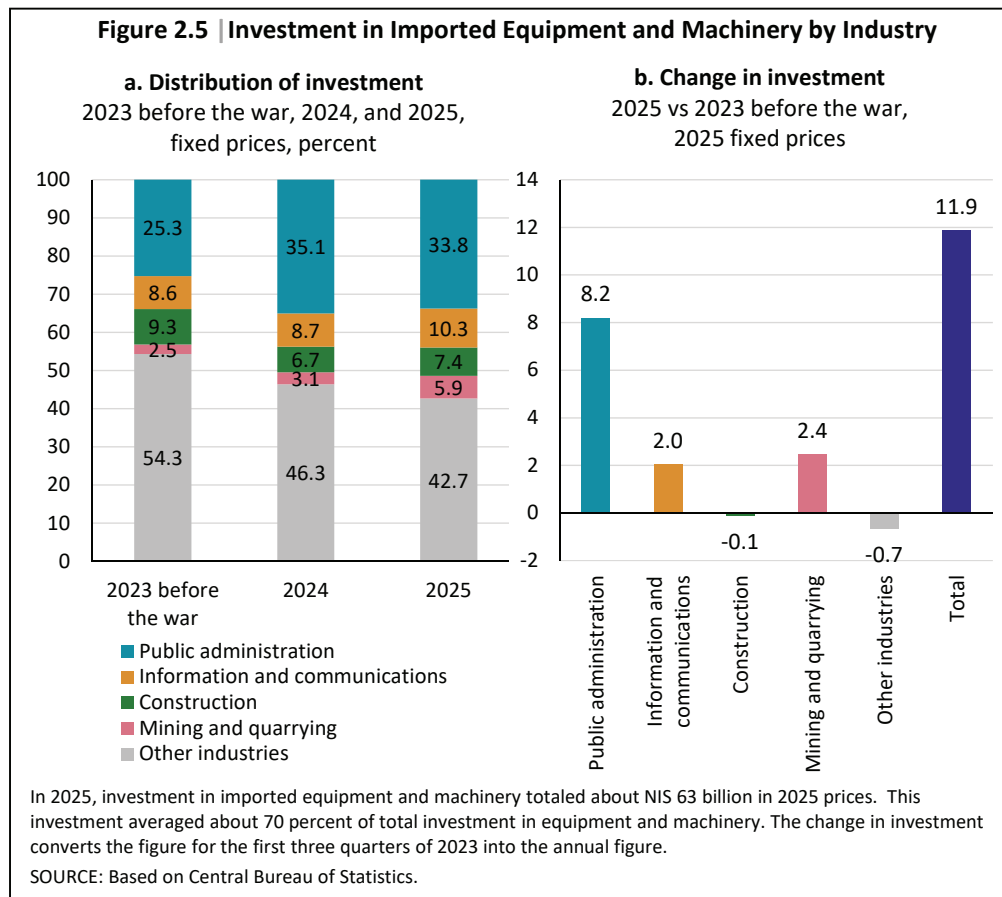
⁸ This loss is measured relative to a scenario in which investment in the industry would have grown from 2023:Q4 onward in line with its trend in 2014–2019 (5.6 percent per year). This is a macroeconomic loss because it is not the result of workers moving to other industries, but is rather due to a contraction in the labor force in Israel. Had workers moved to other industries—whether more profitable or better suited to them—this shift would have been reflected in increased activity in those industries, offsetting the decline in construction investment.

⁹ There are discrepancies between employment data for the construction industry according to the Labor Force Survey and the data based on employee post reports to the National Insurance Institute, which point to only a more partial recovery. (See Chapter 5 of this Report for a discussion of this discrepancy.) During the war period, the Central Bureau of Statistics shifted from estimating construction investment on the basis of housing starts to an estimate combining employment data in the industry with employee post data in the industry.

In contrast to construction, investment in machinery and equipment continued to increase throughout the war. These investments are divided between imports (70 percent) and domestic production (30 percent), both of which increased at similar rates. In 2024–2025, the overwhelming majority of the increase in investment in machinery and equipment was due to imports by local and public administration, which includes the security forces (Figure 2.5). Investment by the information and communications industry also increased, but investment by the other industries did not change. In addition, from prewar 2023 through 2025, imports of defense investment goods increased by 50 percent (without a breakdown by type of investment). Taken together, this indicates that the increase in investment in machinery and equipment in the economy was mainly defense-related as a result of the war, and that most of it was not due to increased investment by the business sector. Accordingly, the data do not support the claim that the increase in investment in imported machinery and equipment served the business sector as a substitute for missing workers.

The increase in investment in machinery and equipment was mainly defense-related as a result of the war and not due to increased investment by the business sector.

Even in the construction industry, which experienced a large decline in manpower, investment in imported machinery and equipment declined in 2024–2025 (Figure 2.5).



BOX 2.2: ISRAELI EXPORTS TO THE EUROPEAN UNION AS A CASE STUDY OF THE ECONOMIC IMPACT OF POLITICAL CRITICISM ON THE ISRAELI ECONOMY

- During 2024–25, political and public pressures intensified in some European Union member states to scale back trade relations with Israel, against the background of the protracted war in Gaza.
- Total exports to moderate countries, which account for the lion’s share of exports to the European Union continued to increase during the war period (from late 2023 to 2025), but exports to the more critical EU countries declined moderately. This pattern may indicate that political positions affected the value of exports to those countries.

In 2025, Israel’s civilian goods exports to the European Union (excluding diamonds and chips)¹ increased by about 3 percent relative to 2024, reaching approximately \$14 billion. During this period, political tensions between Israel and some EU member states increased. The link between exports and political tensions is also reflected in a survey according to which about 84 percent of Israeli industrialists reported the cancellation of transactions with companies in the European Union, mostly for “political reasons” (Manufacturers Association of Israel, 2025).

As political tensions intensified, countries and institutions in the European Union took steps toward suspending the free trade agreement with Israel, although this move was put on hold following the ceasefire (October 2025). Formally, only Turkey and Colombia—neither of which are EU member states—imposed an embargo on civilian trade with Israel (Bank of Israel, 2025).²

The analysis in this box examines the relationship between the political positions of EU member states toward Israel and the value of Israeli civilian goods exports to EU countries, which account for about 29 percent of total goods exports.³ Exports to EU countries provide a convenient case study for examining the relationship between political positions and foreign trade. This is due to the variation in the political positions of different member states alongside the uniformity of EU trade agreements, as well as the fact that most EU member states use the euro.

For the purposes of the analysis, we classified European countries according to the degree of criticism toward Israel, based on official recognition of a “Palestinian state” in recent years. The critical group includes eight European countries—including Ireland, Belgium, Spain, and France—that recognized “Palestine” in 2024–25, as well as Sweden, which recognized “Palestine” in 2014. The moderate group includes countries that have not recognized the “State of Palestine”, including major export destinations such as Germany, the Netherlands, and Italy. In addition, the moderate group includes countries in Eastern and Southern Europe that recognized “Palestine” back in the 1980s and 1990s, but most of

¹ Israel’s chip exports to the European Union declined sharply in 2025, mainly due to a shift from chip exports to the United States routed through Ireland to direct exports to the United States. This reflected changes in the global semiconductor market that were unrelated to Israel’s political standing. Accordingly, the analysis in this box examines exports to the European Union excluding chips and diamonds. The analysis is based on foreign trade data reflecting goods that passed through customs, rather than on national accounts data, which are adjusted to conform to balance of payments definitions.

² Several countries imposed restrictions on trade with Israel in defense goods and dual-use products.

³ Civilian exports (excluding diamonds) to the European Union exceed the corresponding exports to the United States, which accounted for about 26 percent of total exports (excluding diamonds) in 2025.

which have moderated their critical stance toward Israel in recent decades, including Hungary, Greece, Poland, and Cyprus, and some maintain close relations with Israel.⁴ The difference in political positions between the two groups of EU countries is also reflected, to some extent, in voting patterns in the UN General Assembly (Table 1, Panel A).

Table 1 | Policy Stances of EU Countries, and Israeli Exports to the EU, 2021–2025

	2021	2022	2023	2024	2025
a. Support for UN decisions critical of Israel (percent)^a					
Countries critical of Israel ^b	73	69	66	73	80
Countries moderate toward Israel	68	65	66	64	71
Difference	5	5	0	10	9
b. Goods exports to EU, excluding diamonds and chips (\$ billion or percent)					
Total exports	11.8	14.1	13.0	13.6	14.0
<i>of which</i> : To critical countries	4.5	5.4	4.7	4.4	4.2
To moderate countries	7.3	8.7	8.3	9.2	9.8
Share of exports to critical countries (%)	38	38	36	32	30
Share of exports to moderate countries (%)	62	62	64	68	70
<i>of which</i> : To Germany	15	13	16	17	21
To other countries	47	49	49	51	49

^a Support of UN General Assembly resolutions critical of Israel is defined as a vote similar to Iran and different from the US on resolutions regarding Israel. The votes of each country were weighted by the volume of Israeli exports to it in 2023.

^b Countries critical of Israel are countries that recognized a "Palestinian state" in 2024-2025 and Sweden, which recognized such a state in 2014.

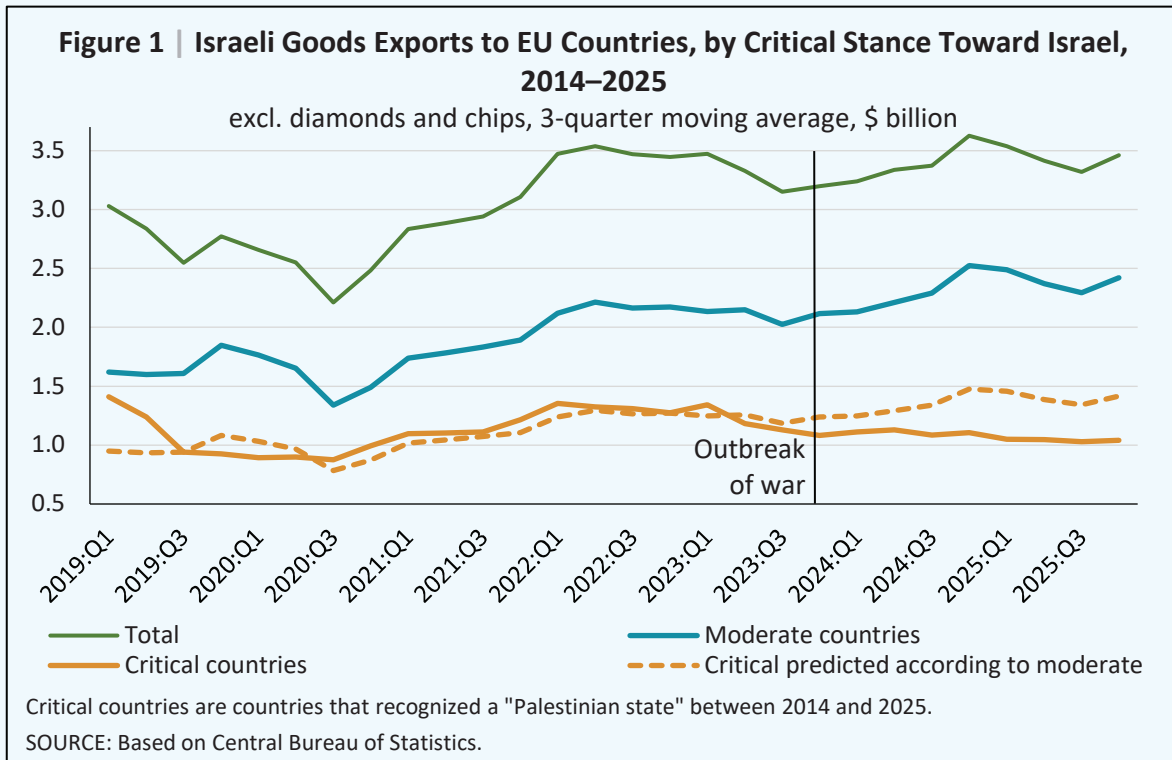
SOURCE: Based on Central Bureau of Statistics and United Nations.

In the years preceding the war (between 2021 and late 2023), Israel's exports (see Footnote 1) to the critical countries and to the moderate countries grew at a similar pace, such that exports to the critical countries maintained their share—about 38 percent—of total exports to the EU. During the war period (between late 2023 and 2025), however, exports to the critical countries declined moderately, while exports to the moderate countries continued to increase. As a result, the moderate countries' share in exports to the EU rose gradually—from about 62 percent in 2021–22 to about 70 percent in 2025. This was due mainly to an increase in exports to Germany, while exports to the other moderate countries maintained their share of total exports to the European Union (Table 1, Panel B, and Figure 1).

The cumulative gap between actual exports excluding diamonds and chips to the critical countries and the exports projected to those countries on the basis of exports to the moderate countries amounted to about \$1 billion in 2024 and about \$1.5 billion in 2025, equivalent to about 2.7 percent of goods

⁴ The critical countries are Ireland, Belgium, Luxembourg, Malta, Slovenia, Spain, Portugal, France, and Sweden. The moderate countries in this context are Austria, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, Germany, Greece, Hungary, Italy, Latvia, Lithuania, the Netherlands, Poland, Romania, and Slovakia.

exports excluding diamonds in 2025. This estimate does not take into account a possible effect of the deterioration in Israel’s political standing on exports to the moderate countries or to countries outside the European Union, and may therefore understate the damage to exports. On the other hand, to the extent that export volumes were diverted from the critical EU countries to moderate EU countries or to other countries outside the EU, the actual damage to Israeli exports would be smaller than implied by this estimate.



References

Bank of Israel (2025), “The Impact of the Turkish Embargo on Israel’s Economy,” *Bank of Israel Annual Report 2024*, pp. 47–50.

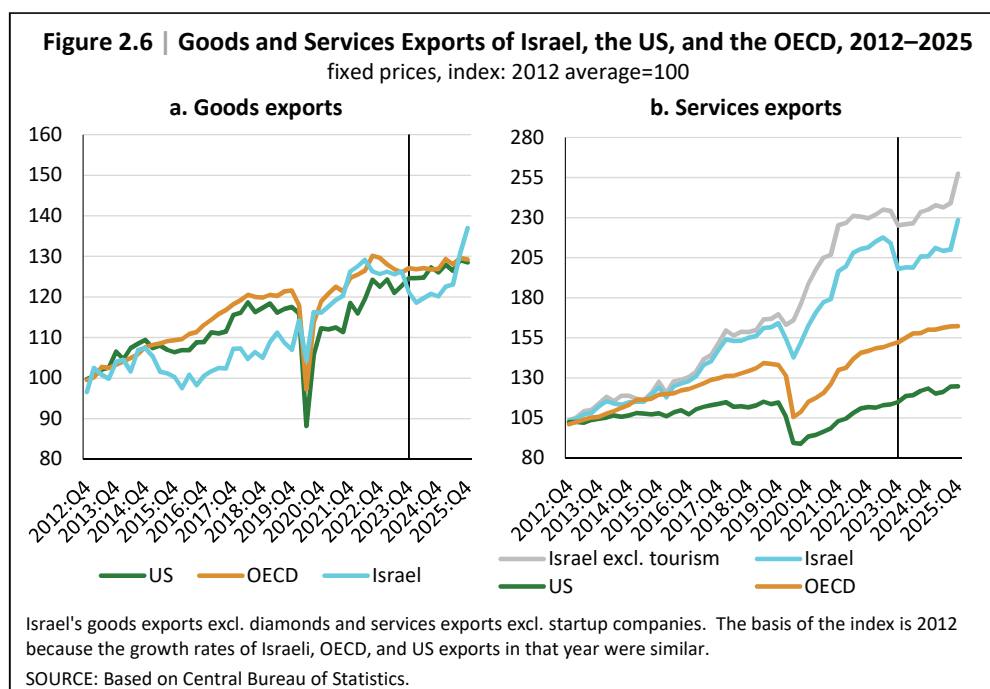
Manufacturers Association of Israel (September 2025), “Interim Findings of a Survey on the Impact of the War on International Trade.”

f. Exports

Following weak growth during most of the war period, including a decline in 2024, goods and services exports increased rapidly in the second half of 2025. The strength of exports at the end of the year was due to a surge in the high-tech field (Figure 2.6). This surge was largely due to production abroad by several Israeli companies.

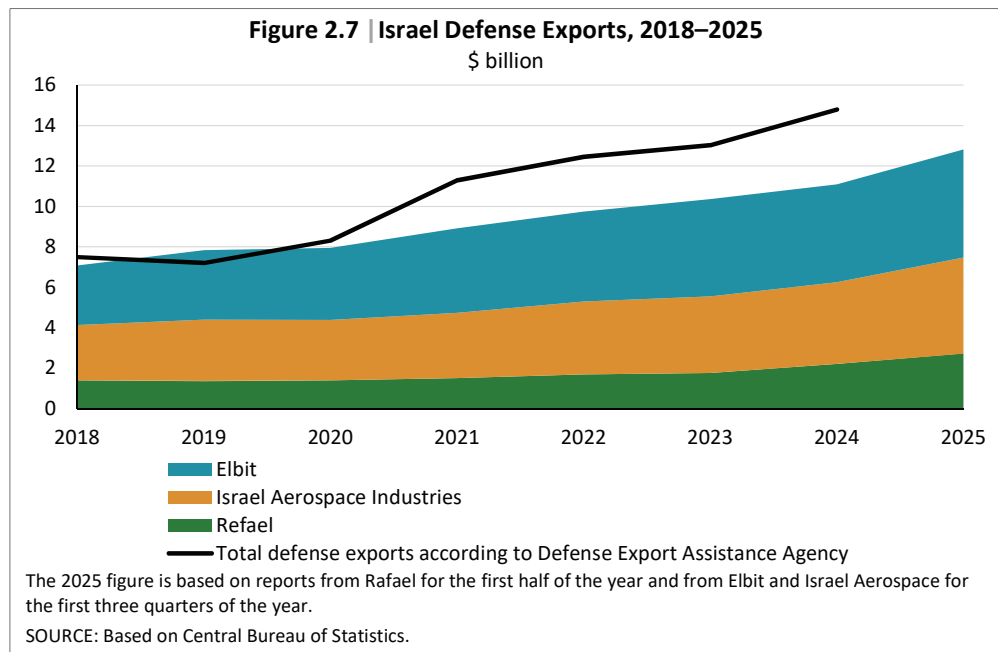
Goods and services exports increased rapidly, particularly in the second half of the year, due to a surge in the high-tech field.

The slow growth of exports during most of the war period (until the second half of 2025) differs markedly from their development during the COVID-19 period, when Israeli exports—and particularly exports of high-tech services—grew rapidly. Several factors may explain the difference during the war period. First, the labor supply constraint created by the extensive reserve mobilization reduced the available workforce. Second, during the COVID-19 period there was a jump in global demand for high-tech services due to the desire to reduce physical activity in proximity to others. At the same time, workers in high-tech services were able to work remotely to a greater extent than workers in most other industries. Both of these factors are less relevant during the war. Third, it is possible that negative sentiment toward Israel that emerged in some of its export markets due to the war adversely affected demand for Israeli goods and services. Box 2.2 in this chapter presents evidence of this phenomenon in Israel’s goods exports to Europe, raising the possibility of a similar tendency in other export markets as well.



Between 2019 and 2024, Israel's defense exports doubled. They continued to grow rapidly this year as well.

Between 2019 and 2024, Israel's defense exports doubled from \$7.2 billion to \$14.8 billion¹⁰, accounting for about 10 percent of Israel's goods and services exports. Publicly available data indicate that the total exports of Israel's three largest exporters of defense products and services increased by 41 percent during those years (Figure 2.7), and in 2025 they increased by a further 15.6 percent—far more rapidly than any other export component. The increase in defense exports over these years reflected the global rise in defense procurement against the background of the Russia–Ukraine war, and may also have been supported by the performance of Israeli defense equipment in the war here.



In April 2025, the US administration announced the imposition of a broad tariff of 10 percent on imports of goods into the United States, as well as higher tariffs on imports from countries with which the United States runs a goods trade deficit, including Israel. However, a broad list of industry exemptions was established, while noting the possibility that these exemptions would be reexamined in the future. In the initial announcement, a tariff of 17 percent was set for imports from Israel, but following negotiations between the countries, the tariff was set at 15 percent on August 7, 2025.

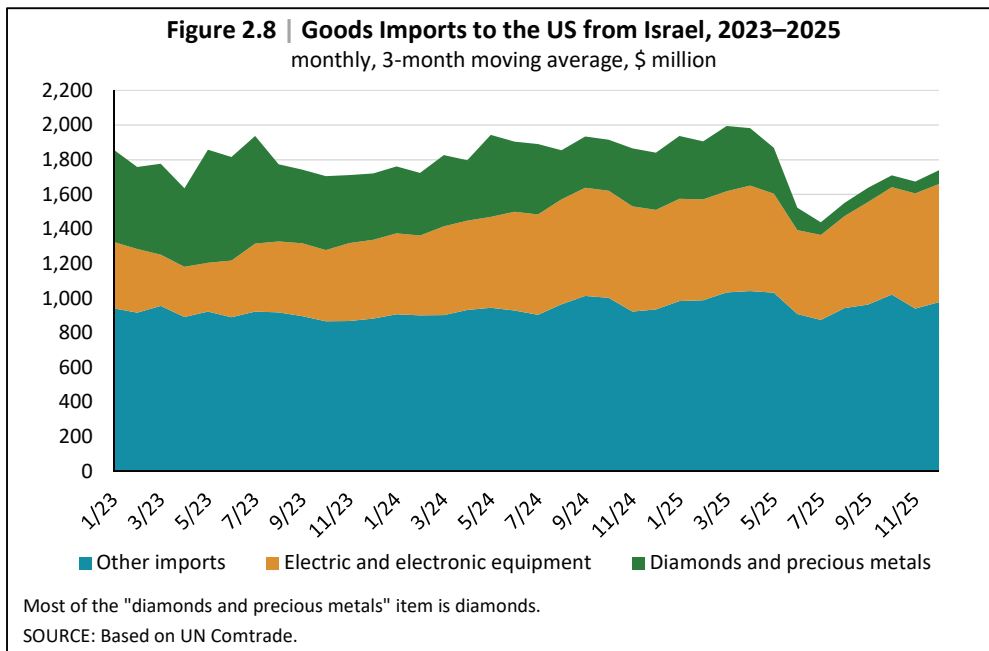
The direct effect of US tariffs on Israeli exports appears limited so far.

So far, the direct effect of the tariffs on Israeli exports appears limited, mainly due to the weight of the exemptions (Figure 2.8). The exemption list includes electronic components and pharmaceuticals, which are among Israel's main export products to the United States. The main export industry affected is the diamond industry, which

¹⁰ Press releases of the Defense Export Assistance Agency in the Ministry of Defense (SIBAT).

is not included in the exemption list. Diamond exports began to decline sharply in May, such that in the second half of 2025 they stood at only 30 percent of their level in the first half of the year. The effect of this decline on GDP is limited because the domestic value added of Israel’s diamond industry is very low (about 4.5 percent on average in 2021–2025, according to national accounts data).

The direct and indirect effects of the US tariffs on Israel have not yet been fully clarified. The direct effects are due to the higher cost of purchasing from Israel for a US importer required to pay the tariff. The indirect effects may arise from a general decline in world trade, as various institutions have estimated would occur in view of the tariff increases. In their assessment, this increase would weaken demand for Israeli exports regardless of the specific trade destination. In addition, the US government is reviewing the exemption list, and changes to it could harm other major Israeli export industries.



3. COMPOSITION OF SOURCES

a. Output

Supply constraints in the labor market were the key factor shaping output developments in 2025 and throughout the war period. These constraints came from numerous sources. Reserve mobilization shifted many individuals from civilian life to military service and likely delayed young people’s entry into the labor market. The ban on the entry of Palestinian workers into Israel sharply reduced the number of

Supply constraints in the labor market were the key factor shaping output developments in 2025 and throughout the war period.

workers, particularly in the construction industry, while the increase in the number of foreign workers in their place was gradual. The evacuation of communities in the south and the north at the beginning of the war distanced people from their homes and workplaces. The large number of war casualties, both physical and psychological, had limited ability to return to the labor market; and emigration from Israel increased. These issues are discussed in detail in Chapter 5 of this Report.

The production of output requires a combination of labor, capital, and productivity (technology). Constraints on the labor supply increase the return on capital that substitutes for workers, while reducing the return on capital that is complementary to workers, and encourage the search for technological improvements that raise productivity. In 2025, the capital stock continued to increase, but at a pace that moderated for the second consecutive year (Table 2.4). During the war, investment in machinery and equipment increased rapidly, but the overwhelming majority of this increase was apparently defense imports that do not contribute directly to production in the business sector (see the investment section in this chapter).

Before the war, output deviated positively from the trend (Figure 2.1). With the outbreak of the war, this positive gap closed and turned negative due to the labor supply constraints noted above. The same labor shortage also led to a decline in capital utilization, as reflected, for example, in reports by manufacturing firms in the Business Tendency Survey. The decline in the available labor force should also be viewed as a decline in potential output, which reflects the economy's immediate productive capacity. Accordingly, a situation emerged in which output declined while excess demand and a tight labor market persisted, as reflected in a low unemployment rate and a high level of job vacancies, which slowed the convergence of inflation to the target.

Table 2.2 | Sources and uses, 2009–2025

	annual rates of change, percent					Change during the war ^b
	2009–2022 ^a	2022	2023	2024	2025	
GDP	4.1	6.4	2.1	1.0	2.9	1.7
Imports (excluding ships, aircraft, diamonds, and defense imports)	6.1	12.4	-6.9	-2.2	8.8	3.4
Domestic uses (excl. inventory)	4.1	6.7	0.7	2.8	3.7	2.5
<i>of which</i> : Private consumption	3.8	7.3	-0.6	3.9	2.6	2.6
Fixed capital formation (excluding ships and aircraft)	5.6	11.5	-2.6	-5.5	8.5	-1.4
Investment in inventory (excluding diamonds and startups, percent of GDP)	0.2	0.2	0.2	0.0	-0.1	
Public consumption (excluding defense imports)	3.2	1.1	7.5	9.4	2.0	7.4
Startup companies output	12.2	22.3	-23.3	-48.1	-0.1	-24.2
Exports (excluding diamonds and startups)	5.5	10.2	0.0	-3.7	5.9	2.1

^a Average annual rate of change or average annual level, as relevant.

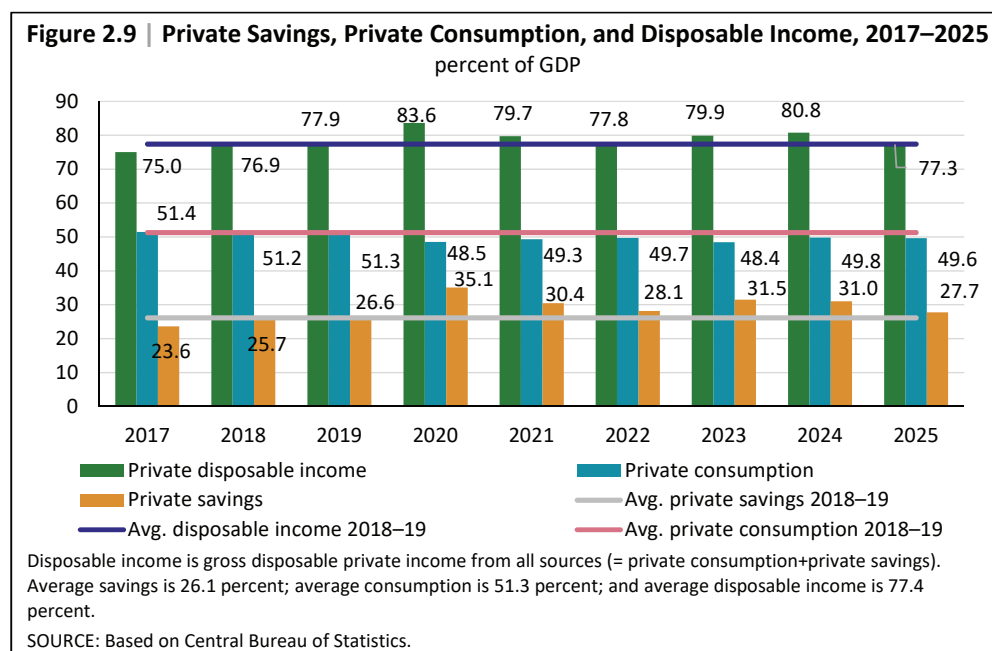
^b Average annual rate of change between 2023:Q3 and the most recent quarterly figure, or the difference in levels between the most recent quarter and 2023:Q3, as relevant.

SOURCE: Based on Central Bureau of Statistics.

b. Imports

In 2025, goods and services imports (excluding ships, aircraft, and defense imports) increased rapidly, by 8.8 percent. This followed a decline in 2024 due to the war’s adverse effect on domestic demand. During the war period, imports increased at an annual rate of 3.4 percent—twice the rate of GDP growth—and their share in the economy’s sources increased. This increase provided the sources for the growing demand in 2025, which had difficulty being met domestically due to supply constraints. The increase encompassed all components of goods imports: investment goods, consumption goods, and raw materials alike. However, a substantial portion of the increase in imports of investment goods was apparently defense-related, while imports of investment goods for the business sector increased less (see the investment section above). In 2025, services imports (even excluding tourism services imports¹¹) also increased sharply, following a decline in 2024. It is likely that the sharp appreciation of the shekel in 2025 contributed to demand for imports. According to Barak and Brand (2022), the negative effect of appreciation on the sales of domestic manufacturing (which is exposed to competing imports) is immediate, whereas in exports the effect of the exchange rate is smaller and occurs with a lag of about two years.¹²

The rapid increase in imports this year provided the sources for the growing demand due to supply constraints.



¹¹ For a discussion of tourism imports, i.e., Israelis’ consumption abroad, see the section on private consumption.

¹² Arnon Barak and Gilad Brand (2022), “The Heterogeneous Effect of the Exchange Rate on Firms in Israel’s Manufacturing Industries”, Discussion Paper 2022.12, Bank of Israel Research Department.

4. SAVING, INVESTMENT, AND THE CURRENT ACCOUNT

In 2025, the private saving rate declined by about 3.3 percent of GDP, alongside a decline in the rate of disposable income.

In 2025, the private saving rate stood at 27.7 percent of GDP (Table 2.5). This rate was about 3.3 percent of GDP lower than in 2024 (Figure 2.9). This decline was accompanied by a decline in disposable income as a share of GDP, while private consumption's share declined only slightly. In view of the tendency toward consumption smoothing, private saving—the excess of current income over current consumption—tends to be sensitive to income shocks, and accordingly, sharp fluctuations in its rate have been observed in recent years.

Table 2.5 presents the correlation coefficients between the uses of disposable income—saving and consumption—and the main sources of that income—net wages and transfer payments, and firms' operating surplus.¹³ The data indicate that private consumption is positively correlated with changes in households' current income (from net wages and transfer payments), but only weakly, if at all, with total disposable income or business sector profits. Private saving, by contrast, generally moves together with changes in disposable income and in the operating surplus of the business sector. On the basis of these correlations, the sharp decline in saving alongside only a slight decline in consumption in the past year can be explained by the declines in the business sector's operating surplus and in disposable income, together with the simultaneous increase in net wages (see Table 2.3).

a. The Current Account

In 2025, the current account surplus amounted to 1.5 percent of national income—a decline of 1.4 percentage points, or about \$7 billion, relative to 2024 (Table 2.6 and Figure 2.10). The main reason for this decline is that a substantial portion of the increase in exports in 2025 was generated by Israeli companies under foreign ownership (abroad). The profits of these companies are recorded as primary income of nonresidents and are therefore deducted from the economy's income and from the current account surplus. At the same time, insofar as the owners of these companies do not actually withdraw those profits, they are recorded as direct investment in Israel in the financial account.¹⁴ This year, the economy's net primary income declined by approximately \$5.4 billion (0.9 percent of national income).¹⁵

¹³ Israel does not compile separate sectoral accounts for households and firms, so disposable income cannot be fully decomposed into its components. However, total wages net of income tax, National Insurance and health contributions, current government transfer payments to the public, and the business sector's operating surplus is the main component, accounting for 90–95 percent of private disposable income. Other components include net transfers from abroad, interest on domestic government debt, and capital income.

¹⁴ This year, net direct investment in Israel increased by \$6.9 billion.

¹⁵ This year, the income of Israeli residents from investments abroad increased by approximately \$6.5 billion, while the income of nonresidents from investments in Israel increased by approximately \$11.8 billion.

CHAPTER 2 | GROWTH AND AGGREGATE ACTIVITY

Table 2.5 | Correlation between changes in private savings, consumption, and income aggregates in the short and medium term

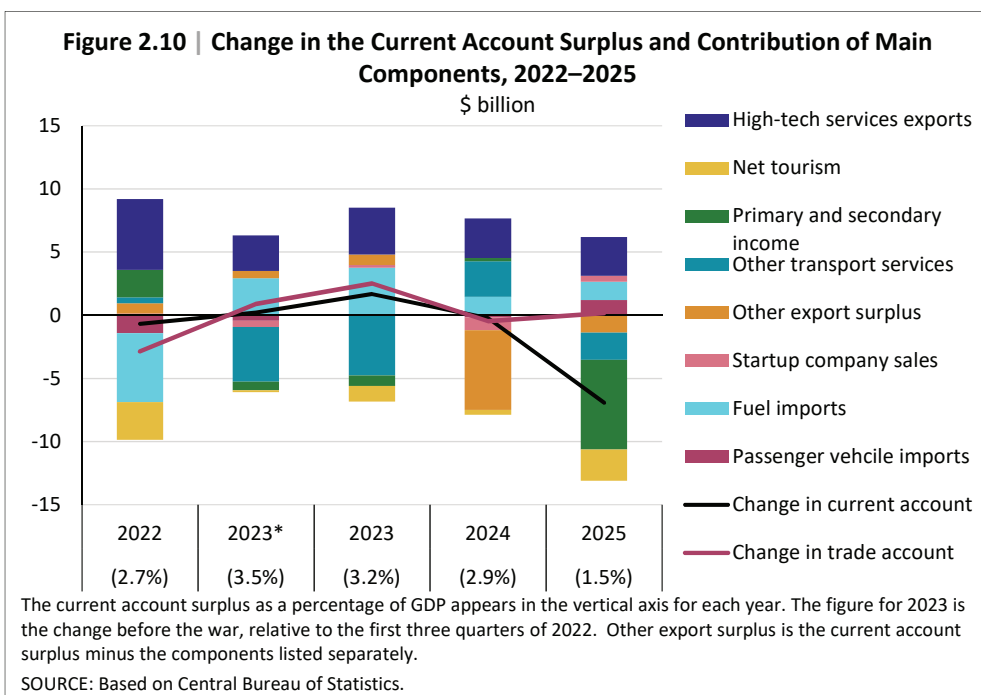
	correlation coefficients between -1 and 1				
	Business sector operating surplus ^a	Net wages+ transfer payments ^b	Private consumption	Private savings	Disposable income ^c
2020–2025					
Disposable private income	0.72	0.12	-0.19	0.65	1.00
Private savings	0.49	-0.42	-0.86	1.00	
Private consumption	-0.11	0.58	1.00		
Net wages+transfer payments	-0.32	1.00			
Business sector operating surplus	1.00				
2005–2025					
Disposable private income	0.50	0.19	0.01	0.65	1.00
Private savings	0.48	-0.28	-0.75	1.00	
Private consumption	-0.12	0.44	1.00		
Net wages+transfer payments	-0.28	1.00			
Business sector operating surplus	1.00				

^a Total profits of business sector firms after current expenses and before interest and tax payments.

^b GDP labor share (including imputation to self-employed) plus current transfer payments from the government to the public, minus income tax, National Insurance, and health tax payments.

^c Gross disposable private income from all sources = private consumption + private savings.

SOURCE: Based on Central Bureau of Statistics.



The surplus in the goods and services account did not change in dollar terms relative to 2024.¹⁶ The main factors contributing to this were high-tech services exports (excluding startups), which increased by \$3.1 billion, and net tourism exports, which declined by \$2.5 billion due to the increase in outbound tourism.

Table 2.6 | Savings, investment, and the current account, 2009–2015

	percentage of national income				
	2009– 2022 ^a	2022	2023	2024	2025
Gross national savings	26.0	30.2	29.4	26.6	26.0
Public	0.0	2.5	-1.9	-3.5	-1.3
Private	26.0	27.7	31.3	30.1	27.3
Gross investment	23.4	27.5	26.3	23.7	24.5
In nonhousing fixed assets	16.1	17.8	18.0	17.6	17.8
<i>of which</i> : General government's investments ^b	2.8	2.8	3.0	3.0	3.3
In housing	6.4	7.3	6.5	5.4	6.2
In inventory	0.8	2.4	1.7	0.7	0.5
Net current account^c	2.7	2.7	3.2	2.9	1.5
<i>of which</i> : Balance of goods and services	1.5	2.1	2.7	2.4	2.1
Net income account	-0.2	-0.1	-0.5	-0.5	-1.4
Net current transfers	1.4	0.8	1.0	1.1	0.7
Terms of trade ^c	0.7	-1.4	-4.1	3.9	1.5
Real effective exchange rate ^{c,d}	-1.7	0.1	9.2	-0.5	-5.6

^a Average annual rate of change or average annual level, as relevant.

^b Including investment grants.

^c Annual rate of change, percent.

^d An increase means depreciation.

SOURCE: Based on Central Bureau of Statistics.

¹⁶ This surplus declined by 0.3 percent of national income due to the increase in national income and the appreciation of the shekel.

BOX 2.3: THE EFFECTS OF OPERATION “RISING LION” ON THE ECONOMY

On June 13, 2025, Operation “Rising Lion”—Israel’s military campaign against Iran—commenced. The campaign lasted 12 days, until a ceasefire was reached. During that time, Iran launched hundreds of missiles toward Israel, some of which struck populated areas, destroying buildings, causing property damage, and resulting in casualties.

During the campaign, the Home Front Command instructed the public to remain near shelters and protected spaces and to avoid travel, while educational institutions remained closed. These directives led to a marked contraction in economic activity. Many businesses were closed or operated on a reduced basis. Air traffic at Ben Gurion Airport was suspended for most of the campaign, effectively halting Israel’s airborne foreign trade, which on the export side consists largely of relatively high-value high-tech products. About 25 percent of Israel’s exports and 21 percent of its imports (goods and services, by value) are transported by air.

Many workers were absent from their workplaces, while the furlough mechanism was activated retroactively under eased conditions. As a result, the broad unemployment rate jumped to 9.2 percent in June, and the participation and employment rates declined slightly.

Immediately after the campaign ended, economic activity began to recover. Businesses resumed normal operations, and activity in the public sphere returned to its precampaign level. By July, the unemployment, employment, and participation rates had already returned to their May levels. Credit card expenditures, which had fallen sharply during the campaign, rebounded rapidly and within less than a month exceeded their precampaign levels. Reporting in the Central Bureau of Statistics Business Tendency Survey indicated that business activity returned quickly to normal and that the campaign did not lead to a decline in export orders.

The sharp decline in activity for nearly two weeks led to a marked decline in GDP and in all uses in the second quarter of 2025, and moderated import growth during that period. By contrast, the national accounts data for the third quarter of 2025 showed a very sharp increase in GDP and in uses during that quarter. Ultimately, growth between the first and third quarters of 2025 stood at 3.8 percent (in annual terms), slightly above the average growth rate since the beginning of 2024. Credit card purchases also remained slightly above the precampaign trend in the months following the campaign. These developments indicate that there was some compensatory activity after the campaign (in the third quarter of 2025).

Based on a growth model and estimates of the damage from previous events, we assess that the impact of Operation “Rising Lion” on annual growth was about 0.3 percent of GDP¹, including the offset in subsequent quarters, estimated at 0.1 percent of GDP. That is, excluding the 12 days of Operation “Rising Lion,” annual growth in 2025 would have been about 3.4 percent—still slightly below the economy’s previous growth trend.

¹ An alternative estimate, which assumes that all fluctuations in GDP between the first and third quarters reflect the effects of the campaign, generates a slightly higher result—0.45 percent of GDP.

Chapter 3

Inflation and Monetary Policy

- » The Consumer Price Index rose by 2.6 percent in 2025, remaining within the inflation target range, after inflation in 2024 was 3.2 percent—above the upper bound of the range. Excluding volatile components and one-off factors, the slowdown in inflation was even more pronounced. The moderation process was volatile, and during most of the year inflation remained above the upper bound of the target range.
- » In view of inflation being above the upper bound of the target range for much of the year, supply constraints, and significant geopolitical uncertainty, the Monetary Committee kept the policy rate unchanged at 4.5 percent for most of the year. Given the supply constraints, a faster reduction in the policy rate would likely have contributed little, if at all, to growth while significantly increasing inflation.
- » The stability of the policy interest rate during most of the year, alongside the decline in inflation expectations, was reflected in an increase in real yields, thereby contributing to the restraint of aggregate demand and to the easing of inflationary pressures. In November, following the moderation of inflation and inflation expectations and in the wake of the ceasefire agreement, the Monetary Committee reduced the policy rate to 4.25 percent. The appreciation of the shekel, the ongoing improvement in the security situation, and signs of easing in labor market tightness led to an additional rate cut in January 2026, to 4.0 percent.
- » The appreciation of the shekel played a major role in moderating inflation. This appreciation was largely due to the decline in Israel’s risk premium following geopolitical developments, and fiscal restraint measures that offset part of the war-related costs, as well as from the gradual pace of monetary easing. Part of the appreciation also reflected the global weakening of the US dollar.
- » Inflation expectations converged during the year toward the midpoint of the target range, supporting the moderation of actual inflation.
- » Supply constraints in the labor market—alongside the fiscal impulse that was mainly due to high defense expenditures—continued to exert upward pressure on inflation, offsetting part of the effect of the moderating factors. Although preliminary indicators toward year-end pointed to some easing, they still suggested that the labor market remained tight.



Inflation declined this year to 2.6%, within the target range



The **strengthening of the shekel** helped moderate inflation



The **tight labor market** slowed the decline of inflation

4.5%

The **interest rate remained steady** for most of the year, and was lowered following the ceasefire

1. INTRODUCTION

In 2025, inflation returned to within the price stability target range, reaching 2.6 percent compared with 3.2 percent in 2024. A key factor behind this moderation was the significant appreciation of the shekel, which largely reflected the decline in Israel's risk premium following geopolitical developments and fiscal restraint measures, as well as the global weakening of the US dollar.

In face of the appreciation, there were strong inflationary forces—particularly excess demand amid supply constraints created by the war, especially in the still-tight labor market, and the fiscal impulse resulting from high defense spending.

In this environment, where the supply of production factors remained limited, a rapid reduction in the policy rate was expected to contribute little, if at all, to growth, while significantly increasing inflation. The Monetary Committee therefore maintained the interest rate at a restrictive level of 4.5 percent for most of the year. Keeping the rate unchanged, alongside the decline in inflation expectations, led to higher real yields, which helped restrain excess demand, supported the appreciation of the shekel, and prevented domestic demand pressures from translating into higher inflation. Only after inflation had firmly settled within the target range, the risk premium had declined, and the ceasefire agreement signaled a possible easing of supply constraints, did the Committee begin to gradually reduce the interest rate.

This chapter opens with a review of inflation developments and quantifies the contribution of the various forces that influenced it—namely, the exchange rate, excess demand, labor market tightness, and inflation expectations. It then discusses monetary policy: the considerations that led the Committee to keep the interest rate unchanged for most of the year, the way in which rising real yields contributed to restraining demand and moderating inflation, and the circumstances that prompted the rate reductions toward the end of 2025 and early 2026. The chapter concludes with an overview of developments in the monetary base and monetary aggregates.

2. INFLATION

a. Background

In 2025, inflation continued to be significantly influenced by the war that began in October 2023. The labor supply remained constrained, mainly due to the high level of reserve duty call-ups, which persisted until the ceasefire in the Gaza Strip in October 2025, and due to the continued stoppage in the entry of Palestinian workers, whose replacement by foreign workers was gradual and partial.

The war's impact on aggregate demand was less clear. Demand was likely dampened by the elevated risk premium, but there was also a sharp increase in defense expenditures, including extensive government transfers to reservists and domestic purchases by the government, which increased aggregate demand. (See Box 2.1 in Chapter 2.) In addition, the sharp rise in the stock market contributed demand through its effect on the public's assets ("the wealth effect").¹

As the supply side was more severely affected, the labor market remained tight, and the economy was characterized by excess aggregate demand. The economy's risk premium declined during the year, reaching a level that was close to the prevailing level before the war. This development contributed to a sharp appreciation of the shekel, which was also supported by the general weakness of the US dollar globally.

Table 3.1 summarizes the main indicators related to inflation and monetary policy, with an emphasis on 2025.

Inflation continued to be significantly influenced by the war that began in October 2023.

The labor market remained tight and the economy was characterized by excess aggregate demand.

b. Survey of the development of inflation

In 2025, inflation totaled 2.6 percent, within the inflation target range (Figure 3.1), following an inflation rate of 3.2 percent in 2024. The moderation of inflation was driven mainly by the tradable component, which is particularly sensitive to the exchange rate and to the price of oil, and increased by just 1.4 percent this year, compared with 2.8 percent in 2024. In contrast, the nontradable component rose by 3.4 percent in 2025 compared with 3.5 percent in 2024.

The development of annual inflation was also affected by government tax and regulatory measures, particularly the one percentage point increase in the VAT rate in January 2025. This increase led to a temporary acceleration in annual inflation in January, to 3.8 percent², but from that point until the end of the year, inflation moderated gradually. Excluding the effects of tax and regulatory measures, inflation totaled 2.2 percent in 2025, compared with 2.8 percent in 2024 (Figure 3.2).³

Inflation declined to 2.6 percent, returning to within the target range.

¹ For evidence regarding the effect of changes in the public's financial asset values on private consumption, see Arnon Barak (2017), "The Private Consumption Function in Israel", Discussion Papers Series 2017.04, Bank of Israel Research Department.

² According to the Bank's assessment, the VAT increase in January contributed about 0.4 percentage points to annual inflation.

³ Monitoring the CPI excluding tax and regulatory measures makes it possible to distinguish between temporary regulatory effects on inflation and underlying inflationary processes in the economy. For further discussion, see Box 3.1 in the Bank of Israel Annual Report for 2024.

Table 3.1 | Main indicators of inflation and monetary policy, 2021–2025

	2021	2022	2023	2024	2025	2025			
						Q1	Q2	Q3	Q4
Inflation (percent)									
Actual inflation ^a	2.8	5.3	3.0	3.2	2.6	4.4	2.8	1.6	1.9
Inflation excluding energy, fruits and vegetables	2.7	5.0	2.7	3.3	2.7	4.0	4.8	2.4	-0.4
One-year inflation expectations derived from the capital market ^b	1.9	3.1	2.8	2.9	1.8	2.0	1.8	1.7	1.6
Ten-year inflation expectations derived from the capital market ^b	2.0	2.3	3.0	2.9	2.5	2.6	2.5	2.6	2.5
Forecasters' one-year inflation projections ^b	1.2	2.8	2.8	2.9	2.3	2.6	2.4	2.3	2.0
Yields (percent)									
Bank of Israel declared interest rate	0.10	1.25	4.50	4.50	4.48	4.50	4.50	4.50	4.41
Real yield to maturity on one-year government bonds ^b	-1.9	-1.4	1.6	1.3	2.3	2.1	2.3	2.4	2.3
Nominal yield to maturity on ten-year government bonds ^b	1.2	2.6	3.9	4.7	4.3	4.4	4.4	4.2	4.0
Real yield to maturity on ten-year government bonds ^b	-0.8	0.1	1.2	2.0	2.0	2.0	2.2	2.0	1.8
Change in the shekel exchange rate (percent)^c									
Nominal effective	-8.4	3.9	4.3	-5.1	-7.7	2.2	-2.0	-3.9	-4.1
Vis-à-vis the dollar	-3.6	10.2	6.4	-1.5	-11.1	1.0	-4.7	-4.0	-3.8
Vis-à-vis the euro	-10.4	3.2	9.6	-5.4	-0.7	4.2	1.6	-2.3	-4.0
Asset prices (percent)									
Overall yield on shares (general shares index, nominal) ^d	30.9	-15.5	4.9	30.7	47.0	-0.2	22.9	6.5	12.4
Rate of change in home prices	13.1	14.7	-1.0	7.7	-0.9	0.2	-0.9	-1.5	1.3
Additional background data (percent, quarterly data are seasonally adjusted)									
Unemployment in the primary working ages (25–64)	4.6	3.3	3.0	2.8	2.7	2.6	2.6	2.9	2.8
GDP growth ^e	9.3	6.4	2.1	1.0	2.9	5.8	-4.5	12.1	4.2
Additional background data (percent)									
S&P Index of commodities excluding energy ^f	22.5	1.3	-7.3	7.6	16.7	4.8	1.8	1.5	6.1
Brent crude oil price (per barrel) ^f	48.7	8.9	-4.9	-5.4	-15.7	1.3	-11.0	2.2	-7.5

^a Change in CPI during the period. Quarterly figures are seasonally adjusted in annual terms as calculated by the Central Bureau of Statistics. Due to methodological changes the Central Bureau of Statistics made in recent years in how flight prices are measured, the quarterly inflation rates may not fully reflect updated seasonality patterns.

^b Based on the zero coupon yield curve. Period average.

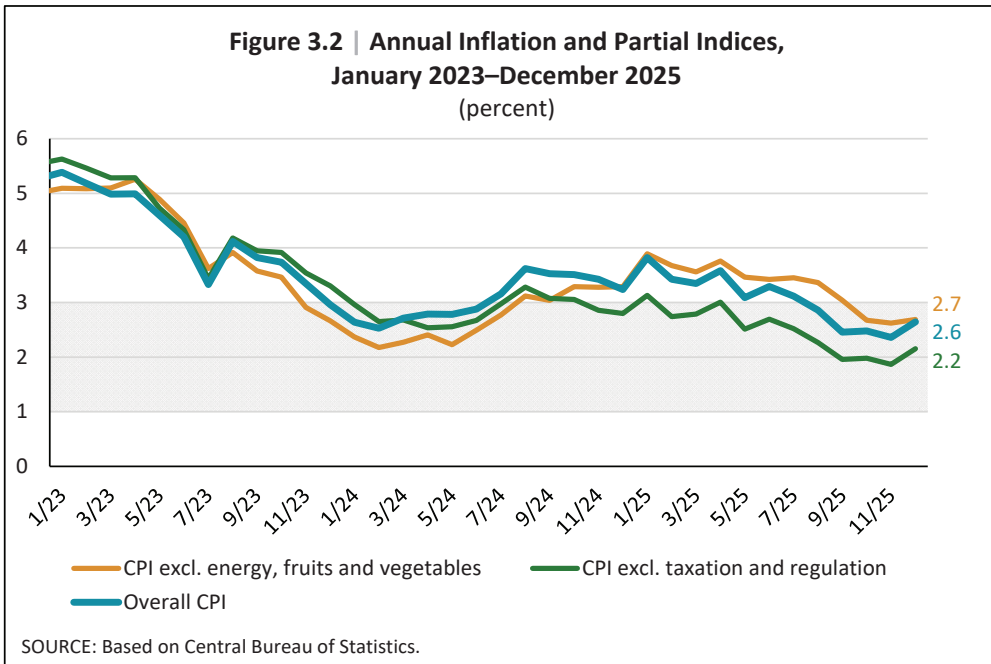
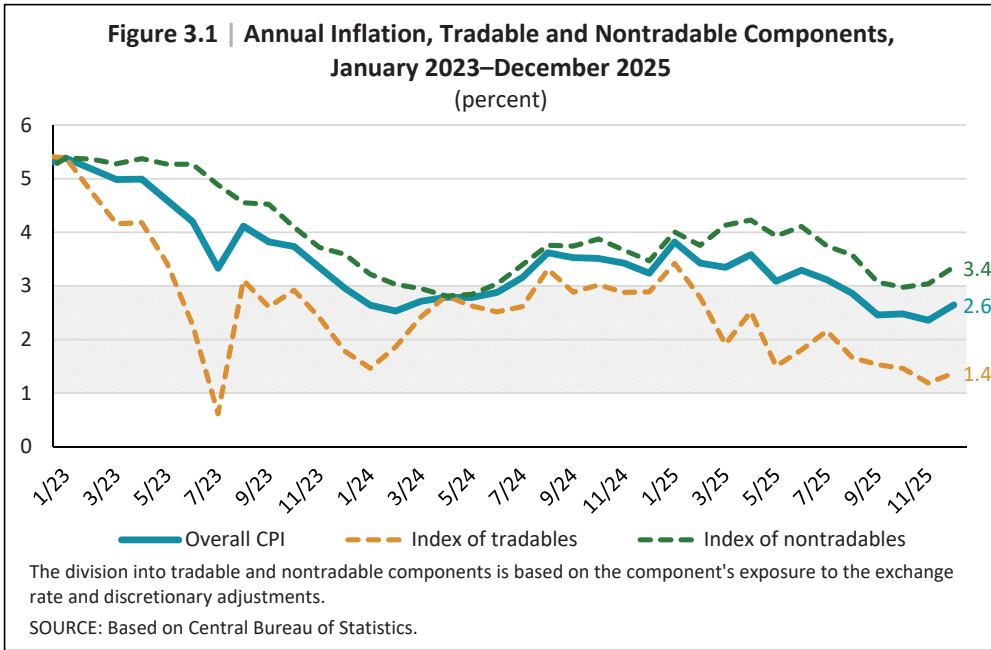
^c Yearly figures are the December average compared with the December average of the previous year. Quarterly figures are the average in the final month of the quarter compared with the average in the final month of the previous quarter.

^d Yearly figures are the last day of the year compared with the last day of the previous year. Quarterly figures are the last day of the quarter compared with the last day of the previous quarter.

^e The average during the period compared with the average during the previous period, in annual terms.

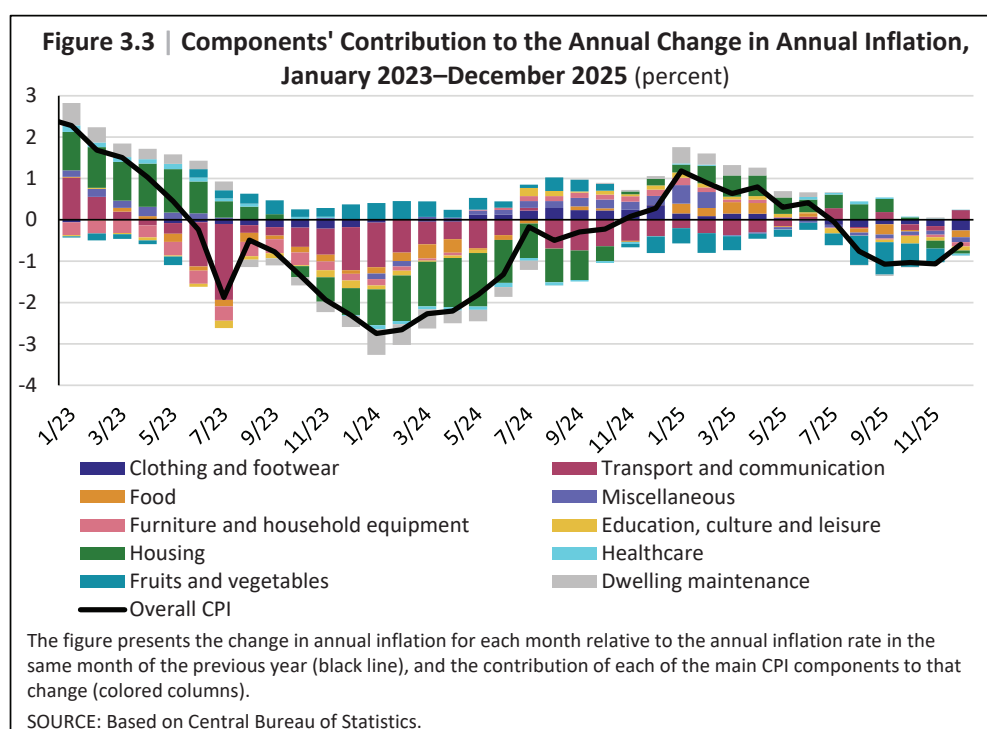
^f Yearly figures are the December average compared with the December average of the previous year. Quarterly figures are the quarterly average compared with the previous quarter.

SOURCE: Bank of Israel, Ministry of Finance, Central Bureau of Statistics, and Bloomberg.



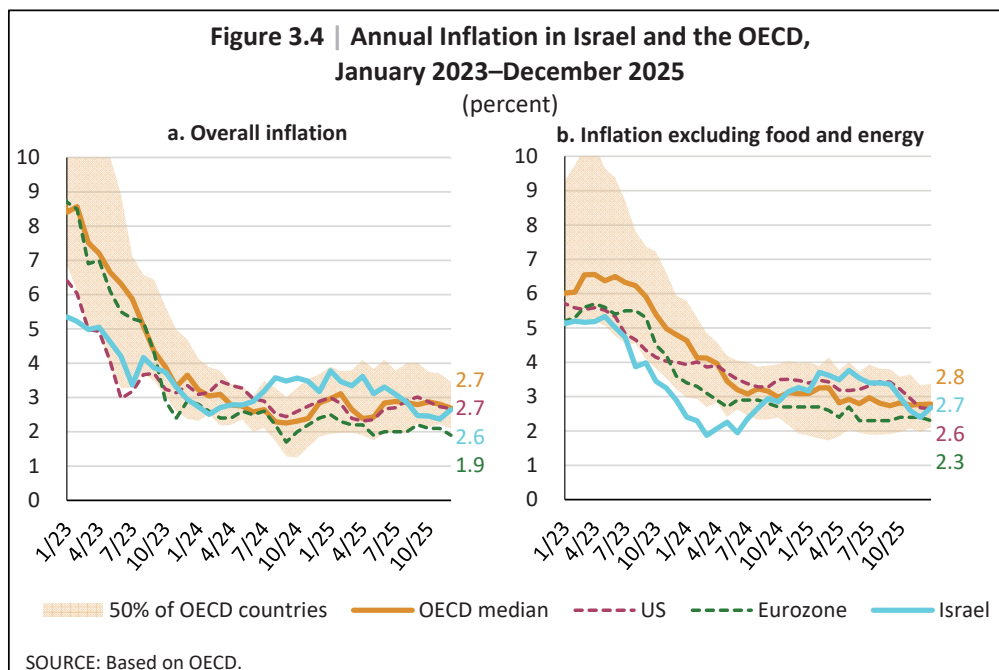
The moderation of inflation was also evident in indices that exclude volatile components—energy, fruit and vegetables, and airfares (a component that was particularly volatile during the year in view of restrictions on airlines’ supply, and that influenced the volatility of the CPI as a whole).

The moderation of inflation was apparent across almost all components of the Consumer Price Index. Figure 3.3 presents the annual change in annual inflation and the contributions of the main CPI components to that change. The figure illustrates the impact of the shekel’s appreciation, which reduced import prices, on inflation this year. The main contributions to the slowdown in the annual inflation rate during 2025 came from components with a large tradable share—clothing and footwear, food, miscellaneous items, and furniture and household equipment. Among the nontradable components, the housing item—the largest in the index—also made a prominent contribution to the moderation of inflation, reflecting the increase in the ratio of the housing stock to the population. (For a discussion of the factors that contributed to the moderation in rent increases, see Chapter 8 – The Housing Market.)⁴



⁴ While the fruit and vegetables component showed more moderate increases in many months relative to the same months in the previous year, it did not contribute to the moderation of inflation over the year as a whole, since its rate of increase during 2025 as a whole was slightly higher than in 2024 (as reflected in the column for December 2025).

The moderation of inflation during the year brought Israel’s inflation rate, by yearend, close to the OECD median, and even slightly below it. This followed a period shortly after the outbreak of the war when inflation in Israel had risen above the OECD level (Figure 3.4a). A similar picture emerges when excluding the volatile food and energy components (Figure 3.4b).



c. The forces that affected inflation

The war led to an increase in inflation in 2024 through three main channels: a rise in the economy’s risk premium; supply constraints due to the decline in the number of available workers—mainly as a result of the large-scale reserve call-ups and the ban on the entry of Palestinian workers into Israel; and demand pressures due to a sharp increase in domestic defense and war-related expenditures.

The moderation of inflation in 2025 reflects a decline in the inflationary effects of the war, although some of these effects appear not to have fully dissipated. In particular, while the risk premium declined to a level close to that prevailing before the war, and the fiscal pressure was partly offset by tax increases, the labor market remained tight.

The moderation of inflation reflects a decline in the effects of the war, although some effects are still noticeable.

The following sections provide a detailed review of the main factors that influenced inflation during the year.

(1) The Exchange Rate

The shekel strengthened by about 8 percent in terms of the nominal effective exchange rate.

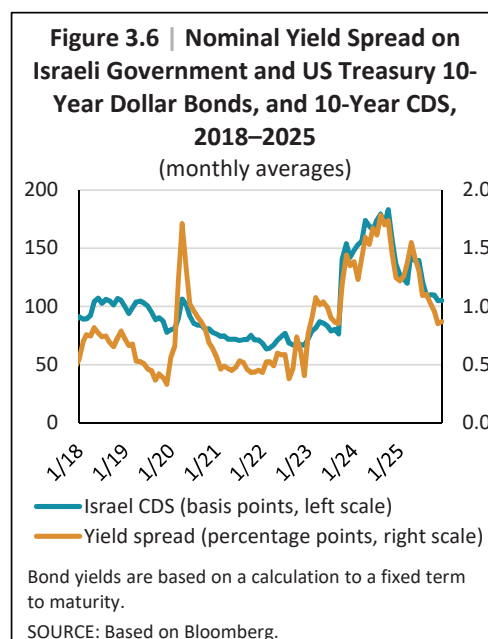
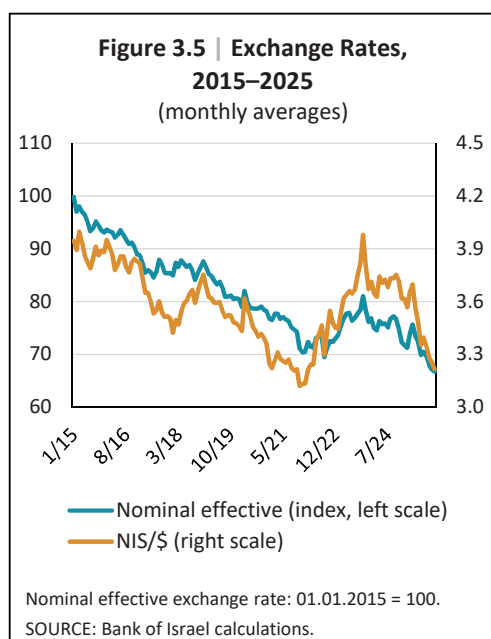
The exchange rate directly affects the shekel cost of imported goods and therefore has a direct impact on inflation—mainly on the prices of tradable goods (imports and import substitutes), but also on the nontradable component through the cost of imported inputs such as oil. During the year, the shekel appreciated significantly (December 2025 average compared with December 2024 average)—by about 8 percent in terms of the nominal effective exchange rate; by about 11 percent against the US dollar (Figure 3.5); and by about 1 percent against the euro.

A common framework for analyzing exchange rate developments is the Uncovered Interest Rate Parity (UIP) equation. This equation explains exchange rate movements through changes in interest rate differentials between currencies and through changes in perceived currency risk. While in the mid-to-long term, the exchange rate is influenced mainly by real factors, in the short-to-medium term (a few years) it is affected primarily by factors such as the degree of monetary restraint adopted or expected by central banks, short-term changes in risk perception, and financial pressures arising from investors' hedging needs.

Box 3.1 empirically examines the short-term factors affecting the shekel-dollar exchange rate and their contribution to its development over the past three years. The appreciation of the shekel this year was stronger than that implied by the historical trend of the exchange rate. This trend reflects real factors such as the persistent current account surplus and the relative improvement in Israel's productivity. The box shows that about some of the appreciation this year can be attributed to global factors—the weakening of the US dollar worldwide and the rise in US equity prices—while some is attributed to domestic factors.

The strengthening of the shekel was largely due to the decline in Israel's risk premium.

Among the domestic factors are the decline in the economy's risk premium, as measured by CDS contracts and by the dollar yield spread between Israel and the US (Figure 3.6). The current level of the risk premium is close to its prewar level. Monetary policy also contributed to the appreciation of the shekel. Despite the marked decline in the risk premium, which was reflected in the appreciation, the Bank of Israel's interest rate remained unchanged for most of the year and was reduced moderately only toward year-end. This increased the risk-adjusted interest rate differential vis-à-vis the Fed and the ECB (see Section 2 – Monetary Policy).



BOX 3.1: THE LOCAL COMPONENT OF THE EXCHANGE RATE: TO WHAT EXTENT DID THE SHEKEL DEVIATE FROM THE GLOBAL CONDITIONS

- This box examines the extent to which recent fluctuations in the shekel–dollar exchange rate have been driven by global factors and to what degree they reflect unique domestic factors.
- From the beginning of 2023 through the first year of the war, the shekel depreciated beyond what would be expected based on global developments. This finding is consistent with a deterioration in sentiment toward Israel, against the backdrop of the political and social tensions during 2023 and the outbreak of the war toward the end of that year.
- Since Operation Northern Arrows at the end of 2024, the domestic component has contributed to the appreciation of the shekel, and the exchange rate has gradually converged to a level close to that implied by global factors.
- The estimated domestic component of the exchange rate is correlated with the sovereign credit risk of the Israeli government, as reflected in the CDS spread, and with long-term nominal interest rates in Israel, but it provides a broader measure of investor sentiment toward Israel.

Introduction

In recent years, the shekel–dollar exchange rate has exhibited considerable volatility. The shekel began to depreciate in early 2023, and with the outbreak of the war, the exchange rate reached a peak of more than 4 shekels per dollar. From late 2024 onward, the shekel appreciated, reaching approximately 3.2

shekels per dollar by the end of 2025. During this period, there were significant changes in both the domestic and international spheres. Locally, these included legislative initiatives concerning the judicial system, the war, and significant military operations within it; and globally, there were changes in US interest rates and trade policy.

This box focuses on the domestic component in the pricing of the shekel, particularly short-term fluctuations in the exchange rate that cannot be explained by global factors. Although the methodology does not allow attribution of deviations from global developments to specific causal factors, it provides a simple and practical measure of the domestic component in the pricing of the shekel, which can serve as an indicator of investor sentiment toward Israel.

Estimating the Domestic Component of the Shekel–Dollar Exchange Rate

To assess the influence of global factors on the exchange rate, the following regression was estimated:

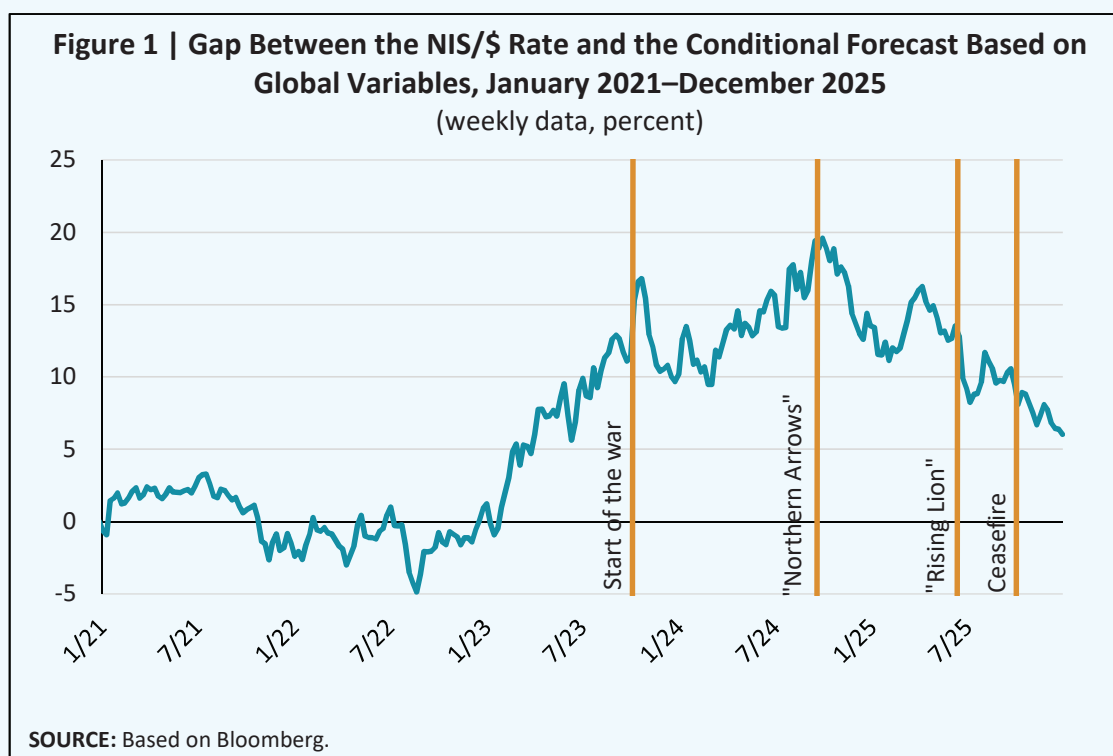
$$(1) \quad \Delta ILS = \beta_0 + \beta_1 \Delta SP500 + \beta_2 \Delta EUR + \beta_3 \Delta TB10 + \beta_4 VIX + \varepsilon$$

where ΔILS denotes the rate of change in the shekel–dollar exchange rate. The explanatory variables represent the main global factors affecting the exchange rate. $\Delta SP500$ is the return on the S&P500 index, serving as a proxy for short-term capital flows, partly because it induces portfolio adjustments by institutional and other investors (Hau and Rey, 2004; Ben Zeev and Nathan, 2024). ΔEUR is the rate of change in the euro-dollar exchange rate, reflecting the dollar’s status as a safe-haven asset. An appreciation of the dollar against the euro is typically accompanied by depreciatory pressure on the shekel. $\Delta TB10$ is the change in the US 10-year interest rate, $\Delta TB10$ which captures expectations regarding the risk-free rate in the US economy, which form the basis for the pricing of the exchange rate, and reflects global liquidity conditions that influence capital flows. VIX is the implied volatility of options on the S&P 500 index, which serves as an estimate of market risk perception and volatility, which also affect capital flows (Rey, 2013). The model is estimated using weekly data, and therefore captures short-term comovements of the variables rather than long-term common trends.¹

Using Equation (1), a conditional forecast of the exchange rate based on global variables was constructed. The forecast was derived from the coefficients estimated in a weekly sample between 2016–2020, together with the actual values of the explanatory variables for 2021–2025.² Figure 1 shows the deviation in percent between the actual exchange rate and this conditional forecast. It shows that until the end of 2022, the exchange rate closely followed global conditions, since the deviation from the conditional forecast is small and ranges around zero. However, between 2023 and 2025, the shekel was more depreciated than predicted by global factors.

¹ The estimate of the domestic component assumes stability in the relationship between the exchange rate and the explanatory variables. Sensitivity tests on samples including the forecast period confirm the stability of the estimated coefficients.

² The estimate in Figure 1 remains similar when Equation (1) includes lagged changes in the exchange rate and explanatory variables, or when the forecast begins from different starting points.



The deviation from global factors was not uniform over time. From early 2023 until the outbreak of the war—a period characterized by social and political tensions surrounding legislative changes concerning the judicial system—the exchange rate increasingly diverged from global conditions. Following the outbreak of the war, the deviation widened further, reaching its peak on the eve of Operation Northern Arrows, when the shekel was approximately 20 percent weaker than implied by global factors. Since that operation, the deviation has gradually narrowed. These findings are consistent with the view that until the operation, domestic developments adversely affected investor sentiment toward the shekel and contributed to its depreciation, while from that point onward, the influence of these factors gradually diminished.

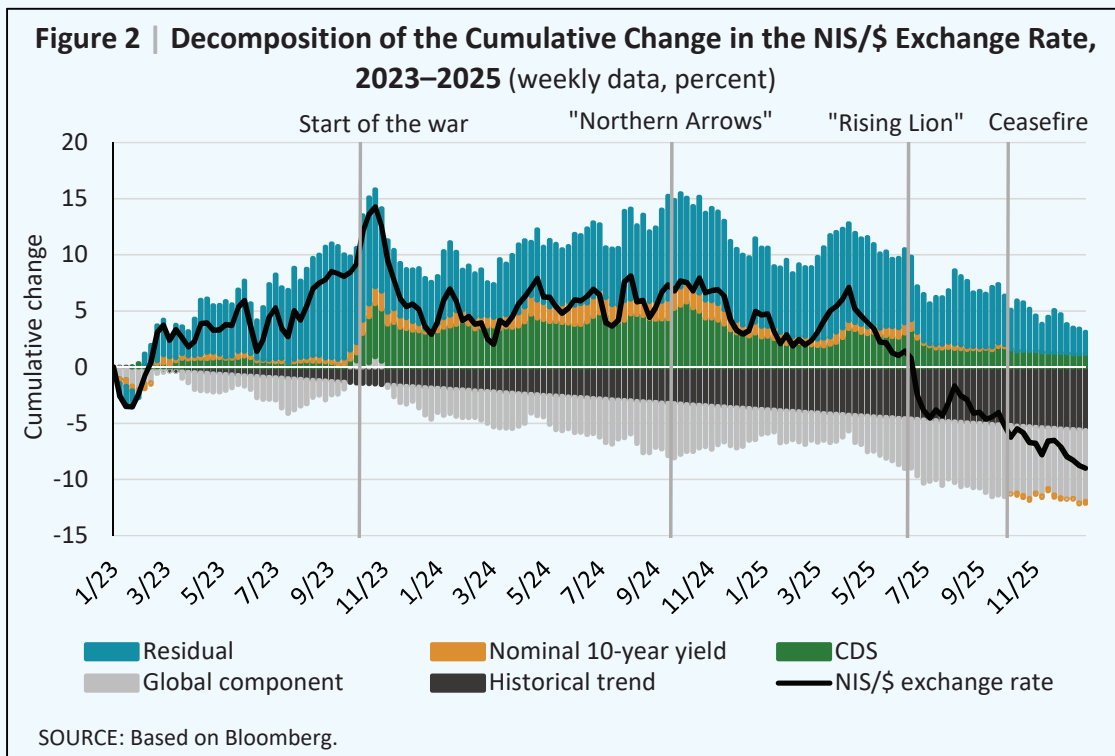
Explaining the Development of the Domestic Component

This section explores possible explanations for the exchange rate's deviation from global factors, focusing on the relationship between this deviation and developments in sovereign credit risk and domestic interest rates. To this end, the following regression was estimated for the period 2016–2025:

$$(2) \quad \Delta ILS = \alpha_0 + \vec{\beta} \cdot \overrightarrow{Global} + \alpha_1 \Delta CDS + \alpha_2 \Delta I10Y + u$$

where \overrightarrow{Global} includes the explanatory variables from Equation (1), ΔCDS denotes the change in the five-year sovereign CDS spread on Israeli government bonds, which serves as an estimate of the credit risk on Israeli government bonds, and $\Delta IL10Y$ represents the change in the interest rate on 10-year Israeli government bonds, which is influenced both by sovereign credit risk and by the short-term interest rate and expectations thereof.

Based on this estimation, Figure 2 presents a decomposition of the cumulative change in the shekel-dollar exchange rate since the beginning of 2023. The sum of the colored bars (CDS, nominal 10-year interest rate, and residual) approximates the domestic component of the exchange rate.³ The constant term in the regression captures a long-term trend in the exchange rate⁴, which may be related to changes in the relative productivity of the Israeli economy or to its persistent current account surplus (Frish, 2016; Eckstein and Friedman, 2011).⁵



³ This is only an approximation of the domestic component, as Equation (2) includes two additional explanatory variables that are correlated with global factors and therefore alter their explanatory power relative to Equation (1).

⁴ All explanatory variables in Equation (2) are demeaned, so the constant term captures a long-term linear trend in the shekel-dollar exchange rate, unaffected by long-term trends in the explanatory variables.

⁵ From 2016 until the outbreak of the war, Israel's per capita GDP grew by approximately 4 percent relative to that of the United States, and the current account surplus averaged about 3 percent of GDP. These trends support a real appreciation of the shekel.

Figure 2 indicates that for most of the period, global factors supported an appreciation of the shekel. In contrast, the contribution of domestic factors varied over time. Until the outbreak of the war, the depreciation was domestically driven but not correlated with the CDS or the long-term nominal interest rate, and thus appears as a residual. It is likely that internal tensions during that period weakened investor sentiment toward Israel and the shekel, while their expected fiscal implications were moderate, resulting in only limited increases in the CDS and the long-term nominal interest rate.

With the outbreak of the war, government expenditures rose sharply, and since then, a significant portion of the domestic component of the exchange rate is explained by movements in the CDS and the long-term interest rate. Following Operation Rising Lion and, more markedly, after the ceasefire in Gaza, the shekel appreciated substantially, partly explained by declines in the CDS and the long-term, nominal interest rate. These developments were perceived by markets as reducing sovereign credit risk, thereby supporting the moderation of the CDS and the long-term interest rate and the appreciation of the shekel. Nevertheless, part of the appreciation during this period remains unexplained and likely reflects a general improvement in investor sentiment toward Israel.

Conclusion

The analysis indicates that since early 2023, the shekel weakened against the dollar primarily due to domestic factors, while the government's credit risk increased only after the outbreak of the war at the end of that year. Since Operation Northern Arrows in late 2024, the shekel has strengthened against the dollar, supported by domestic factors including an improvement in sovereign credit risk.

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The impact of appreciation on inflation

The appreciation of the shekel had a significant moderating effect on inflation during the year. Bank of Israel Research Department estimates of the passthrough from the exchange rate to inflation vary depending on the model used and the sample period, but most fall within the range of 0.13–0.25.⁵ Based on this range of coefficients and the change in the exchange rate (taking into account the relevant currency and timing for each model), the appreciation of the shekel contributed between 1.6 and 2.5 percentage points to the decline in inflation relative to a scenario in which the exchange rate had remained unchanged.⁶

This estimate reflects the combined impact of all factors that affected the economy through the exchange rate channel—whether their sole effect on inflation operates through the exchange rate (such as changes in demand for the shekel) or whether they also have additional effects on inflation beyond that channel (such as the Bank of Israel’s interest rate, which influences inflation through its effect on aggregate demand; see discussion in the Monetary Policy section).

To quantify the contribution of the appreciation to the moderation of inflation relative to 2024, when the shekel also appreciated, a similar calculation was applied to the appreciation that occurred then. The difference between the estimated contribution of the appreciation to inflation this year and its estimated contribution in 2024 represents the estimated contribution of the appreciation to the moderation in inflation. Based on this calculation, the appreciation of the shekel contributed about 1.3 percentage points to the moderation in the inflation rate compared with 2024.⁷

⁵ The analysis in this section is based on two types of tests: a structural (DSGE) model and empirical regressions. The structural model results are based on an update of the analysis presented in the Monetary Policy Report for the Second Half of 2019 (“How Does the Relationship Between the Exchange Rate and Inflation Depend on the Source of the Exchange Rate Change”), according to which a 1percent appreciation against the currency basket lasting four quarters reduces inflation over that period by 0.25 percentage points. The empirical regressions are based on an update of the analysis published in Policy Analysis and Research Notes, December 2023 (“Pass-Through from the Exchange Rate to Prices”), which found that over the past decade, a 1percent appreciation against the US dollar leads in subsequent months to a decline in inflation of about 0.13 percentage points. The empirical regressions indicate a somewhat weaker passthrough in cases of appreciation than in cases of depreciation (the value used here corresponds to appreciation). In the DSGE model, the passthrough is symmetric by definition.

⁶ The relevant appreciation for the DSGE model (average effective exchange rate, 2025:Q4 vs. 2024:Q4) was about 10 percent. Assuming a passthrough of 0.25, this implies a contribution of -2.5 percentage points to inflation in 2025. The relevant appreciation for the empirical regressions (average exchange rate against the US dollar, November 2025 vs. November 2024) was about 12 percent. Assuming a passthrough of 0.13, this implies a contribution of -1.6 percentage points to inflation in 2025.

⁷ The relevant appreciation for the DSGE model (average effective exchange rate, 2024:Q4 vs. 2023:Q4) was about 5 percent. Assuming a passthrough of 0.25, this implies a contribution of -1.2 percentage points to inflation in 2024. The relevant appreciation for the empirical regressions (average exchange rate against the US dollar, November 2024 vs. November 2023) was about 2.3 percent. Assuming a passthrough of 0.13, this implies a contribution of -0.3 percentage points to inflation in 2024.

The later decline in the nontradable component relative to the tradable component is consistent with the estimated passthrough effects cited above. The impact of exchange rate changes on the tradable component is largely realized within about three months, while the effect on the nontradable component takes about six months to materialize. Quantitatively, these regressions yield a passthrough of about 0.1 for the nontradable component (compared with about 0.2 for the tradable component), implying an estimated contribution of about 0.5 percentage points to the moderation in nontradable inflation relative to last year. Offsetting this moderating factor, the tightness of the labor market contributed to an acceleration in the nontradable component (see discussion in the following section), thereby offsetting most of the moderating effect of the appreciation on this component.

(2) Excess demand

Due to its impact on reducing the labor supply and increasing demand for public defense consumption, the war led to the creation of excess demand. Excess demand tends to raise inflation through two channels. First, it may enable producers to charge higher price margins relative to production costs, particularly in industries where consumer demand is relatively inelastic. Second, it leads to higher wages—a key component of production costs for many goods and services. Rising production costs prompt producers to raise prices to the extent that demand allows.

The war reduced the supply of workers and increased defense consumption, thereby contributing to the creation of excess demand.

A common measure in the literature for labor market tightness is the ratio of job vacancies to unemployed persons (V/U), which expresses the relationship between firms' demand for workers and the supply of available labor. This measure has been found in several studies to have explanatory power with respect to inflation.⁸ Despite moderating during the year from its peak level in 2024, the V/U ratio remained high—an indication that the labor market is still tight. (For further discussion, see Chapter 5 in this Report.) Empirical analysis for Israel shows that the V/U ratio has considerable explanatory power for developments in the inflation of nontradable components.⁹

⁸ For evidence on the superior performance of the V/U ratio relative to other measures of labor market tightness, see Régis Barnichon and Adam Hale Shapiro (2024), "Phillips Meets Beveridge," *Journal of Monetary Economics*, 148: 103660. For a discussion of the advantages of the V/U ratio as a measure of tightness relative to the unemployment rate and its application to the US, see Ben Bernanke and Olivier Blanchard (2025), "What Caused the US Pandemic Era Inflation?," *American Economic Journal: Macroeconomics*, 17(3): 1–35.

⁹ The analysis is based on the estimation of a New Keynesian Phillips curve of the following form:

$$\pi_t = \alpha + \beta_1 \pi_{t-1} + \beta_2 \pi_t^e + \beta_3 VU_{t-1}^{low} + \beta_4 VU_{t-1}^{high} + \beta_5 \Delta E_t$$

where π_t is quarterly annualized inflation of the nontradable component excluding fruit and vegetables (seasonally adjusted); π_{t-1} is inflation with a one-quarter lag; π_t^e is one-year-ahead inflation expectations from the capital market; VU_{t-1}^{low} is the deviation of the V/U ratio in the previous quarter from its average when negative and 0 otherwise; VU_{t-1}^{high} is the deviation of the V/U ratio in the previous quarter from its average when positive and 0 otherwise; and ΔE_t is the rate of change in the effective exchange rate (quarterly average vs. previous quarterly average).

An important finding from the analysis is that the effect of labor market tightness on inflation is nonlinear. It intensifies when the labor market is very tight.¹⁰ Based on the estimation results, and taking into account the weight of the nontradable component in the overall index, labor market constraints contributed more than 0.9 percentage points to inflation in 2025. The estimated contribution in 2024 was 0.6 percentage points. It was lower than in 2025 because in the first half of 2024, the labor market had not yet reached the high levels of tightness that were characteristic of it in the second half of the year. Overall, labor market tightness accelerated inflation by about 0.3 percentage points this year.

While in 2024 inflation rose even though production costs did not increase, in 2025 production costs began to rise. A common measure of production costs is the GDP labor share, calculated as the ratio of total wage expenditures to nominal GDP (which approximates total wages and profits). After several years of decline in the GDP labor share in the business sector (a more accurate indicator for supply constraints relevant to inflation than the economywide ratio), the ratio began to rise this year—consistent with the effects of supply constraints in the labor market. (For further discussion, see Chapter 5 in this Report.) As noted, inflation began to rise already in 2024, before production costs increased. This development may reflect wage rigidity relative to prices or producers' ability to charge higher margins above production costs under conditions of excess demand.

(3) Inflation Expectations

Inflation expectations influence the pricing decisions of firms and workers, who take into account the expected rise in prices when negotiating wages. Therefore, an important role of central banks is to ensure that economic shocks do not feed too strongly into inflation expectations, thereby generating a stronger and more persistent response in actual inflation (“secondround effects”). This role became particularly important under the conditions experienced by the Israeli economy following the war: first, supply constraints that created inflationary pressures up to and beyond the upper bound of the inflation target; and second, a significant increase in the government’s financing needs—a development that tends to raise public inflation expectations, both due to the expected increase in excess demand and, potentially, due to concerns about fiscal sustainability or expectations of future tax increases.¹¹ All this followed a prolonged period of inflation above the target during the postCOVID recovery.

¹⁰ Nonlinearity may arise, among other reasons, because as the pool of available workers shrinks, firms are forced to hire less suitable workers, thereby increasing production costs at an accelerating pace. Evidence of nonlinearity in the relationship between the V/U ratio and inflation appears in Pierpaolo Benigno and Gauti B. Eggertsson (2024), “Slanted Phillips Curve,” AEA Papers and Proceedings, 114: 84–89, among other sources.

¹¹ For example, Box 3.3 in the Bank of Israel Annual Report for 2024 found that the increase in the deficit in 2024 contributed between 0.5 and 1 percentage point to oneyear inflation expectations.

In view of this, the moderation of inflation expectations across all horizons this year was a positive development, reflecting the decline in the intensity of the security conflict and the fading of the war's inflationary effects, alongside monetary policy that maintained the credibility of the inflation target. One-year expectations, which in 2024 hovered around the upper bound of the target range, moderated significantly this year to around the midpoint of the target range (Figure 3.7). Since producers' pricing decisions are influenced by their inflation expectations, it is likely that the moderate rise in expectations during the war and their rapid decline this year contributed to tempering the increase in actual inflation and shortening the period during which inflation remained above the target range. The decline in inflation expectations also contributed to moderating inflation through its effect on the rise in real yields—a factor that dampens consumption and investment demand. (See further discussion in the Monetary Policy section.)

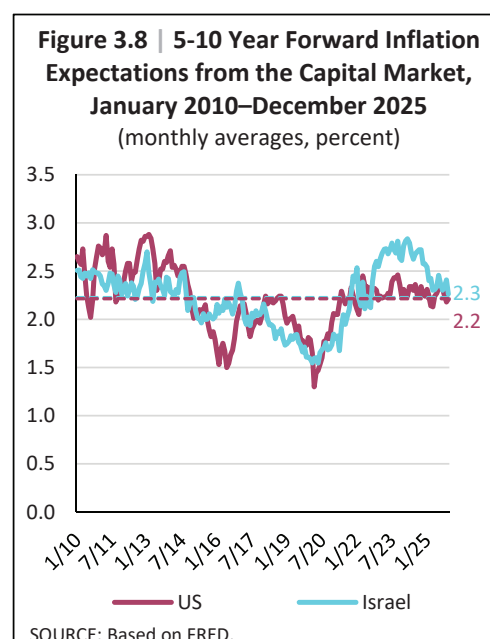
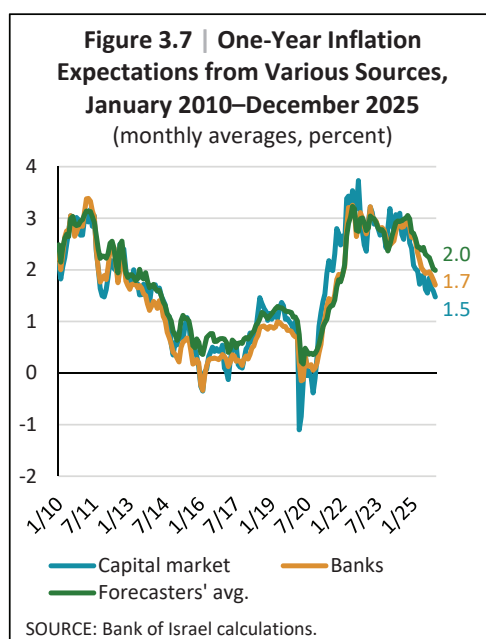
Longterm (forward) inflation expectations also declined markedly (Figure 3.8).¹² The figure shows that after historically high expectation levels during 2024 (continuing the increase that began in late 2022), expectations moderated during 2025 to 2.3 percent at yearend—close to the longterm average. The figure also presents a comparison with expectations for corresponding horizons in the US. As shown, there is a positive correlation between expectations in Israel and in the US (and the average level in the sample is very similar). This correlation may be due to the influence of US inflation on Israeli inflation through imports, as well as from common economic forces in both economies. In any case, periods in which one country experienced inflationary pressures not shared by the other are reflected in gaps between the series. Following the decline in expectations in Israel, they stood at a level similar to that in the US at the end of 2025.

Historically, longterm inflation expectations in Israel have been well anchored.¹³ This characteristic, reflecting the credibility that the public ascribes to monetary policy, is an asset that helps moderate inflation's response to macroeconomic shocks—as indeed occurred over the past two years.

The anchoring of inflation expectations helped moderate inflation's response to the war.

¹² Inflation expectations are calculated as the difference between nominal and real yields and may include liquidity and risk premia.

¹³ See Box 3.1 in the Bank of Israel Annual Report for 2021.



Summary of contributions to the moderation of inflation

Inflation in 2025 totaled 2.6 percent—a decline of 0.6 percentage points relative to the previous year. A summary of the estimated contributions presented above indicates that a principal factor behind the moderation in inflation was the appreciation of the shekel, which largely reflected the decline in the economy’s risk premium. This appreciation contributed an estimated 1.3 percentage points to the reduction in inflation. Conversely, labor market tightness is estimated to have contributed approximately 0.3 percentage points to the increase in inflation.¹⁴

As described in the section on monetary policy below, some of these effects were due to the Bank of Israel’s policy stance. The fact that the Bank of Israel’s policy rate remained unchanged for most of the year contributed to the moderation of inflation, through its contribution to the appreciation of the shekel, its anchoring of inflation expectations, and its dampening impact on domestic demand, thereby preventing an increase in inflation due to a further tightening of the labor market.¹⁵

¹⁴ The price of oil declined by approximately 15 percent during the year (Table 3.1), compared with a decline of about 5 percent in 2024. According to our assessment, this contributed roughly 0.2 percentage points to the moderation of inflation. Fiscal and regulatory measures contributed only about 0.1 percentage points to the acceleration of inflation, as their impact was already significant in 2024 (an estimated 0.4 percentage points), stemming from the increase in cigarette taxes, the elimination of the fuel excise discount, and the reduction in subsidies for afternoon childcare programs. For further details, see Box 3.1 in the Bank of Israel Annual Report for 2024.

¹⁵ The aggregation of the estimated contributions implies a larger decline in inflation than was actually observed. It is important to note that these estimates are subject to a wide range of uncertainty. Moreover, in any given year, inflation may also be affected by idiosyncratic factors that are not captured in the analysis presented here.

3. MONETARY POLICY

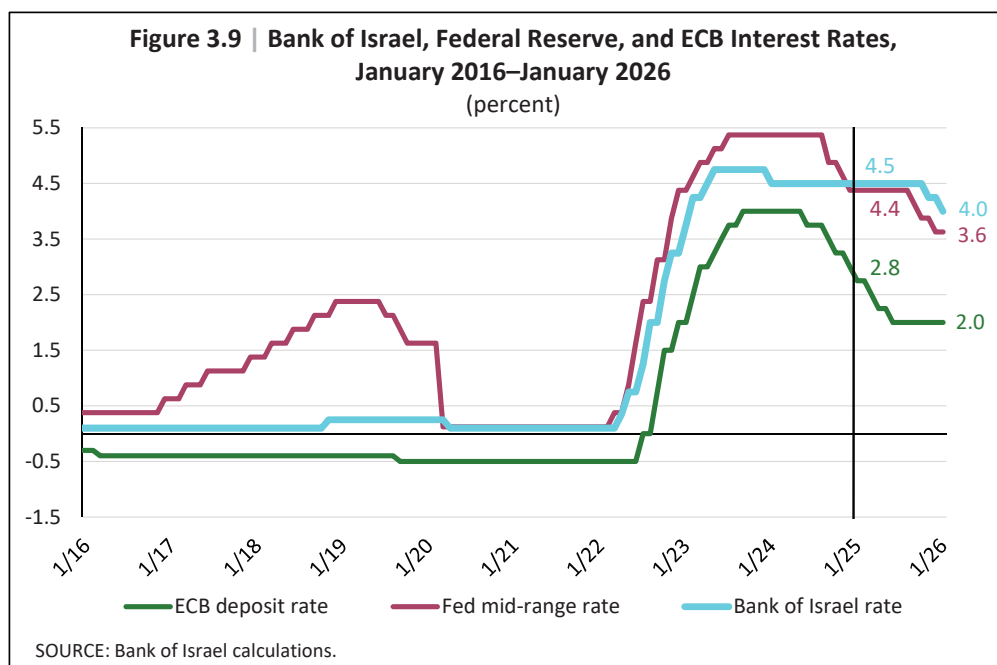
a. Policy measures and the Monetary Committee’s considerations

The Bank of Israel’s policy rate remained unchanged for most of the year, at 4.5 percent (Figure 3.9). In November, after the annual inflation environment had stabilized within the target range and after the risk premium in financial markets declined against the backdrop of geopolitical developments—including the ceasefire agreement in Gaza in October—the Monetary Committee reduced the interest rate to 4.25 percent. This was the first rate cut since January 2024.

In January 2026, in view of the continuation of these trends and signs of a slight easing in labor market tightness, the Committee further reduced the rate to 4.0 percent.

The moderate decline in the Bank of Israel’s policy rate was slower than the declines in the eurozone, which meant that the interest rate differential vis-à-vis the eurozone widened. The differential vis-à-vis the Federal Reserve increased only slightly, as the pace of rate reductions in the United States was also very gradual (Figure 3.9).

The interest rate remained at 4.5 percent for most of the year, and was lowered in November and in January 2026.



The decision to leave the policy rate unchanged for most of the year reflected both the need to preserve a sufficiently restrictive monetary stance—aimed at aligning demand with the constrained supply and thereby moderating inflationary pressures—and considerations related to risk management. Until midyear, the pace of inflation exceeded the upper bound of the target range, with volatility, while

Keeping the interest rate unchanged for most of the year reflected the need for monetary restraint alongside risk management considerations.

economic activity remained moderate due to supply constraints. In other words, it reflected excess demand that required monetary restraint in order to bring demand in line with limited supply. In such circumstances, a rate reduction would have been expected to yield only a modest increase, if any, in activity but a significant rise in inflation.

Although the Research Department had already assessed at the beginning of the year that inflation would moderate to within the target range during the course of the year, there was considerable uncertainty surrounding this forecast. This uncertainty was mainly due to the inability to predict the evolution of the war and its implications for the risk premium and the exchange rate, the labor market, and government expenditures—and, to a lesser extent, to uncertainty regarding the impact of tariff increases in the United States and their spillover effects.

Even after inflation entered the target range (in the August CPI, which was published in mid-September), the Monetary Committee decided to wait in order to ensure that the moderation in inflation was firmly established and that the security situation did not deteriorate.¹⁶ This caution was intended to avoid an overly early rate reduction that might later have required a reversal in policy to respond to a renewed rise in inflation. A resurgence of inflation after a period of moderation could also have undermined the anchoring of inflation expectations. Moreover, frequent policy reversals tend to generate excessive volatility in financial markets and may weaken the effectiveness of monetary policy over time.¹⁷

A significant moderation of the inflation environment was an important precondition for lowering the policy rate, since even under a scenario of improved security conditions there remained a risk of renewed inflationary pressures if demand were to recover faster than supply. The combination of inflation moderating to within the target range and remaining there, the decline in the risk premium following Operation Rising Lion (the Israeli operation against Iran in June 2025) and the associated appreciation of the shekel and decline in inflation expectations, as well as the ceasefire agreement reached in October and its potential implications for the labor market, led the Monetary Committee to reduce the policy rate to 4.25 percent in November. In addition to these factors, there were initial indications leading up to the January 2026 decision that the supply constraints in the labor market were easing, which led the Monetary Committee to again lower the rate, to 4.0 percent.

The assessment that the economy was characterized by excess demand was supported by several real indicators, as well as by the composition of inflation, particularly during the first half of the year. The inflation rate of the tradable

The more relaxed security situation, the appreciation of the shekel, and the decline in inflation expectations all supported a reduction of the interest rate at the end of the year.

¹⁶ When the interest rate decision was made at the beginning of October, it was highly likely that the “Chariots of Gideon 2” military offensive in Gaza, which began in August 2025, would be expanded, with implications for reserve mobilization, government expenditures, international sentiment toward Israel, and more.

¹⁷ For a discussion of the value of gradual interest rate adjustments, see for example: Michael Woodford (2003), “Optimal Interest-Rate Smoothing”, *The Review of Economic Studies*, 70(4): 861–886.

component moderated—reflecting the impact of the shekel’s appreciation—while inflation in the nontradable component, which is more strongly influenced by domestic demand pressures, remained high and even accelerated. The rapid increase in the prices of nontradables, although partly reflecting the effect of the VAT increase at the beginning of the year, supported the assessment that supply constraints in the labor market continued to manifest as excess demand pressures that were driving price increases.

The rapid rise in the nontradable component was also a reason for delaying rate reductions for another consideration: This component tends to exhibit greater persistence (“stickiness”) than the tradable component. In other words, an increase in inflation of the nontradable component tends to last longer. This difference may reflect variations in the persistence of the underlying forces driving each component (for example, the tradable component is more affected by the exchange rate, which is inherently volatile), or it may stem from structural differences in the markets in which these goods and services are traded. In any case, the factors described above—the indication provided by the nontradable component regarding excess demand in the economy, and its higher persistence—justify a more restrictive monetary policy response to an increase in inflation of the nontradable component than to an increase originating in the tradable component.

In keeping with this, Figure 3.10 illustrates that in Israel, as in many other countries, the services component of inflation—which constitutes a major part of the nontradable segment—exhibits greater persistence than the goods component.

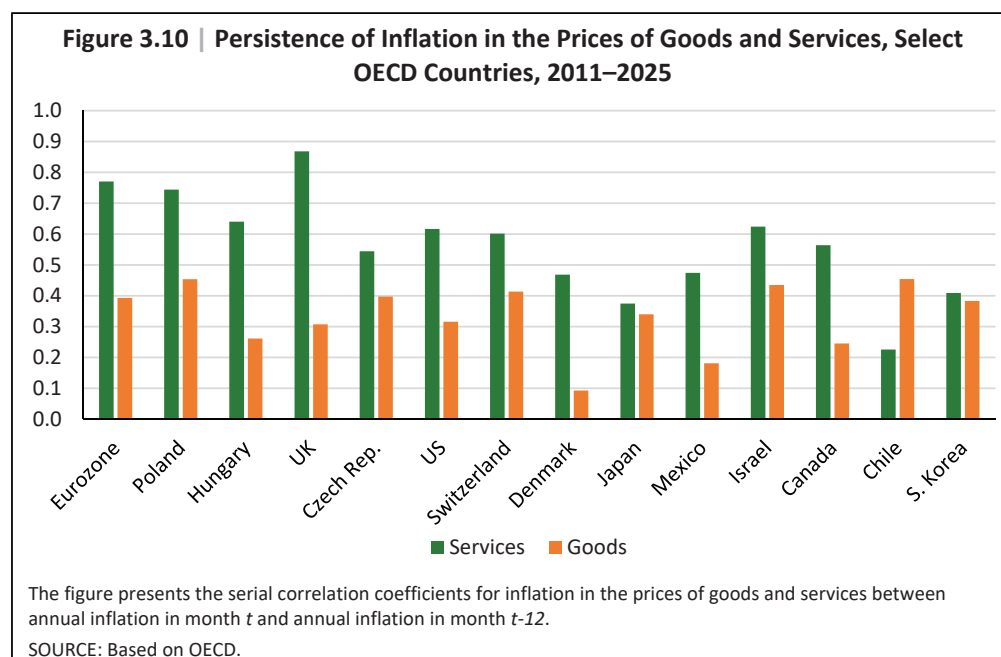
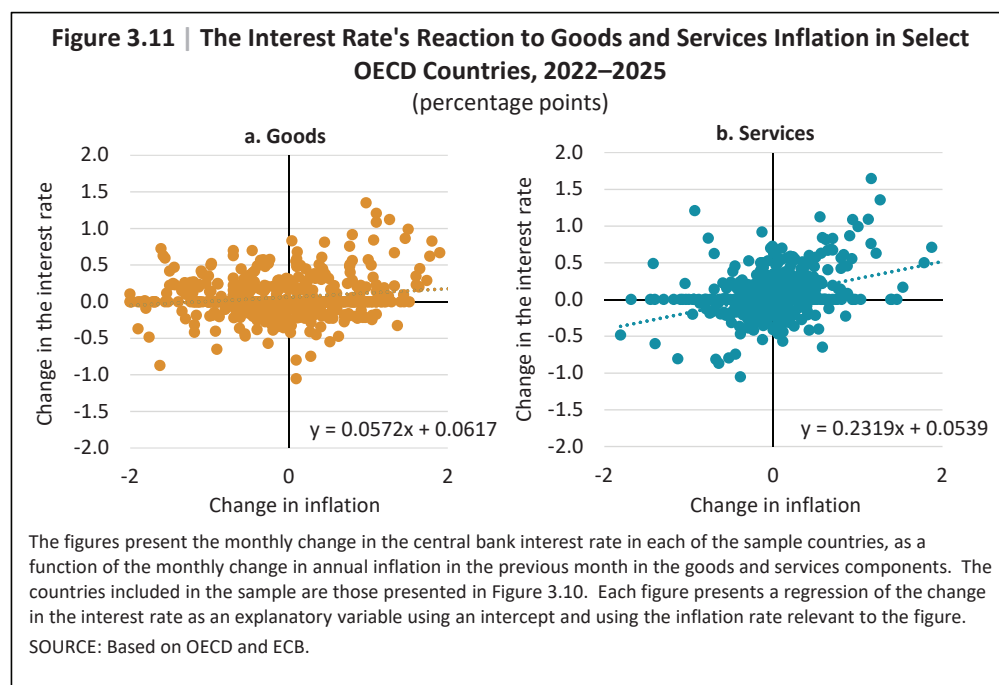


Figure 3.11 provides evidence that central banks indeed tend to respond more strongly to changes in services inflation than to changes in goods inflation.¹⁸



b. The real interest rate and the extent of monetary restraint

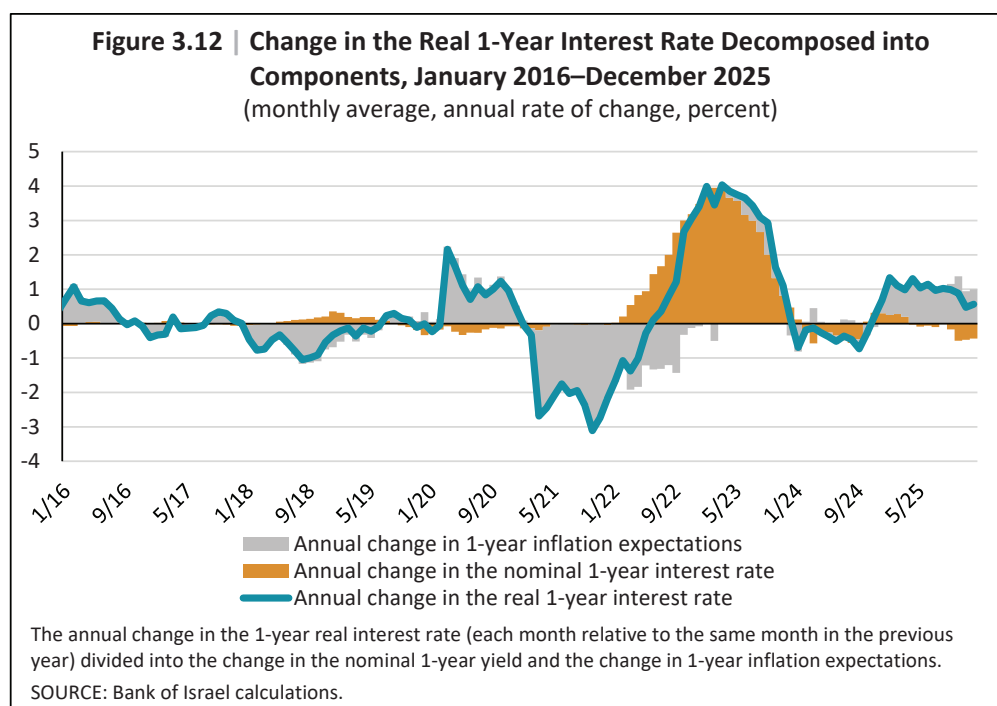
The short-term real interest rate

Monetary policy's effect on the economy operates largely through real yields, which influence aggregate demand—particularly private consumption and investment. To assess the effect of monetary policy, it is customary to focus mainly on short- to medium-term real yields, as these are the ones most directly affected by monetary policy: directly, through nominal yields; and indirectly, through the public's inflation expectations.

To examine policy's effect on real yields, Figure 3.12 presents a decomposition of the annual change in the one-year real interest rate (each month compared with the corresponding month in the previous year) into two components: the change in

¹⁸ The figure focuses on the period from 2022 onward, since in the preceding decade policy rates in many countries were constrained by the zero lower bound. Consequently, changes in inflation—whether in goods or services—did not lead to changes in policy rates, which biases the regression slopes. Nevertheless, the qualitative result remains valid even when that period is included. In addition, the positive gap between the coefficient of the policy rate response to services inflation and that of the response to goods inflation is statistically significant.

the one-year nominal yield and the change in one-year inflation expectations.¹⁹ The figure shows that at the beginning of the year there was a significant increase—of about one percentage point—in the one-year real yield, so that for most of the year the real interest rate was higher than in the corresponding months of 2024. The figure indicates that the decline in inflation expectations, together with the Bank of Israel’s decision to maintain the same policy rate (and its implications for the expected path of rates), led to an increase in the real interest rate. Toward the end of the year, there was a decline in the real yield, reflecting the reduction in the Bank of Israel’s policy rate.

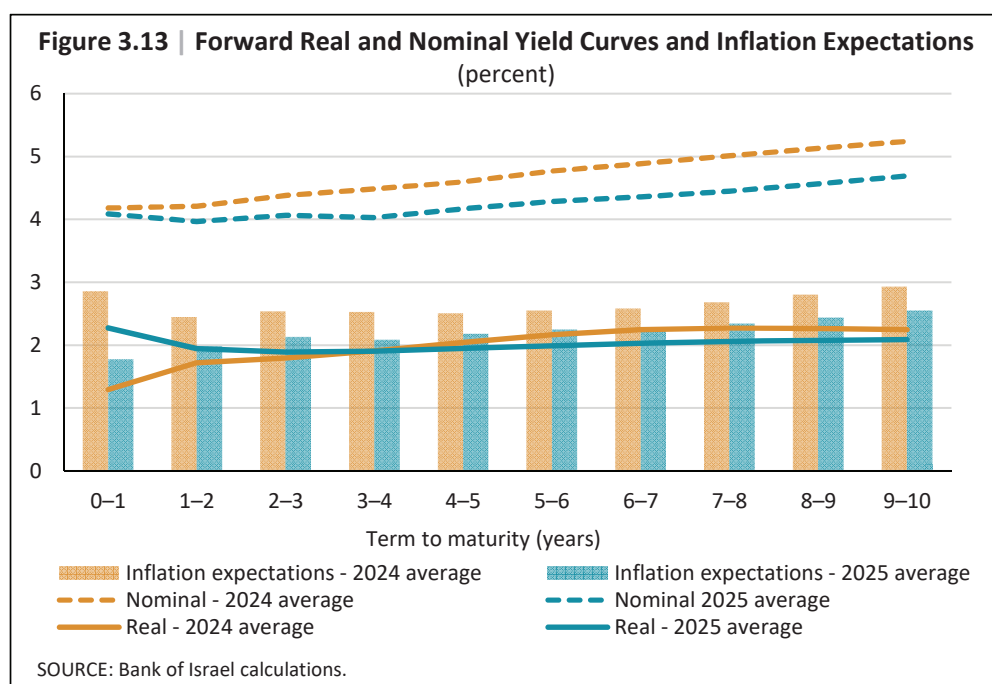


The increase in real yields was also evident at the two-year horizon (Figure 3.13) and led to a rise in the real spot yield curve along its entire length (not shown). The increase in real yields acted to moderate aggregate demand—a development consistent with the need to align aggregate demand with the constrained supply.²⁰

Monetary policy led to an increase in the real interest rate, thereby contributing to the necessary restraining of demand.

¹⁹ From a technical perspective, one-year inflation expectations are calculated as the difference between the one-year nominal yield and the one-year real yield. The decomposition presented here reflects an economic interpretation whereby, in the short term, the nominal interest rate is set by the central bank, inflation expectations are determined according to the public’s assessments, and the real yield is derived from these two components.

²⁰ Even when monetary policy is restrictive, financing conditions in the market may change simultaneously due to other factors, such as risk premia and credit spreads. In 2025, these components eased, particularly in the capital market. For further discussion, see Chapter 4 – Developments in the Financing Sources of the Nonfinancial Private Sector.



The long-term real interest rate and the extent of monetary restraint

The discussion above highlighted the increase in real yields during the year as a restraining factor on excess demand. This section shows that, given the supply constraints created by the war and the need to restrain the excess demand that resulted from them, a relatively high real interest rate was required.

To describe the extent to which monetary policy is restrictive or accommodative, it is customary to refer to the gap between the actual real interest rate and a benchmark rate known as the neutral interest rate.²¹

In practice, since the neutral rate is a theoretical concept that cannot be directly observed, its level is difficult to estimate. Under the conditions prevailing in the economy this year, it is reasonable to assume that the neutral rate was relatively high—a situation that required maintaining a high real interest rate. To illustrate this, the neutral rate can be represented as consisting of two components: a structural component, reflecting long-term structural forces; and a cyclical component, influenced mainly by short-term developments (up to about five years). Formally²²:

²¹ According to the neo-Keynesian framework, the neutral interest rate is the real interest rate that would prevail in an economy where prices are fully flexible, such that monetary policy would be neutral in its effect on economic activity. In practice, since prices are not fully flexible, central banks can influence short- and medium-term real interest rates and thereby steer the economy in the desired direction—restraining demand when it is excessive, or stimulating it when it is weak. In the literature, the neutral rate is sometimes referred to as the natural rate of interest.

²² For a similar decomposition of Equation (1) and a discussion of methods for measuring the monetary policy stance, see: Olamide Harrison and Vina Nguyen (2025). “How to Measure the Monetary Policy Stance,” IMF How To Notes, <https://doi.org/10.5089/9798400298882.061>.

$$(1) \quad \underbrace{rn}_{\text{Neutral interest rate}} = \underbrace{rn_{long\ run}}_{\text{Long-term factors}} + \underbrace{rn_{cyclical}}_{\text{Cyclical factors}}$$

Using this decomposition, the short-term real interest rate set by the central bank can be described as consisting of three elements: the degree of monetary restraint that the central bank seeks to achieve; short-term cyclical factors that affect the neutral rate; and long-term structural factors that also affect it. Formally:

$$(2) \quad \underbrace{r}_{\text{Short-term real interest rate}} = \underbrace{\underbrace{r - rn}_{\text{Desired monetary restraint}} + \underbrace{rn_{cyclical}}_{\text{Cyclical factors}} + \underbrace{rn_{long\ run}}_{\text{Long-term factors}}}_{\text{Slope of the real curve (short minus long)}}$$

Equation (2) implies that if the central bank wishes to maintain the same degree of monetary restraint—or to increase it—it must act to raise the real interest rate in a way that offsets both the long-term structural forces and the short-term cyclical forces that push the neutral rate upward. Under the conditions prevailing in the Israeli economy in recent years, it is likely that cyclical factors—namely, excess demand—acted to raise the neutral rate, since excess demand reduces aggregate savings and thereby exerts upward pressure on the interest rate level that balances the demand for savings with its supply.

A high real interest rate relative to previous years was necessary in order to maintain monetary restraint.

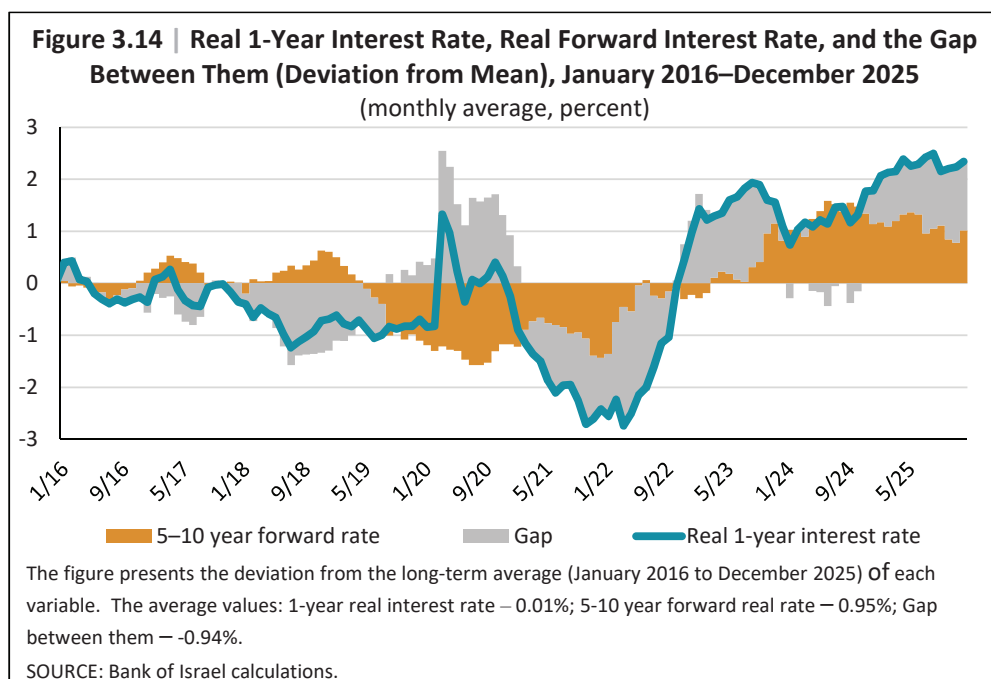
As for long-term factors, in the years following the COVID-19 crisis, long-term interest rates rose in many countries, and the literature and recent policy measures offer several explanations for this.²³ The rise in long-term rates indicates the presence of economic forces that require maintaining a higher short-term rate in order to achieve the same degree of monetary restraint. Accordingly, both short-term and long-term factors likely contributed to the need for a high real interest rate relative to what was common in the previous decade in order to maintain the degree of monetary restraint that is consistent with market conditions.

Figure 3.14 indeed shows that this was the case. The figure presents a decomposition of the short-term interest rate into two components. The first is the forward real yield between the fifth and tenth years, representing the long-term factors in Equation (2). This yield reflects market participants' expectations regarding the level of the short-

²³ In the decade preceding the COVID-19 crisis, many central banks purchased bonds—a measure that worked to lower yields, while the banks' exits from the bond markets contributed to increased yields. Another factor was the deficits, which grew in many countries due to the COVID-19 crisis and are expected to remain high in many countries, partly due to an expected increase in their defense expenditures in view of increased geopolitical tensions. For a review of this topic, see: Gianluca Benigno, Boris Hofmann, Galo Nuño, and Damiano Sandri (2024). "Quo Vadis, r*? The Natural Rate of Interest After the Pandemic," BIS Quarterly Review, December 2024, pp. 17–30.

term real interest rate that will prevail in the future.²⁴ The second component is the gap between the short-term rate and the forward yield. In accordance with Equation (2), this component captures the degree of monetary restraint, $r-rn$, together with cyclical factors, $rn_{cyclical}$, that affect the neutral rate in the short term.²⁵ The figure shows that over the past year, the one-year real interest rate reached a high level compared with the past decade—in fact, the highest level since 2008—and that this reflected contributions from both components: a high forward yield and a large gap between the short-term rate and the forward yield.

It is worth emphasizing that because changes in the short-term real interest rate are also due to the response to the development of the neutral interest rate and not just changes in the extent of monetary tightening, it is impossible to determine how the extent of monetary tightening changed this year based solely on the figure. However, in view of the evidence of excess demand, tightness in the labor market, and supply constraints presented in the chapter it is likely that a significant part, and perhaps even most, of the increase in the real interest rate reflected an increase in the cyclical component of the neutral interest rate and not just a tightening of policy.



²⁴ The measured forward real yields include a term premium, which ideally should be deducted to obtain a more accurate estimate of the short-term real interest rate expected to prevail in the future. The implicit assumption in the analysis presented here is that the term premium is relatively stable over time.

²⁵ Figure 3.14 shows each variable in terms of its deviation from its historical average. This view is intended to focus the analysis on factors that were markedly different this year by historical comparison, and that led to the fact that the real interest rate was higher this year than in the past.

Monetary policy's contribution to the moderation of inflation

As described above, the Monetary Committee adopted a policy aimed at ensuring that inflation would moderate to within the target range and become entrenched within it. In retrospect, inflation at the end of the year actually was within the target range, and in January 2026 it declined to around the midpoint of the range. This policy was reflected in the decision to maintain the policy rate at its existing level for most of the year, against the background of volatility in inflation, geopolitical uncertainty, and fluctuations in the risk premium. As a direct result, and in view of the decline in inflation expectations, the real interest rate increased—a factor that acts to moderate demand for consumption and investment. The rise in the real interest rate also contributes to a real appreciation, and, given price rigidity, to a nominal appreciation as well. All of these factors work to reduce inflation.

Monetary policy's contribution to the moderation of inflation can be assessed using an estimate derived from the Research Department's DSGE model.²⁶ According to the model, a one percentage point increase in the expected one-year real yield leads to a decline of about 0.6 percentage points in inflation in the same year.²⁷ To translate this relationship into an estimate of the policy's impact, two calculations are presented. The first compares the actual development of the real yield with a counterfactual scenario in which the Committee had reduced the policy rate so that the real interest rate would have remained at its 2024 level. The second compares the actual development of the real yield with the path that was priced into the market in 2024.

For the first calculation, we rely on Figure 3.12, which shows that the one-year real interest rate was about one percentage point higher, on average, than in 2024. From this, we can infer that had the Bank of Israel reduced the policy rate so that the real interest rate had remained similar to its 2024 level, inflation would have been about 0.6 percentage points higher, and would have exceeded the target range at the end of the year.

For the second calculation, we rely on Figure 3.13, which indicates that already in 2024 the market expected the real yield to rise by about 0.4 percentage points in 2025. This expectation reflected the assessment that the Bank of Israel would maintain a similar policy rate to that of 2024, despite a projected decline in inflation expectations (which in practice declined even further).²⁸ In other words, roughly half of the increase in the real yield was already priced into the market in 2024, and may therefore have affected inflation even before 2025. Applying the model's

²⁶ The working paper describing the DSGE model is available on the Bank of Israel website: "MOISE: A DSGE Model for the Israeli Economy", Discussion Paper No. 2012.06.

²⁷ The assumption is that at the beginning of the year a contractionary monetary shock occurs, leading to a one percentage point increase in the expected one-year real yield. Roughly half of the increase in the real yield is directly due to the rise in the nominal interest rate, and half is due to an endogenous decline in inflation expectations.

²⁸ It is assumed here that the term premium for horizons of one to two years ahead is relatively small.

transmission coefficients to only the unexpected component of the increase in the real yield generates an estimate of about 0.4 percentage points for monetary policy's contribution to the moderation of inflation.

Under both calculations, the conclusion is that keeping the policy rate unchanged for most of the year contributed significantly to bringing inflation back into the target range. In practice, the contribution was likely even greater. The DSGE model estimate is based on average historical relationships, whereas the economy this year faced supply constraints. In such an environment, the ability to expand production factors in response to rising demand is limited. It is therefore reasonable to assume that a monetary expansion would have resulted in a sharper increase in inflation.

Keeping the interest rate unchanged for most of the year helped return inflation to within the target range.

4. THE MONETARY BASE AND MONETARY AGGREGATES

The interest rate is the price of money—the opportunity cost of holding liquidity. Changes in the interest rate, in addition to changes in economic activity, therefore affect the demand for liquidity. When the nominal interest rate serves as the policy instrument, the central bank supplies money elastically at the interest rate it announces, and the monetary base—that is, the total amount of currency in circulation and the commercial banks' demand deposits at the Bank of Israel²⁹—is determined according to the demand for liquidity at the central bank's policy rate.³⁰

The quantity of money, as measured by the M1 aggregate, consists of currency held by the public and the public's demand deposits in the banking system. It too is influenced by the Bank of Israel's policy rate.

In recent decades, the importance of monetary aggregates for the conduct of monetary policy has declined. In the 1970s and 1980s, the quantity of money served as a central anchor for monetary policy and was the main instrument through which central banks operated. Since then, the way monetary policy is conducted has changed. Today, the main policy instrument is the policy interest rate, and its level is not determined by reference to the growth rate of the money supply but is primarily based on an assessment of the level required to achieve the central bank's objectives.

Nevertheless, some economists argue that the importance of monetary aggregates has not disappeared entirely, and that during periods of unusual developments in these aggregates—for example, around episodes in which the central bank purchases assets, particularly in a zero-interest-rate environment—they may contain useful information for policymakers. As shown below, no unusual developments occurred in these aggregates during the year.

²⁹ Banks must maintain demand deposits at the Bank of Israel as part of their liquidity requirements.

³⁰ The monetary base is affected both by flows outside the Bank of Israel's control—such as government operations (since government accounts are held at the Bank of Israel)—and by flows under its control, such as foreign exchange and government bond purchases and the issuance of MAKAM (short-term Bank of Israel bills). The Bank absorbs or injects liquidity to meet the demand for the monetary base at the policy rate, adjusting the base in view of other liquidity flows through interest-bearing deposits offered to banks via auction (which are not included in the monetary base) and through MAKAM issuance.

Developments in 2025 and in previous years

During 2025, the monetary base increased slightly (Table 3.2, Column 0), similar to 2024. The M1 aggregate rose in 2025 (Table 3.2, Column 3), following the very moderate pace of increase observed in 2024. In nominal GDP terms, in the past two years the quantity of money has remained relatively stable, following a period of rapid expansion during the COVID-19 crisis and a subsequent sharp decline as the economy emerged from the crisis (Figure 3.15).

Figure 3.16 suggests the reason for the stability in the quantity of money this year. The figure presents the annual change in the Bank of Israel's policy rate (in logarithmic terms) and the annual change in the ratio of M1 to GDP (also in logarithmic terms). This ratio reflects the public's demand for liquidity. As expected, the figure shows a strong negative correlation between the rate of change in the policy rate and the rate of change in the M1-to-GDP ratio. In periods when the interest rate rises, the opportunity cost of holding cash and demand deposits also rises, and therefore the demand for them declines.

For example, during the COVID-19 crisis, the interest rate fell to near zero and the demand for money increased sharply.³¹ As the economy exited the crisis, the interest rate rose to 4.75 percent and the demand for money contracted accordingly. From then until the end of 2025, the interest rate declined only slightly, and therefore the demand for money remained relatively stable. The figure illustrates that, at business-cycle frequencies, developments in the quantity of money (in terms of GDP) mainly reflect the effect of the Bank of Israel's policy rate.

In parallel with the stability in M1, there was again this year—similar to the previous three years—a rapid increase in term deposits of up to three months (Table 3.2, Column 4). This development may reflect the public's growing awareness of the possibility of earning returns on interest-bearing deposits, including through money market funds, in view of the gap between the Bank of Israel's policy rate and the interest paid on demand deposits.³²

³¹ The demand for money tends to increase nonlinearly as the nominal interest rate—the opportunity cost of holding cash—approaches zero.

³² For details on the public's shift from short-term deposits to money market funds and on the assets in which these funds invest, see Chapter 4.

Table 3.2 | Rate of change in the monetary aggregates, 2021–2025

	0	1	2	1+2=3	4	5	6	3+4+5+6=7
	Monetary base ^a	Cash held by the public	Demand deposits	M1 ^b	Term deposits up to 3 months	Term deposits of 3 months to 1 year	SRO ^c	Total ^d
(Average in December compared with the average in the previous December)								
2021	12.6	6.9	25.2	22.0	-3.6	12.6	23.8	17.5
2022	3.0	6.0	-12.9	-10.0	34.6	85.0	-7.9	4.9
2023	1.6	8.8	-19.8	-14.6	24.9	17.3	-15.5	-3.1
2024	2.4	1.6	0.1	0.4	29.0	-6.3	7.1	6.6
2025	2.3	1.9	6.4	5.4	23.2	4.1	-13.2	6.2
(Quarterly average compared with the average of the previous quarter)								
2025								
Q1	-1.7	-1.5	-1.1	-1.2	3.8	-1.3	-2.6	-0.2
Q2	2.4	2.2	0.7	1.0	4.0	0.3	1.0	1.7
Q3	0.5	-0.1	0.6	0.5	9.3	-0.1	0.5	2.8
Q4	0.1	0.1	6.7	5.2	5.7	0.4	-11.5	1.5

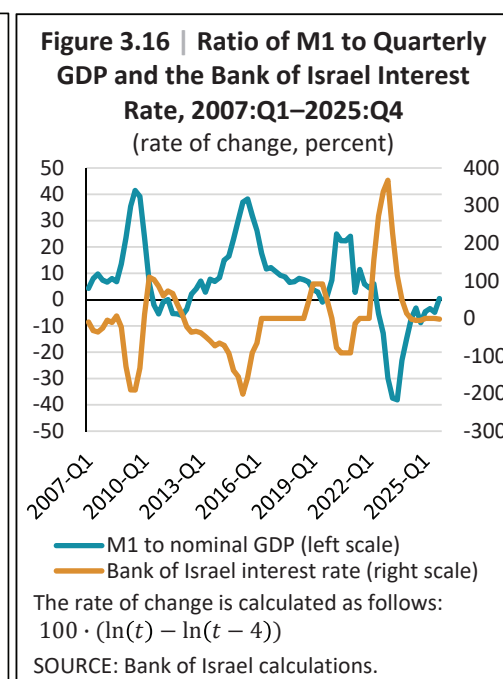
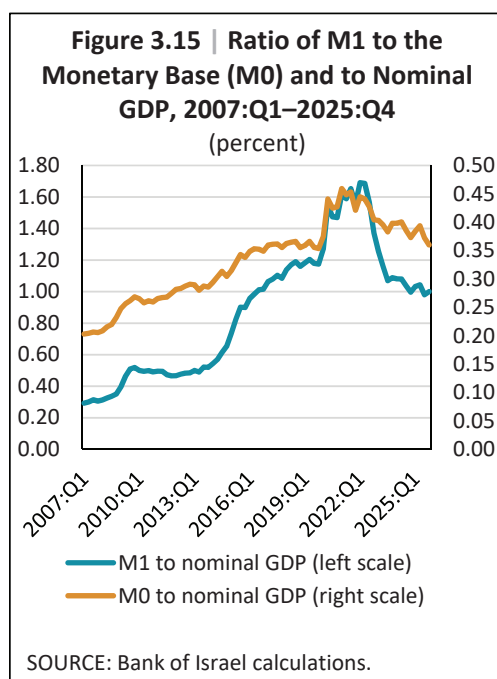
^a Total banknotes and coins in circulation and demand deposits by the commercial banks with the Bank of Israel.

^b M1 = cash and demand deposits.

^c Self-renewing overnight deposit - a liquid daily deposit.

^d M1+SRO+unindexed deposits of up to one year.

SOURCE: Bank of Israel and Central Bureau of Statistics data.



Chapter 4

Development of financing sources for the nonfinancial private sector

- » The recovery trend in private sector financing, which began in 2024, accelerated in 2025. It was reflected in an increase in debt across most borrower segments, alongside an expansion of both bank credit and nonbank financing.
- » Credit to the business sector expanded markedly—both through the banking system, across all business size groups, and through increased activity in the corporate bond market. This activity was reflected in high issuance volumes and a decline in yield spreads to historically low levels, in line with the global trend.
- » The expansion of nonbank financing was supported by an increase in household savings directed to money market funds and mutual funds in place of bank deposits. These developments increased demand for debt instruments in the capital market and contributed to an expansion in the supply of credit to nonfinancial corporations, particularly in the construction and real estate industry.
- » The share of bank credit in arrears remained stable and at a low level in 2025, both for households and in credit to the business sector.
- » In 2025, new mortgage borrowing remained at a relatively high level, despite the decline in the number of transactions in the housing market. This was partly due to the large share of borrowing associated with past transactions, particularly within the framework of sales promotion campaigns offered by contractors in previous years.
- » At the same time, mortgage refinancing remained at a high level, driven mainly by the realization of opportunities to optimize loan terms rather than by cash-flow distress.
- » Long-term trends in the characteristics of new mortgages continued this year as well, including longer repayment periods, higher leverage, and a higher payment-to-income ratio. In addition, the average age and average income of new homebuyers increased.
- » Nonhousing consumer credit continued to expand in 2025, alongside an increase in the share of nonbank entities in general and credit card companies in particular. The growing use of the Credit Data Register by nonbank entities points to its contribution to improving their underwriting capabilities, thereby supporting the upward trend in the volume of this credit within total nonhousing consumer credit.



Business credit from the banks increased markedly – by 18.3%

157
NIS billion

Total issuances in the **corporate bond market** – a record year



The new mortgage market remained stable, with an increase in the volume of refinancing



Nonhousing consumer credit recovered, led by the increase in credit from credit card companies

1. INTRODUCTION AND MAIN DEVELOPMENTS

a. Background

Following a sharp decline in credit activity in 2023 in view of the outbreak of the war, and a partial recovery in 2024, there was a marked increase in both credit to the business sector and credit to households in 2025. Credit growth was due to a combination of two main factors:

- Factors that contributed to improved credit conditions and a marked expansion of bank credit—including declines in the intensity of the fighting and in the risk premium, alongside high levels of equity and record issuance in the banking system's corporate bond market; and
- A significant expansion of nonbank financing to the business sector through the corporate bond market. This occurred against the background of a shift in household savings from deposits to money market funds and mutual funds—a shift that increased the supply of sources in the market.

This set of processes supported the expansion of aggregate economic activity, including the rapid increase in private consumption and investment in the construction industry, thereby assisting the economy's recovery despite the continuing uncertainty.

During 2025, nonfinancial private sector debt¹ increased by about 9.1 percent—a rate higher than GDP growth during the same period and higher than credit growth in 2024, though still lower than the growth rates recorded in the years preceding the outbreak of the war (Table 4.1). The increase in private debt was driven by a rise in business sector debt. This debt expanded by about 11 percent, mainly against the background of an expansion in bank credit (18.3 percent) and an increase in tradable

Private debt increased in 2025 at a rate higher than GDP.

¹ Nonfinancial private sector debt includes the debt of households and the business sector, excluding banks, credit card companies, and institutional investors.

corporate bond issuance (8.6 percent). Credit originating abroad declined, largely due to the appreciation trend of the shekel over the course of the year.

Household debt increased by about 7 percent during the year, with similar rates of expansion in housing credit and nonhousing credit. The rapid growth in private sector debt led to an increase in the debt-to-GDP ratio overall, and in the business debt-to-GDP ratio in particular. This ratio rose from about 70 percent at the end of 2024 to about 73 percent at the end of 2025. Although these ratios remained low by international comparison, a long-term perspective points to a trend of Israel converging toward the OECD median, particularly in business credit, mainly due to a decline in these ratios worldwide that began at the end of 2021 (Figure 4.1).

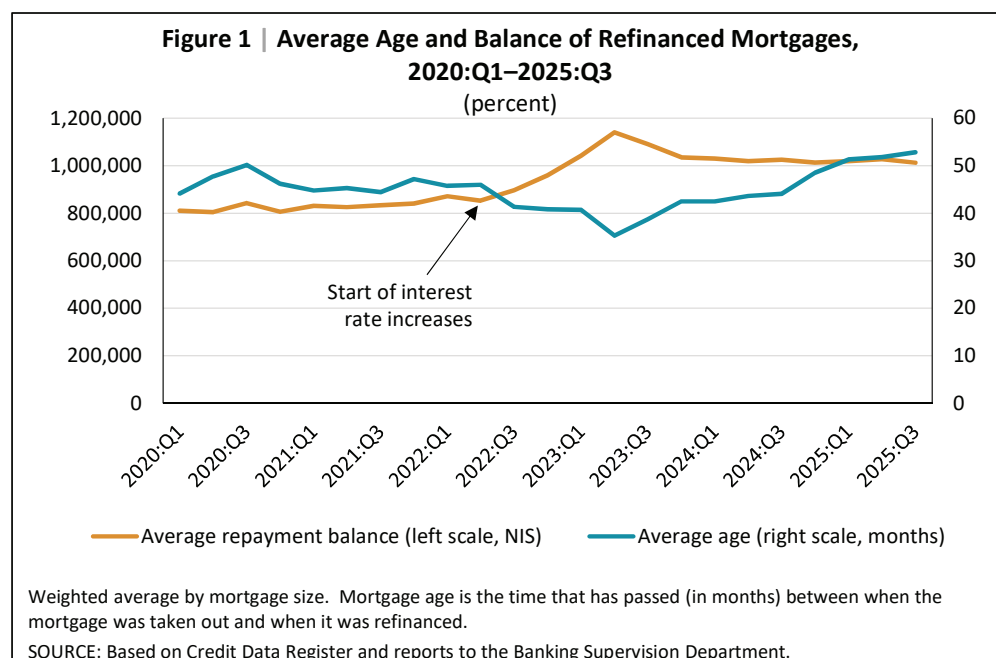


Table 4.1 | Distribution of nonfinancial private sector debt, 2020–2025

	2021	2022	2023	2024	2025	2016– 2020 average	2021	2022	2023	2024	2025
	End-of-period balance (NIS billion, current prices)					Rate of change during the period (percent)					
Nonfinancial private sector debt (1+2)	1,796	2,015	2,098	2,246	2,450	4.4	13.1	12.2	4.1	7.0	9.1
1. Business sector debt	1,104	1,240	1,305	1,400	1,548	3.9	13.0	12.3	5.3	7.3	10.5
Credit from banks	573	658	720	779	921	4.6	17.5	14.8	9.4	8.1	18.3
Domestic nonbank credit	348	383	401	430	448	5.8	7.3	9.9	4.8	7.2	4.2
<i>of which</i> : Tradable bonds in Israel	235	263	278	305	331	6.8	10.8	11.9	5.8	9.6	8.6
Credit from abroad	183	199	184	192	178	-0.5	10.9	8.7	-7.4	4.1	-7.0
2. Household debt	692	775	793	846	903	5.2	13.3	12.0	2.3	6.7	6.7
Housing credit	477	543	568	610	653	0.6	14.5	13.7	4.6	7.5	7.0
<i>of which</i> : Housing credit from the banks	459	521	546	587	628	6.9	15.5	13.5	4.8	7.5	7.1
Nonhousing credit	215	233	225	236	250	2.2	10.8	8.3	-3.3	4.7	6.1
<i>of which</i> : Nonhousing credit from the banks	153	161	161	169	178	-0.2	4.8	5.1	-0.2	5.0	5.6

SOURCE: Based on Tel Aviv Stock Exchange and reports to the Bank of Israel.

b. Business Credit from the Banking System

(1) Trends in Bank Credit to the Business Sector

The banking system led the increase in credit to businesses.

Credit to medium and small businesses recovered after a period of just moderate growth.

The increase in business credit in 2025 was led by credit extended by the banking system. Table 4.2 presents the breakdown of the increase in business debt to banks by firm size and by main industries of activity. In contrast to 2023 and 2024, when most of the increase in business debt was due to the expansion of credit to large firms, in 2025 there was also a marked increase among medium-sized firms, alongside the continued recovery in credit to small and micro businesses. In 2025, bank credit to large and medium-sized firms grew by about 18 percent, while credit to small and micro businesses grew by about 10 percent.

The expansion in bank credit to the business sector in 2025 was led by the construction and real estate industry and by financial services, with growth of about 14 percent and 45 percent, respectively. In the construction industry, the increase in demand for credit reflected the expansion in activity, alongside the need to finance the stock of unsold dwellings and the lengthening of construction periods due to the fighting. These financing needs were exacerbated by the slowdown in demand for housing (for further discussion, see Chapter 8) and by the increased use of sales campaigns initiated by contractors. The sharp increase in credit to the financial services industry was supported by an expansion of credit to nonbank credit providers, alongside growth in other financial activities, such as credit extended to secure activity in derivative instruments for other financial entities. In addition, following two years of only moderate growth, credit to the trade and manufacturing industries recovered.

Table 4.2 | Increase in bank-issued business-sector debt, 2022–2025

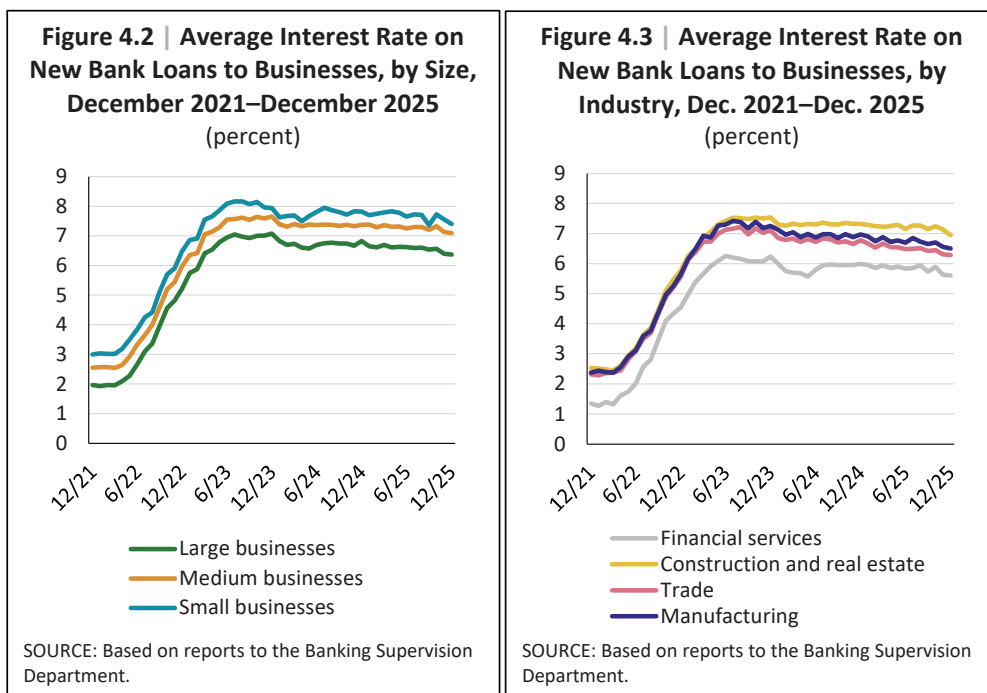
	Share of outstanding debt (end of 2025)	divided by business size and industry, percent					
		Rate of change (percent)					
		2022	2023	2024	2025: first half	2025: second half	2025
Divided by business size							
Large	57.6	30.0	14.5	14.4	7.2	10.2	18.1
Medium	15.4	11.2	4.7	2.9	8.8	8.1	17.6
Small and micro	27.0	7.5	-2.6	8.1	2.6	7.3	10.1
Divided by industry							
Construction and real estate	38.3	18.8	12.4	8.8	7.6	6.2	14.2
Financial services	22.2	28.7	12.5	23.1	20.1	20.8	45.0
Trade	12.4	15.0	5.5	4.7	3.6	2.7	6.4
Manufacturing	11.7	12.9	3.0	3.7	7.9	6.2	14.7
Other Business	15.4	7.7	-0.3	2.6	4.1	4.2	8.5

The manufacturing industry includes: mining and quarrying, and water, electricity, and gas supply. Other business includes: agriculture, transport and storage, hotels, accommodation and food services, information and communications, and other business services.

SOURCE: Based on Tel Aviv Stock Exchange and reports to the Bank of Israel.

An examination of the average interest rate on new bank loans to the business sector indicates that throughout 2025 there was stability, and even a moderate decline in some industries. This decline was particularly pronounced among small and micro businesses, for which the average interest rate in the third quarter of 2025 was 0.27 percentage points lower than in the corresponding period of 2024 (Figure 4.2). By industry, the largest declines were recorded in trade and manufacturing, where the average interest rates in the third quarter of 2025 were lower by 0.31 and 0.19 percentage points, respectively, than in 2024 (Figure 4.3). The decline in interest rates continued in the fourth quarter of 2025 across all sectors and industries, in view of the reduction in the Bank of Israel interest rate.

During 2025, the interest rates on loans to small and micro businesses declined.



The trend toward easier terms in bank business credit in 2025 is also reflected in the Credit Officers Survey.² According to survey respondents, in 2024 the main factors behind the tightening of credit conditions were the macroeconomic situation and difficulties in activity in certain industries, with a particularly high share of respondents reporting tightening for small and medium-sized businesses. In contrast, there was an easing in credit conditions in 2025, mainly due to increased competition in the credit market—from the capital market in the case of large firms, and from nonbank

The Credit Officers Survey indicates greater flexibility in the terms of business credit.

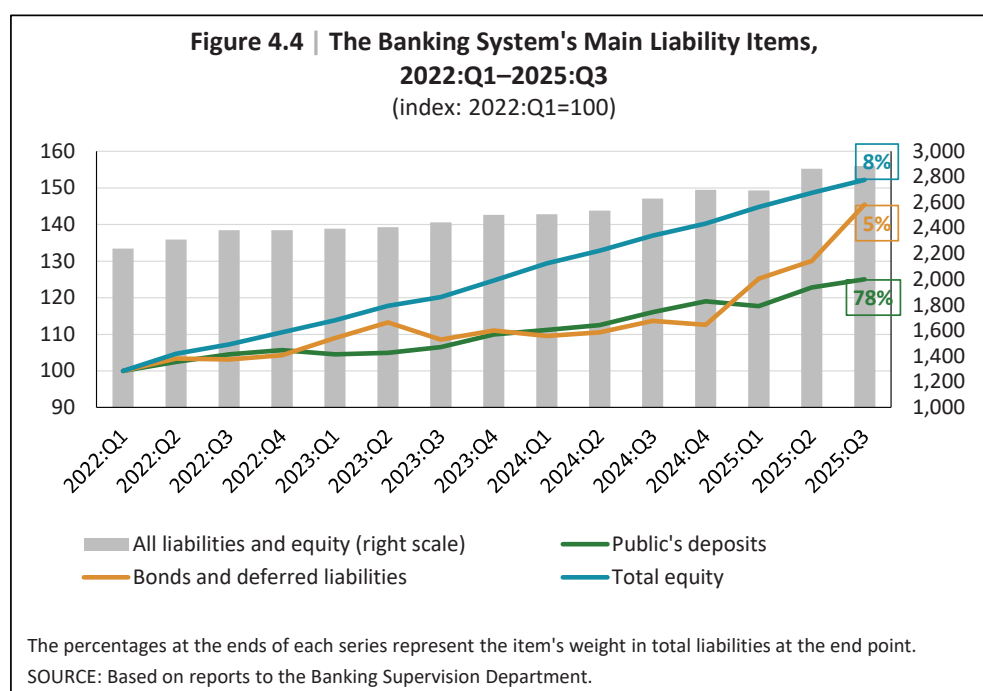
² The Bank of Israel began conducting a Credit Officers Survey in order to obtain additional timely and qualitative information from banking corporations in Israel regarding the bank credit market in Israel. The survey has been conducted quarterly since the third quarter of 2024. For further discussion of the full survey findings, see: [Main Findings from the Bank of Israel Credit Officers Survey for the Last Quarter of 2025](#).

credit providers in the case of small and medium-sized businesses. In addition, the Central Bureau of Statistics' Business Tendency Survey indicated that during 2025 the share of businesses reporting severe constraints in bank credit remained stable at a low level.

(2) Funding Sources of the Banking System

The expansion of bank credit to the business sector in 2025, together with the moderate decline in interest rates and the findings of the Credit Officers Survey, indicate an easing in credit conditions and an expansion in supply. This trend was made possible by growth of about 9.6 percent in the banking system's funding sources. Public deposits, which account for about 78 percent of the banking system's total liabilities, increased by 7.6 percent, compared with growth of about 9 percent in the corresponding period a year earlier. Equity, which accounts for about 8 percent of funding sources, increased by about 11 percent in view of the banks' high profitability, although the pace of growth moderated relative to 2024, partly due to an increase in profit distributions during the year.

The funding source that was particularly notable in 2025 was bonds and notes, which increased sharply by about 28 percent between the third quarter of 2024 and the third quarter of 2025, compared with only 4.6 percent in the corresponding period a year earlier (Figure 4.4). The factors underlying this increase are examined in greater detail later in this chapter.



(3) Uses of Bank Business Credit

An examination of the correlation between the change in the revenue index and the rate of growth in industry-level credit indicates that credit was taken mainly to expand business activity, rather than as a result of cash flow impairment. Theoretically, the increase in credit may reflect firms' efforts to bridge cash flow difficulties that arose during the economic slowdown due to the war—for example, for debt refinancing, customer credit, inventory accumulation, and increased working capital needs. Conversely, part of the increase in credit may have been due to an expansion in business activity in view of the recovery in demand in the economy in 2025, which increased firms' financing needs—for example, for the purchase of equipment, renovation of facilities, expansion of production capacity, and intensified marketing activity. To examine the sources of demand for business credit, we analyzed the relationship between the change in the revenue index and the rate of growth in credit in each industry. A negative correlation between the revenue index and credit growth may indicate the use of credit to bridge a decline in activity and meet cash flow needs, whereas a positive correlation indicates the use of credit to expand activity.

The correlation between the change in the revenue index and the rate of growth in business credit indicates financing of activities and not cash flow distress.

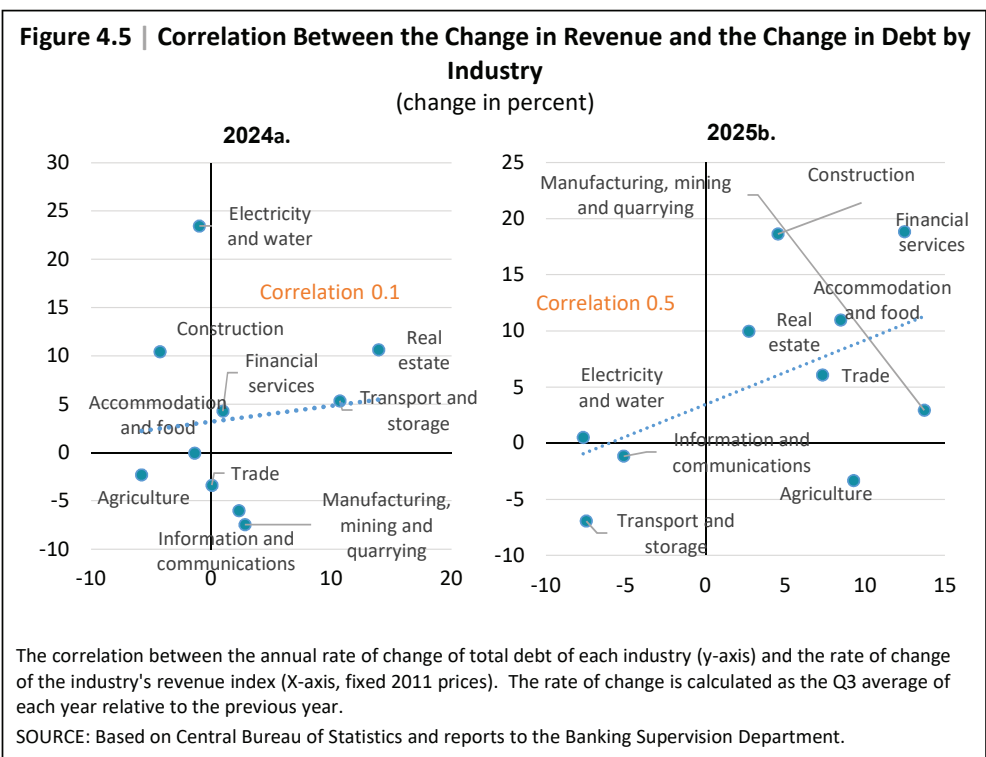
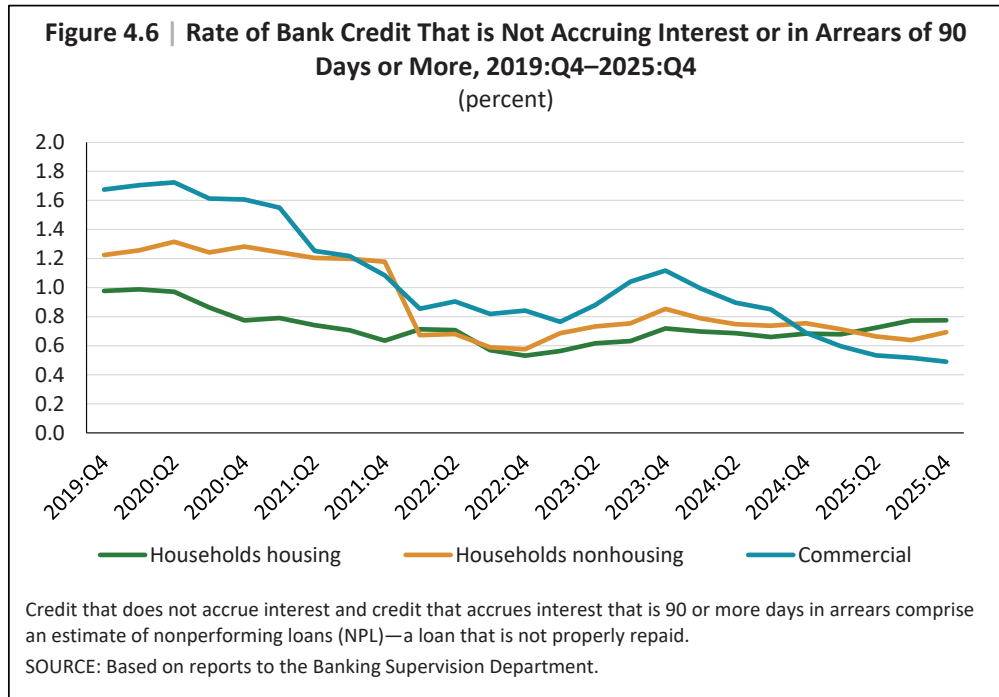


Figure 4.5 shows that in 2025 there was a strong positive correlation between the change in revenue and credit growth—much higher than that recorded in 2024. This result reflects a simultaneous increase in both revenue and credit in most industries, and suggests that the increase in credit was closely linked to the recovery in business activity during the year. This finding is also consistent with the increase in investment recorded in 2025. (For further discussion, see Chapter 2.) It should be noted that between 2017 and 2025, the average correlation between the change in the revenue index and growth in industry-level credit stood at 0.17, making the correlation recorded in 2025 the highest in this period.

An examination of the share of bank credit that is either nonaccrual or more than 90 days in arrears, which constitutes a key estimate of nonperforming credit, indicates stability at a low level throughout 2025 (Figure 4.6). This share remained similar in both the household sector and the business sector, and does not indicate an increase in credit risk at the aggregate level. That is, during the reviewed period there was no deterioration in borrowers’ repayment capacity—providing a further indication that the increase in total credit during the year was not due to cash flow distress.



c. Nonbank Business Credit—Corporate Bonds

Alongside the expansion of bank credit, 2025 was also characterized by heightened activity in corporate bond issuance.³ The outstanding stock of tradable corporate bonds issued by the business sector increased by about 9 percent during 2025, reaching NIS 331 billion. Figure 4.7 presents the volume of corporate bond issuance by industry, alongside the average spread relative to government bonds. In terms of issuance volume, 2025 was a record year. In total, firms (excluding banks and insurance companies) issued debt totaling about NIS 91 billion—around 40 percent higher than total issuance in 2024. The construction and real estate industry led, with issuance totaling about NIS 45 billion, compared with about NIS 35 billion in 2024.

In 2025, corporate bond spreads continued the downward trend that began after their temporary increase following the outbreak of the war. This trend is not unique to Israel, and is consistent with the decline in spreads to historically low levels in global markets as well. The combination of increased issuance volumes and declining spreads points to an expansion in the supply of credit in the bond market.⁴ The factors underlying this expansion are examined later in this chapter.

d. Housing Credit

In 2025, the volume of new mortgage borrowing remained stable, with a monthly average of about NIS 8.8 billion, and increased moderately toward the end of the year (Figure 4.8). This stability persisted despite the decline in the number of transactions in the housing market. The main explanation lies in the continued substantial contribution of new borrowing associated with purchase transactions signed in previous years. About 23 percent of monthly new borrowing in 2025 was due to earlier transactions. This figure is not in itself historically unusual. However, in previous instances, an increase in the share of new borrowing associated with earlier transactions generally occurred during periods of decline in total new borrowing. By contrast, in 2025 the share of new borrowing associated with earlier transactions was high and rising, even though the overall level of new borrowing remained relatively high (marked by arrows in Figure 4.8). This pattern is consistent with the increase in 2025 in the share of “nonlinear” payments in earlier transactions⁵, which reached

The expansion of credit was supported by an increase in nonbank financing through strong activity in the bond market.

In 2025, new mortgage borrowing remained relatively high, despite a decline in the volume of housing transactions.

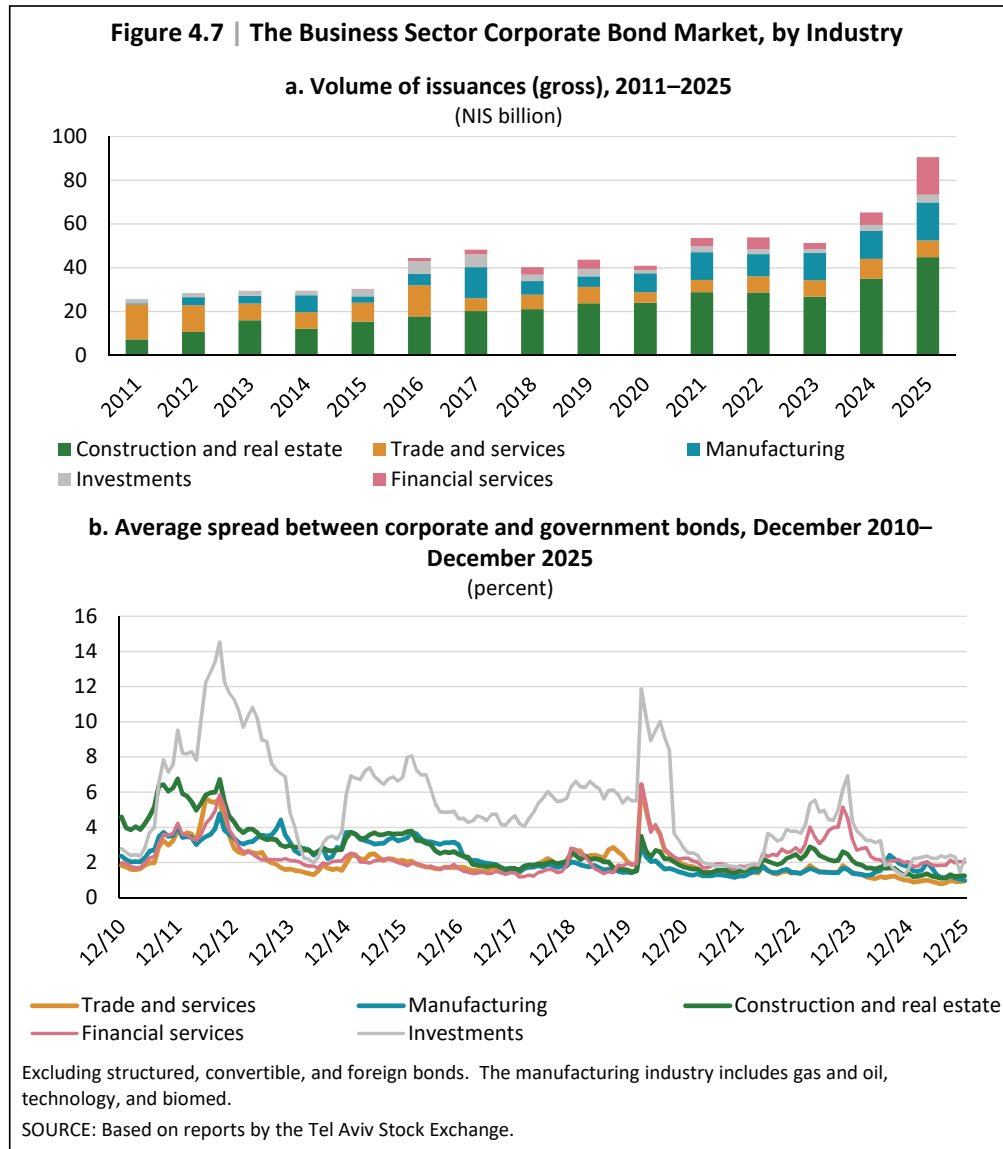
A large part of new mortgage borrowing in 2025 was due to purchase transactions executed in previous years.

³ The corporate bond market includes a variety of securities, including standard corporate bonds, convertible bonds, structured bonds, and commercial paper. Throughout this chapter, we refer to the corporate bond market as the aggregate of all types of debt securities traded in Israel, while distinguishing among the various types where separate analysis is required.

⁴ In addition to the expansion of issuance by firms already active in the market, 32 new firms accounted for about 10 percent of total issuance in 2025—the highest number in the past decade. This figure points to improved market access for firms. For further discussion, see Box 4 in the Financial Stability Report for 2025.

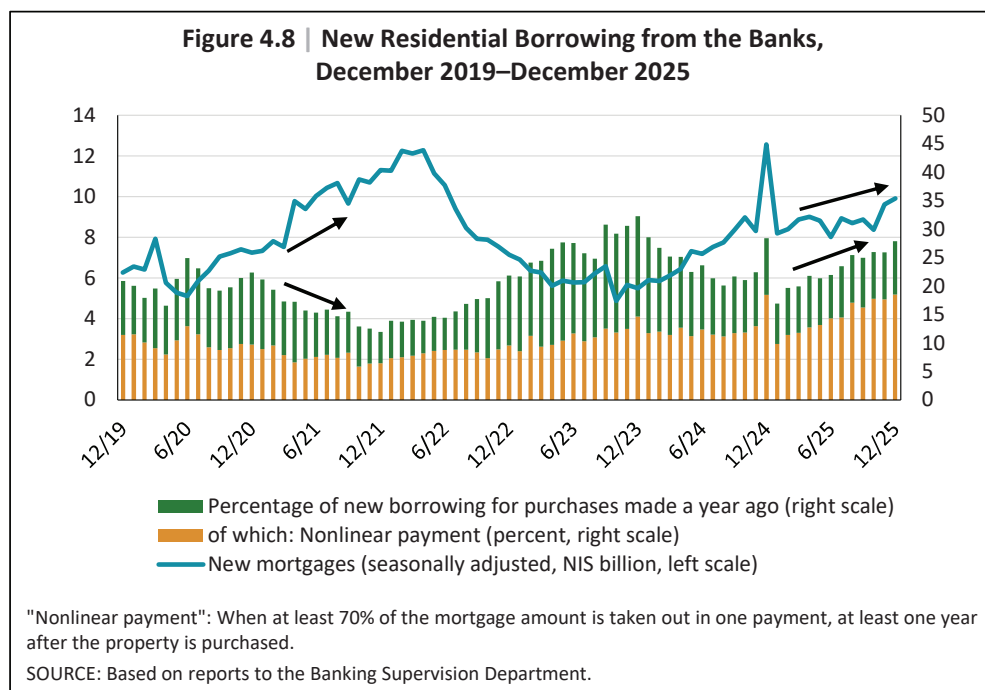
⁵ When purchasing a home “on paper” from a contractor, a payment schedule is set under which the buyer makes payments over the construction period. Under a linear payment schedule, payments are spread continuously over the duration of the project. Under a nonlinear payment schedule, by contrast, the buyer pays the bulk of the price in a single installment. This may result from the buyer’s initiative—for example, to avoid an increase in the apartment price due to indexation to the Construction Input Index or to a VAT increase—or, alternatively, the contractor may offer buyers the option of deferring a substantial portion of the payment until delivery of the apartment, as part of sales promotion campaigns.

about 18.5 percent of total new borrowing toward the end of the year. This trend may reflect the increase in new mortgages for purchases made as part of contractor sales promotion campaigns in 2023–24, which allowed buyers to defer a substantial portion of the home price until the delivery date.⁶



⁶ In 2024 and in the first half of 2025, there was a marked increase in sales campaigns that included the deferral of payments until the delivery date. In view of this trend, the Supervisor of Banks issued a temporary directive in April 2025 that effectively limited the share of transactions involving deferred payments in projects financed by the banks. For further discussion, see [Box 5.2 in the Banking Supervision Department’s Annual Survey of Israel’s Banking System for 2024](#).

Alongside the increase in new borrowing, there was also a slight increase in the average mortgage size, which reached about NIS 1.03 million in 2025, compared with about NIS 993,000 in 2024. The increase in the average mortgage size was despite stability, and even declines, in housing prices during much of the year, and is partly explained by the continued increase in the share of mortgages taken at high loan-to-value ratios of more than 60 percent.



In 2025, mortgage interest rates declined moderately across all track types, mainly in the second half of the year (Figure 4.9). At the same time, the share of the unindexed variable-rate track—where the interest rate is reset every one to two years—continued to increase, at the expense of the prime-rate track and the indexed variable-rate track. This trend reflects households’ preference for tracks offering greater stability than the prime-rate track, while preserving the possibility of benefiting from interest rate declines in the short term. In the second half of 2025, about 65 percent of new mortgages were concentrated in the unindexed variable-rate track and the unindexed fixed-rate track (Figure 4.10). The change in the composition of loan tracks may have implications for the effectiveness of monetary policy, since a shift toward mortgages with more stable interest rates reduces the immediate pass-through of interest rate changes to monthly repayments relative to the situation that prevailed on the eve of the monetary tightening that began in 2022.⁷

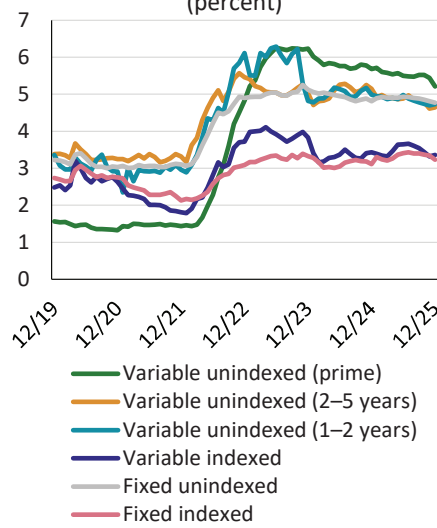
Households preferred unindexed variable rate mortgages over the prime rate track.

⁷ For further discussion of the effect of changes in the Bank of Israel interest rate on consumption by mortgage holders during the monetary tightening in 2022 and 2023, see: Itamar Caspi, Nadav Eshel, and Nimrod Segev (2024), “[The Mortgage Cash-Flow Channel: How Rising Interest Rates Impact Household Consumption](#),” Discussion Paper Series 2024.13, Bank of Israel Research Department.

The high level of mortgage refinancing was mainly due to considerations of optimization of loan terms.

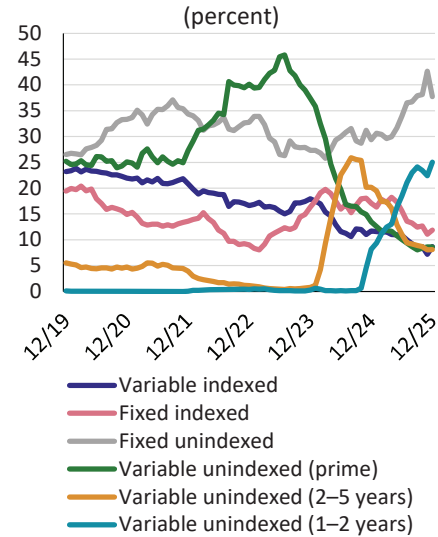
Alongside the stability in the volume of mortgage borrowing, 2025 was also characterized by a relatively high level of mortgage refinancing, both in the number of transactions and in their monetary volume. These averaged about NIS 3.6 billion per month (Figure 4.11). Box 4.1 provides an in-depth examination of the factors underlying the increase in refinancing volumes. The analysis indicates that most refinancing was undertaken for economic reasons related to optimizing loan terms, rather than as a result of borrowers' liquidity distress.

Figure 4.9 | Average Interest Rate on New Mortgages, by Interest and Indexation Type, December 2019–December 2025
(percent)



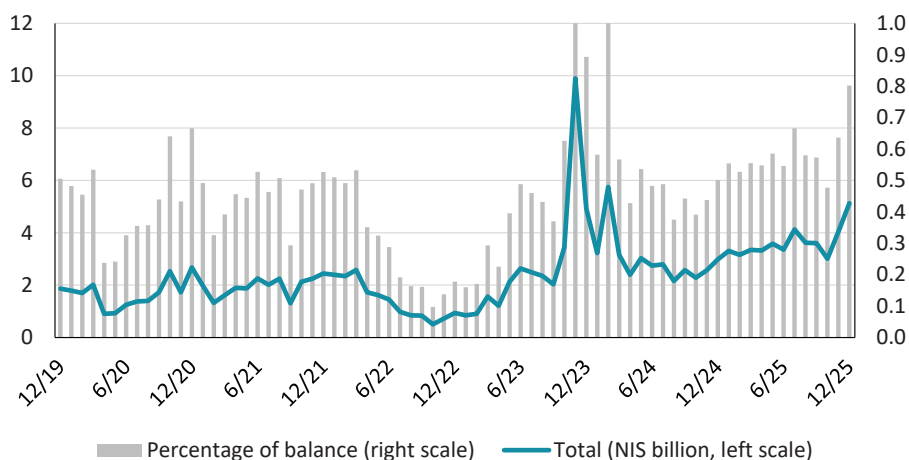
SOURCE: Based on reports to the Banking Supervision Department.

Figure 4.10 | Distribution of New Mortgages Borrowing, by Interest and Indexation Type, December 2019–December 2025
(percent)



SOURCE: Based on Banking Supervision Department data.

Figure 4.11 | Refinancing of Residential Credit, Total Banking System, December 2019–December 2025



During the war, deferrals of more than 3 months are included in "refinanced credit". During the COVID-19 period the guidance to the banks was changed such that deferrals were not included in refinanced credit.

SOURCE: Based on reports to the Banking Supervision Department.

BOX 4.1: MORTGAGE REFINANCING IN HOUSING CREDIT — REASONS, TRENDS, AND BORROWER CHARACTERISTICS

- This box examines recent trends in mortgage refinancing in Israel, distinguishing between refinancing driven by considerations of optimizing the loan mix in order to reduce costs and refinancing intended to ease cash flow pressures.
- The increase in refinancing during 2024–2025 was driven mainly by efforts to optimize mortgage terms (changes in loan composition and pricing).
- About 15 percent of refinancing transactions involved an extension of the mortgage term together with an increase in the projected total interest cost. This pattern points to a cash flow consideration aimed at reducing the monthly repayment burden, even at the cost of a higher overall loan cost.

a. Background

In recent years, the volume of housing credit refinancing has increased (Figure 4.11 in the chapter). In total, about 69,000 mortgages were refinanced in 2025, amounting to approximately NIS 43.6 billion—equivalent to about 7 percent of the banking system's total outstanding mortgage portfolio, compared with an average of about 4.5 percent of the outstanding balance during 2019–2024. For the purposes of this analysis, mortgage refinancing is defined as an action in which the borrower replaces an existing mortgage, or part of it, with a new loan under different terms, including changes in loan tracks and repayment period, whether at the original bank or at another bank.

There may be various reasons for refinancing a mortgage. First, refinancing may be undertaken in order to improve the terms of the existing loan—for example, when the average market interest rate is lower than the rate paid on the current mortgage. In particular, refinancing variable-rate tracks close to the date of the benchmark-rate reset makes it possible to adjust the interest rate to current market conditions without incurring early payment fees. Second, refinancing may be undertaken in order to adjust the mortgage mix to changes in macroeconomic conditions—for example, reducing the weight of CPI-indexed tracks during a period of rising inflation. Alternatively, refinancing may reflect adjustments to changes in the borrower’s financial situation—for example, when a lump sum becomes available that allows for partial repayment and a shortening of the repayment period, or when monthly income rises, enabling a higher monthly repayment and a shorter term. In addition, a customer seeking to take out an all-purpose loan secured by a residential property, or an additional mortgage loan—for example, for renovations—may use the opportunity to refinance and adjust the existing mortgage as well. Finally, in cases where there is difficulty in meeting the monthly repayment, refinancing that includes rescheduling payments and extending the repayment period may make it possible to reduce the monthly payment.

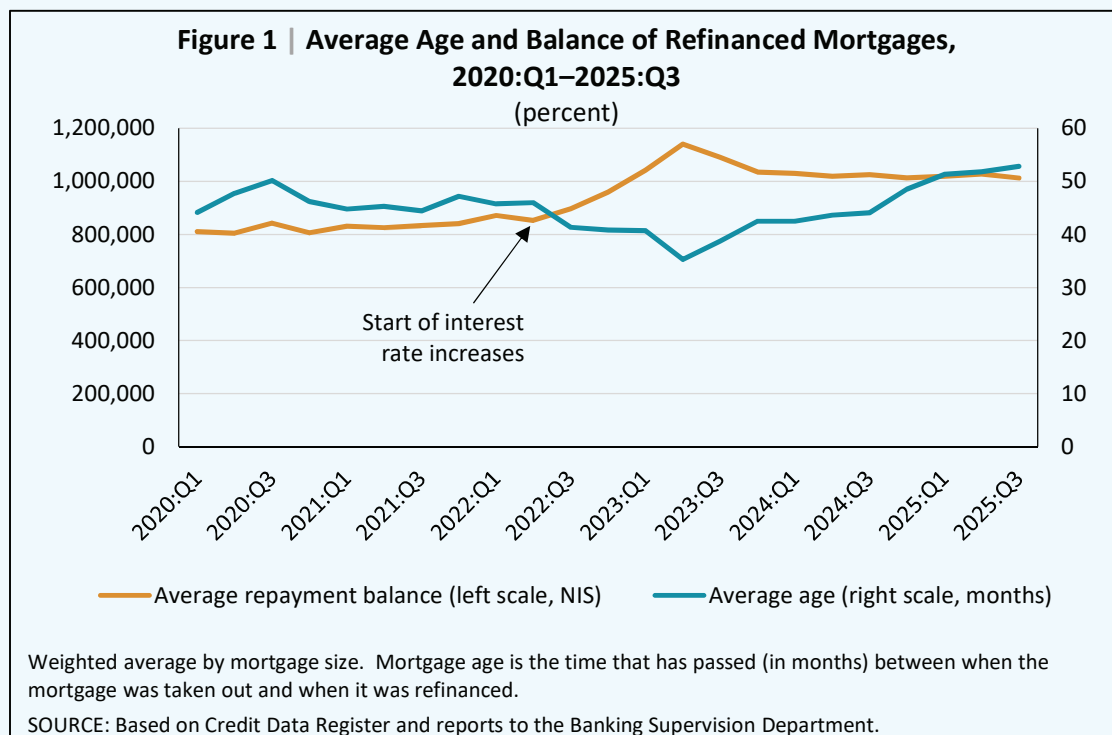
Thus, the increase in refinancing activity may reflect economic considerations aimed at improving loan terms and adjusting the mortgage mix to changes in market conditions and interest-rate expectations, while some refinancing may reflect an attempt to reduce the monthly repayment by extending the loan term, even at the cost of increasing the total cost of the loan.

b. Identifying the Reasons for Refinancing and the Characteristics of Refinancing Transactions

To identify the reasons for mortgage refinancing, we used data from the Credit Data Register, which enables monthly tracking of mortgage tracks, including the opening and closing of tracks and changes in loan terms. Figure 1 presents the average age of the mortgage and the outstanding balance at the time of refinancing. It shows that mortgage refinancing takes place, on average, 40 to 50 months after the mortgage is taken out—consistent with refinancing close to the benchmark-rate reset date for variable-rate tracks updated every two to five years. In this context, it should be noted that in the second half of 2020 and in 2021—a peak period for new mortgage borrowing—about 20 percent of new mortgages were in variable-rate CPI-indexed tracks, mostly with benchmark-rate resets every five years. That is, some of these tracks were expected to reach their reset date during 2025 and toward 2026, a factor that may help explain the increase in the number of refinancing transactions during the year.

Figure 2 presents the change in the balances of refinanced mortgages in each quarter, broken down by track type. For this purpose, the total amount of loans repaid in each track was compared in each quarter with new loans extended as part of mortgage refinancing, and the net change in the balance of each track type was examined. The figure indicates that most of the increase in refinancing over the past two years was due to shifts out of the prime track and CPI-indexed tracks into variable-rate unindexed tracks. This trend is consistent with the changes also recorded in the composition of new mortgage loans, with a sharp decline in the share of the prime track and the variable-rate CPI-indexed track, alongside a sharp increase in the variable-rate unindexed track with benchmark-rate resets every one to two years (Figure 4.10 in the chapter). In addition, the increase in refinancing of variable-rate CPI-

indexed tracks during 2025 is consistent with the benchmark-rate reset dates of such tracks that were taken out during 2021.



As noted, mortgage refinancing may be undertaken either for reasons of economic benefit, in order to adjust loan terms to changes in market conditions, or for cash flow reasons, with the aim of reducing the monthly repayment burden due to financial constraints. When the main reason for refinancing is a desire to reduce the monthly payment, the customer will generally seek to do so by spreading the loan over a longer period, even if this entails an increase in the cost of the mortgage. To identify such cases, we examined the share of refinanced mortgages that involved both an extension of the repayment period and an increase in the projected total interest rate on the loan¹—that is, cases in which the cost of the mortgage rose following refinancing.

¹ Calculation of the mortgage’s internal rate of return (IRR), based on all expected mortgage payments. For details of the calculation method, see: “Appendix 4 – Calculation of the Projected Total Interest Rate (the Effective Cost of Credit),” [Proper Conduct of Banking Business Directive 451](#), Housing Loans, Banking Supervision Department.

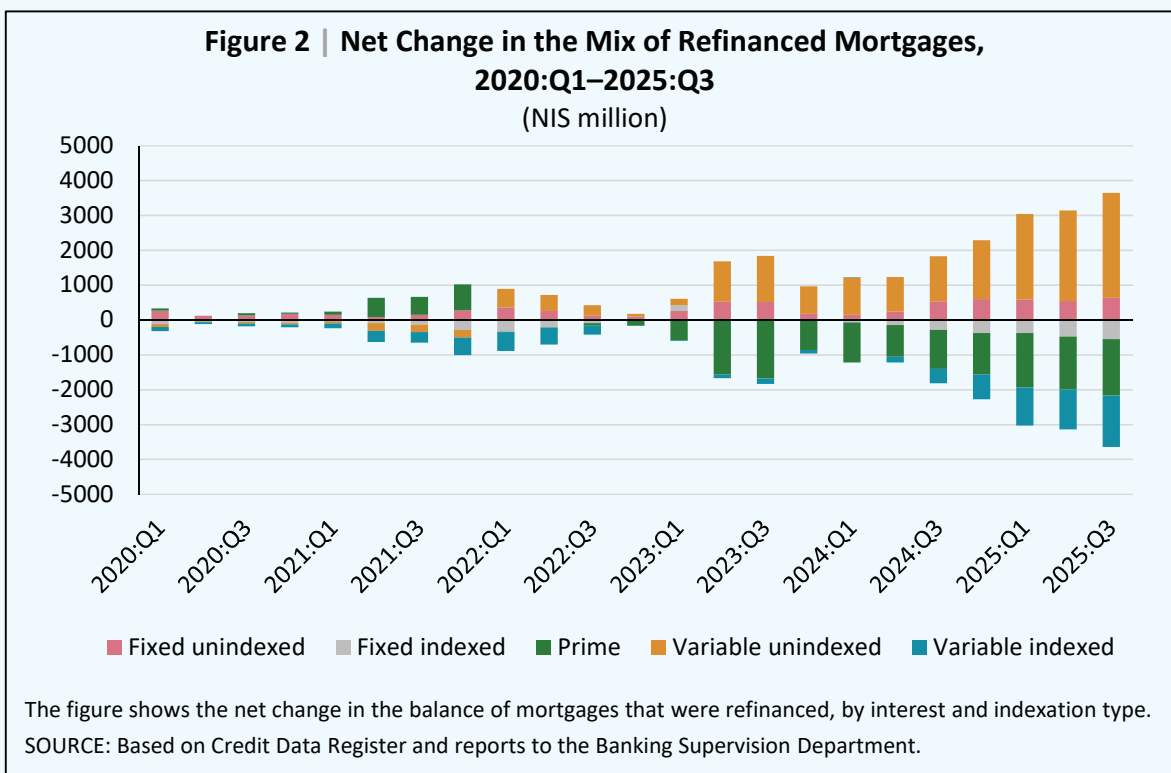


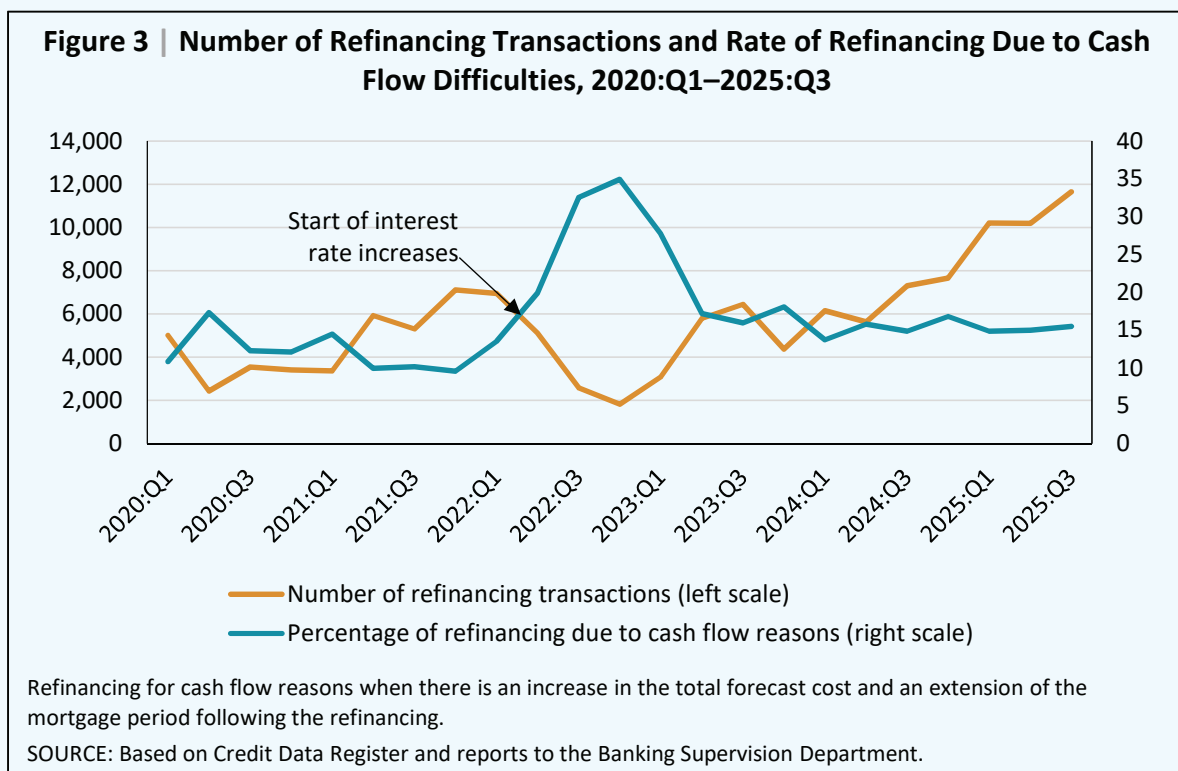
Figure 3 presents the number of mortgage refinancing transactions identified each month in the Credit Data Register, alongside the share of refinancing transactions in which the mortgage term was extended and the projected total mortgage cost increased as a result of the refinancing. The figure shows that, apart from periods of rising interest rates, during which there was a general decline in the number of refinancing transactions, the share of refinancing transactions involving both a term extension and an increase in the projected total interest cost remained relatively stable over most of the period, at about 15 percent.

c. Differences in Customer Characteristics

Thus far, the analysis indicates that mortgage refinancing is undertaken in most cases for reasons of economic benefit rather than because of difficulty in meeting repayments. This section also examines the characteristics of customers who refinanced, relative to two comparison groups: mortgage holders who neither refinanced nor deferred payments, and customers who deferred mortgage payments for at least three months.² Figure 4 examines differences over time in the credit characteristics of the three groups. The figure clearly shows that mortgage holders who deferred payments tend to have a higher-

² Mortgage payment deferrals may at times be granted without bank discretion, as part of customer assistance frameworks during crisis periods, such as the COVID-19 period and the war period. However, payment deferrals may also be granted on an ongoing basis upon application to the bank, usually for personal reasons such as termination of employment, maternity leave, illness, or financial difficulty.

risk profile than the other two groups. This is reflected in higher rates of arrears³, a higher incidence of overdrafts in current accounts, a larger volume of additional consumer credit beyond the mortgage, and greater use of loans drawn against credit card limits.⁴

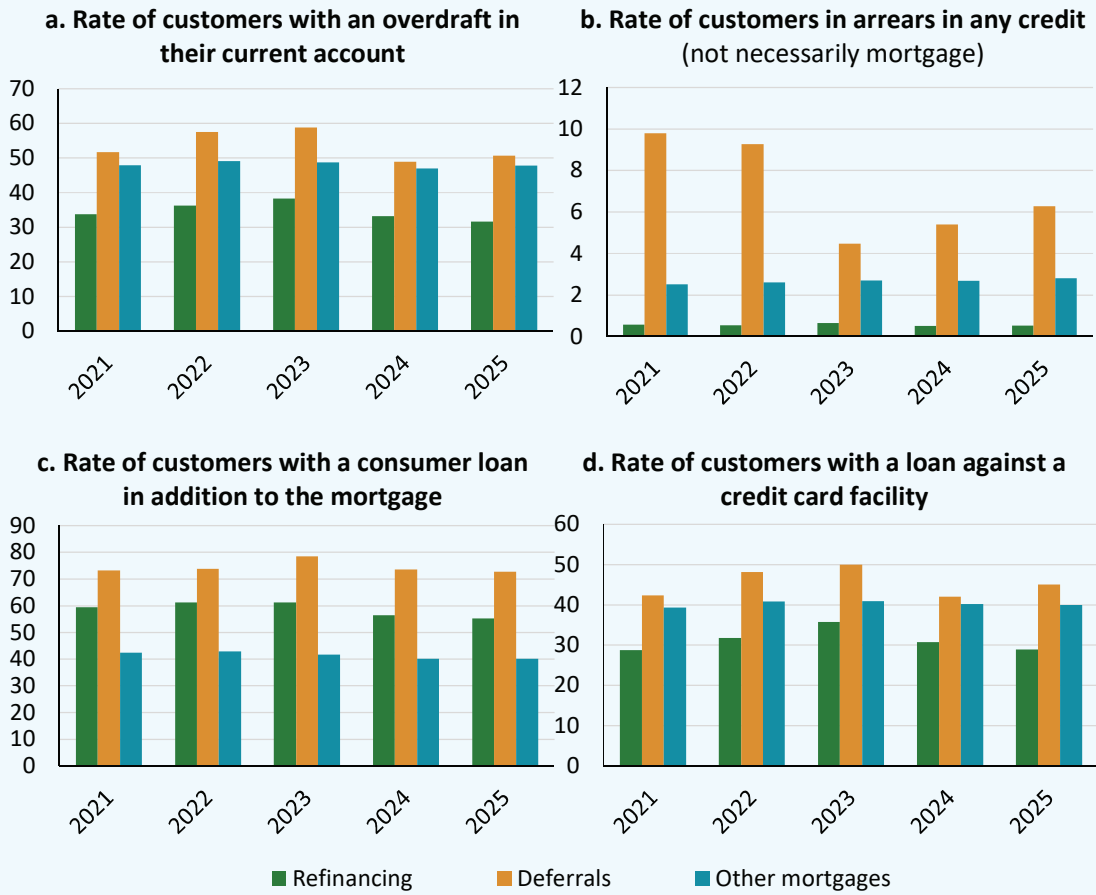


In summary, the increase in mortgage refinancing in recent years appears to have been driven mainly by considerations of economic benefit, related to the realization of options embedded in the original loan agreement, and in particular the updating of mortgage terms for variable-rate tracks in line with market conditions. Nevertheless, about 15 percent of refinancing transactions were motivated by a desire for cash flow relief. Taken together, the findings indicate that the increase in mortgage refinancing volumes does not point to a broad-based rise in financial distress requiring refinancing in order to meet repayment obligations.

³ “Share of customers in arrears” is defined as a situation in which one or more of the customers liable on the mortgage has at least one credit transaction in the Credit Data Register (not necessarily the mortgage itself) that is more than 30 days past due.

⁴ Loans against credit card limits include credit card installment loans bearing interest (“credit” loans) and revolving credit cards.

Figure 4 | Characteristics of Customers Who Refinanced and Other Mortgage Borrowers, 2021–2025
(percent)



SOURCE: Based on Credit Data Register and reports to the Banking Supervision Department.

e. Nonhousing Consumer Credit

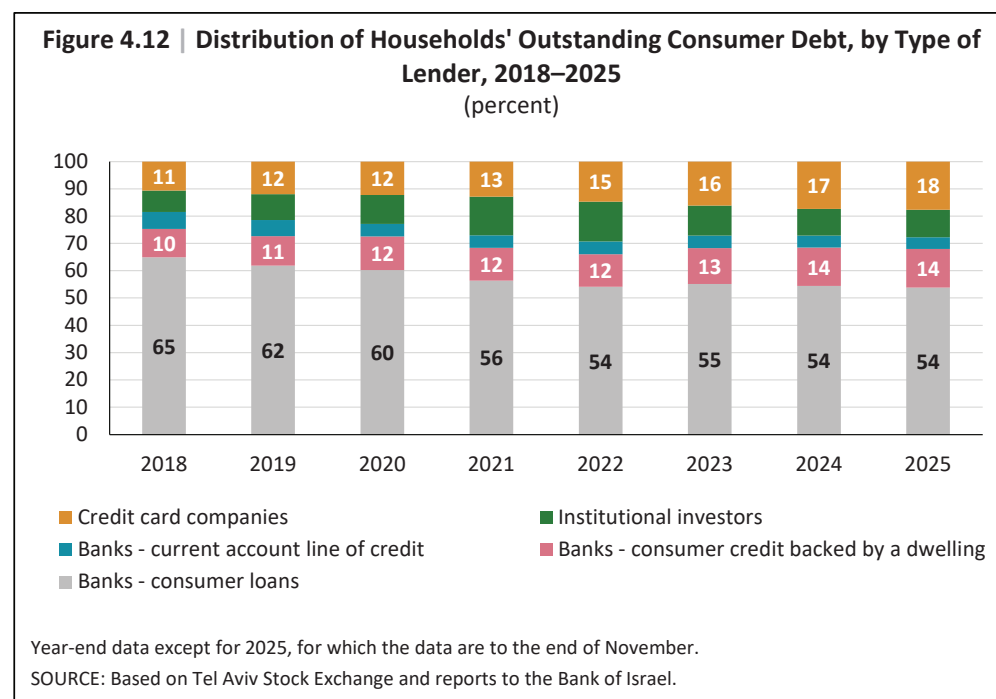
The year 2025 marked a continued recovery in nonhousing consumer credit, following the sharp slowdown recorded in 2023 in view of the outbreak of the war. As of December 2025, nonhousing consumer credit from all sources totaled about NIS 250 billion—an increase of about 6.1 percent since the beginning of the year, compared with growth of 4.7 percent in 2024, a contraction of 3.3 percent in the outstanding credit balance in 2023, and an average annual growth rate of 2.2 percent in the years 2016–20 (the pre-COVID period).

Unlike housing credit, which originates almost exclusively in the banking system, the consumer credit market is characterized by a broader range of funding sources. In addition to banks, households can obtain credit from credit card companies, from nonbank credit companies—mainly in the vehicle financing segment—and from institutional investors through loans to members. Within the banking system itself, there are also various channels of consumer credit, including overdraft facilities, fixed-term consumer loans, and general purpose loans secured by a lien on a residential dwelling.

In terms of growth rates in outstanding consumer credit, credit card companies led in 2025, with growth of about 8.1 percent, compared with growth of about 5.6 percent in consumer credit from banks. This trend supported the continued increase in credit card companies share of total consumer credit—from about 12 percent in 2019 to about 18 percent at the end of 2025 (Figure 4.12). Also notable was the

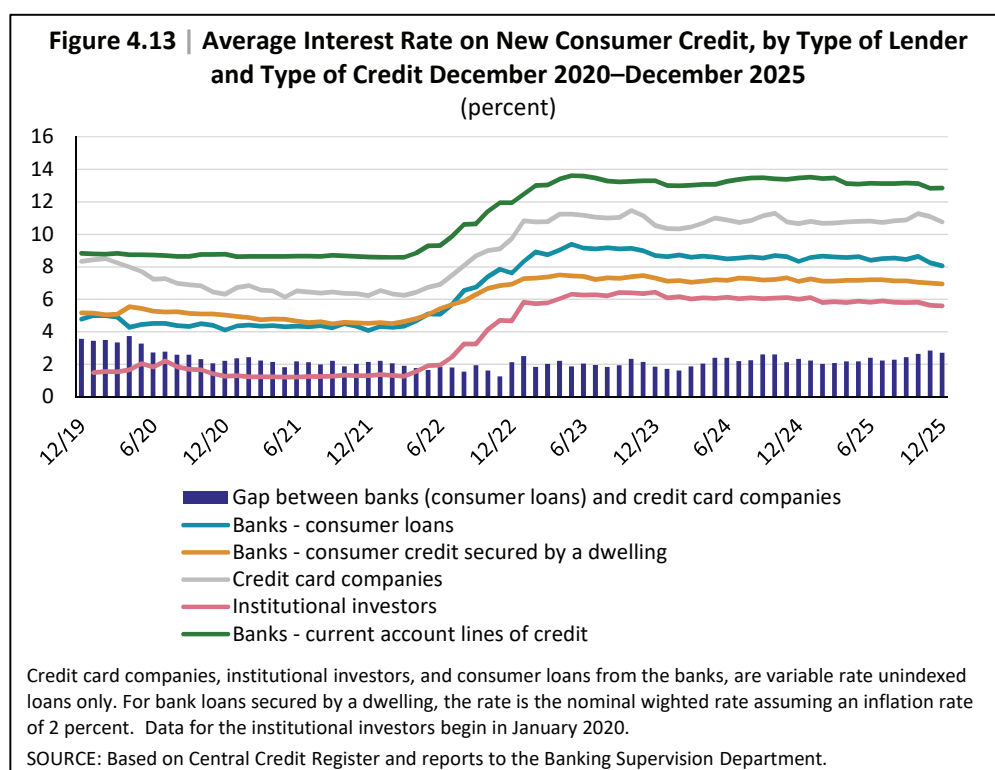
In 2025, nonhousing consumer credit continued to recover, following a slowdown during the war.

Credit card companies increased their share of the consumer credit market in recent years.



increase in the share of consumer credit from banks secured by a residential dwelling, partly in view of the easing of restrictions on the provision of such credit.⁸

Figure 4.13 presents the average interest rate on new consumer credit, broken down by source of credit. The figure indicates that in 2025 there was relative stability in consumer credit interest rates. A higher average interest rate on loans from credit card companies is evident throughout the period compared with loans from the banking system. This gap may reflect the higher funding costs of credit card companies, as well as differences in credit characteristics and in the risk profile of customers borrowing from credit card companies compared with banks.



However, the gap between interest rates narrowed gradually over time. At the beginning of 2020, the gap between credit card companies and banks was about 3.5 percentage points—a gap similar to that between bank loans and credit lines (overdraft). Since then, the two gaps have evolved differently. While the gap between overdraft interest rates and bank loan rates remained stable throughout the period (about 3.5 percentage points), the gap between credit card companies and banks

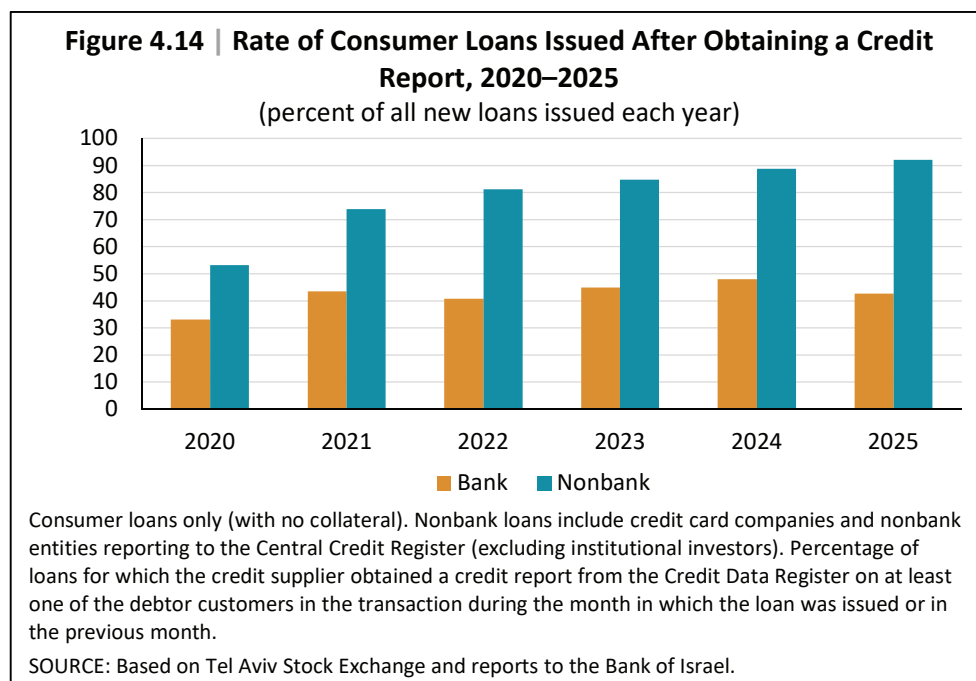
⁸ In December 2023, against the background of the continuation of the war, the Banking Supervision Department raised the maximum loan-to-value ratio on loans secured by a residential dwelling not intended for the purchase of real estate rights from 50 percent to 70 percent, provided that the portion of the loan above a 50 percent loan-to-value ratio did not exceed NIS 200,000. These leniencies were extended several times and became permanent in February 2026.

narrowed, to an average of about 2.3 percentage points in 2025. This is an indication of the increasing competitiveness of these entities vis-à-vis the banks.

In recent years, interest rate spreads have narrowed alongside an increase in the share of consumer credit provided by credit card companies. These developments reflect a strengthening of the competitive pressure exerted by these companies on banks in the retail credit market. This strengthening of competition was supported by reforms implemented in recent years, including the establishment of the Credit Data Register in 2019. The Register was intended to reduce information asymmetries and expand households' access to credit. Information sharing enables credit providers to perform more accurate underwriting. With the customer's consent, they can rely on a credit report and credit score reflecting the customer's financial history. This allows them to offer more tailored credit terms and to manage risk more efficiently.

Figure 4.14 presents the share of consumer loans granted using a credit report from the Credit Data Register, broken down between banks and nonbank entities.⁹ Among banks, use of the Register is relatively low and ranged between 30 and 40 percent throughout the period. This is not surprising in view of the extensive information already available to banks regarding their existing customers. By contrast, nonbank entities show high and sharply rising use—from 53 percent in 2020 to about 90 percent in 2025. This level of use indicates that the Register enabled nonbank

Nonbank lenders are using the Credit Data Registry at particularly high rates.

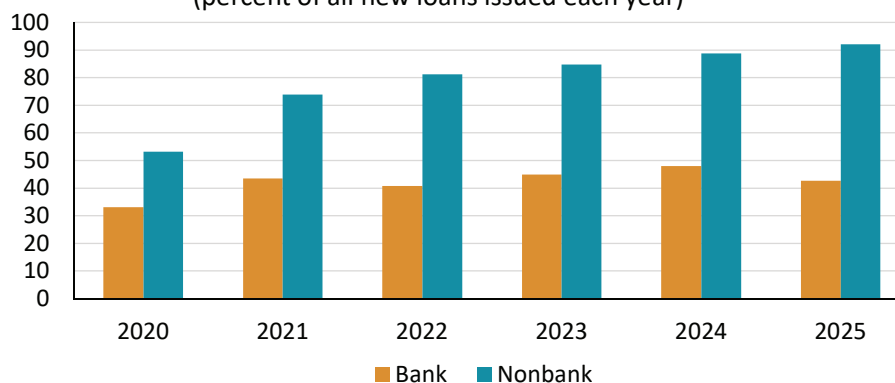


⁹ Credit card companies and regulated nonbank credit providers that report to the Register. Excludes institutional investors.

entities to expand the supply of credit and contributed to the increase in their share of the consumer credit market.

Figure 4.14 | Rate of Consumer Loans Issued After Obtaining a Credit Report, 2020–2025

(percent of all new loans issued each year)



Consumer loans only (with no collateral). Nonbank loans include credit card companies and nonbank entities reporting to the Central Credit Register (excluding institutional investors). Percentage of loans for which the credit supplier obtained a credit report from the Credit Data Register on at least one of the debtor customers in the transaction during the month in which the loan was issued or in the previous month.

SOURCE: Based on Tel Aviv Stock Exchange and reports to the Bank of Israel.

2. DEVELOPMENTS IN NONBANK CREDIT TO THE BUSINESS SECTOR

a. General

The transfer of the public's savings to mutual funds and money market funds increased the demand for corporate debt.

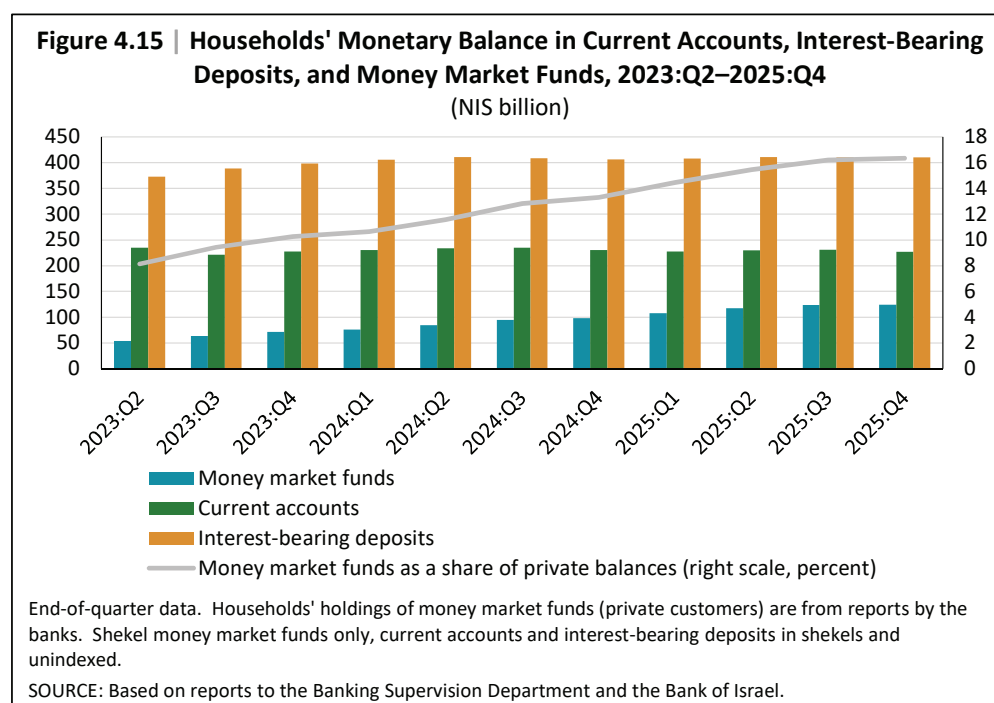
As noted, 2025 was a record year for issuance in the corporate bond market, with total issuance amounting to NIS 156.9 billion (financial and nonfinancial).¹⁰ This represents an increase of about 78 percent relative to total issuance in 2024 and about 100 percent relative to 2023. This expansion is particularly notable against the background of a fairly stable interest rate environment and continued security-related uncertainty throughout most of the year. One of the factors contributing to the heightened market activity in 2025 was the change in the composition of household savings, in particular the public's shift into money market funds and mutual funds. This shift generated demand in the corporate debt market and set in motion processes that improved nonfinancial firms' access to nonbank sources of financing.

¹⁰ Includes standard corporate bonds and commercial paper (CP), and excludes structured bonds, convertible bonds, and foreign bonds.

b. Accumulations in Mutual Funds (Money Market and Non-Money Market Funds)

The gap between the Bank of Israel interest rate and the return on liquid deposits, which has widened since 2022 in view of the increase in interest rates, encouraged households to seek alternative savings instruments combining high liquidity with a higher return than bank deposits. As a result, there was a sharp increase in assets under management in money market funds and non-money market mutual funds.¹¹ In particular, total assets under management in all mutual funds (money market and non-money market) increased from around NIS 330 billion at the beginning of 2022 to more than NIS 668 billion by the end of 2025. Money market funds recorded the highest growth rate, rising from about NIS 12 billion at the beginning of 2022 to about NIS 155 billion by the end of 2025. Figure 4.15 presents household balances in current accounts, interest-bearing deposits in the banking system, and money market funds.¹² It shows that alongside the increase in total balances in recent years, there was also an increase in the share of money market funds relative to households' balances in current accounts and deposits. That is, in recent years money market funds have become a more significant component of the public's liquid assets.

Since 2022, money market fund assets jumped from NIS 12 billion to NIS 155 billion.



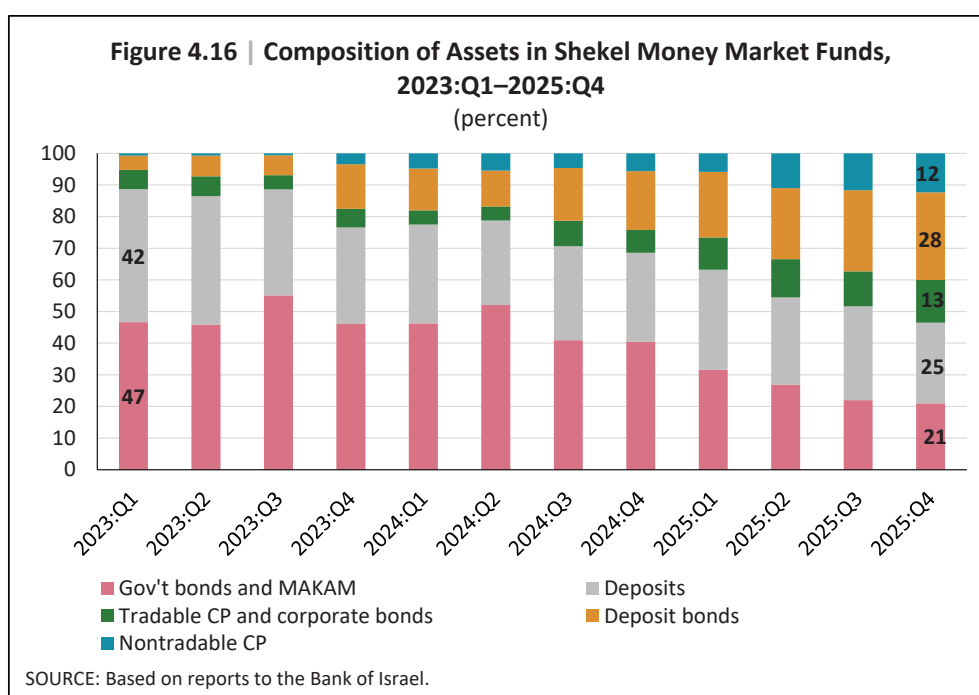
¹¹ Money market funds are mutual funds considered a low-risk investment instrument. Their main objective is to achieve an annual return close to the Bank of Israel interest rate while maintaining minimal risk and high liquidity. To this end, money market funds invest in a limited number of low-risk assets, including bank deposits (jumbo deposits on preferential terms), short-term Bank of Israel bills (MAKAM), short-term government and corporate bonds with high ratings, and highly rated commercial paper.

¹² Total funds managed in money market funds represent both households and business accounts. The estimate of household holdings in money market funds only (private customers) was derived from reports by the banking system.

c. Asset Composition of Money Market Funds

Money market funds' high demand for commercial paper led to the rapid expansion of issuances.

Alongside the increase in accumulations, the asset composition of money market funds also changed. Until 2023, holdings were based mainly on MAKAM and deposits, which accounted for about 90 percent of their assets. Beginning in mid-2023, the range of assets broadened, and in particular there was a persistent increase in the share of deposit bonds¹³ and commercial paper (CP), both tradable and nontradable, which reached about 53 percent of fund assets at the end of the period, compared with about 11 percent at the beginning (Figure 4.16).¹⁴ CP is a corporate short-term debt liability with a maturity of up to one year. Tradable CP is issued to the public and traded continuously until maturity, whereas nontradable CP is a private placement created as part of a contractual arrangement between the issuing corporation and investors, and is held until maturity or until a contractual exit event.¹⁵



¹³ A deposit bond is a structured bond issued against collateralization of a bank deposit. The issuer's profit derives from the spread between the interest the issuer receives on the bank deposit and the interest paid to bondholders.

¹⁴ The funds also hold a limited amount of standard corporate bonds, but in low amounts—less than NIS 1 billion as of December 2025. In Figure 4.16, standard corporate bonds are included under tradable CP.

¹⁵ Nontradable CP is generally issued for a period of one year (the CP term), usually with an option to extend for up to 5 years and with an option for early redemption upon notice of between 7 and 60 business days.

Banks account for a prominent share of tradable CP, constituting about 70 percent of the tradable CP held by the funds. In addition, the construction and real estate industry accounts for about 20 percent of the funds' holdings of tradable and nontradable CP. In the nontradable CP market, the financial services industry also has a notable weight, accounting for about 21 percent of holdings. This industry includes nonbank credit providers that extend business credit, partly to firms in the construction and real estate industry. As of the end of 2025, money market funds held about 73 percent of tradable commercial paper, and all mutual funds together—money market and non-money market—held more than 95 percent of these short-term debt instruments.¹⁶

d. Fund Activity in the Corporate Debt Market

The trends described above may have several implications for nonfinancial firms' access to nonbank credit and for their economic activity. First, the strong demand from money market funds for tradable investment instruments with short duration and high ratings, alongside corporations' demand to issue short-duration debt in a high interest rate environment¹⁷, led to a marked expansion in commercial paper issuance. In 2025, issuance volume grew to about NIS 22 billion, compared with about NIS 10 billion in 2024 and about NIS 7 billion in 2023, following negligible levels beforehand (Figure 4.17). Although most of the increase was led by banks and financial companies, nonfinancial firms—mainly in the construction and real estate industry—also increased issuance through this channel. In particular, in 2024 and 2025, CP issuance by firms in the construction and real estate industry reached about 8 percent of total fundraising by firms in the industry, compared with less than 1 percent in preceding years.

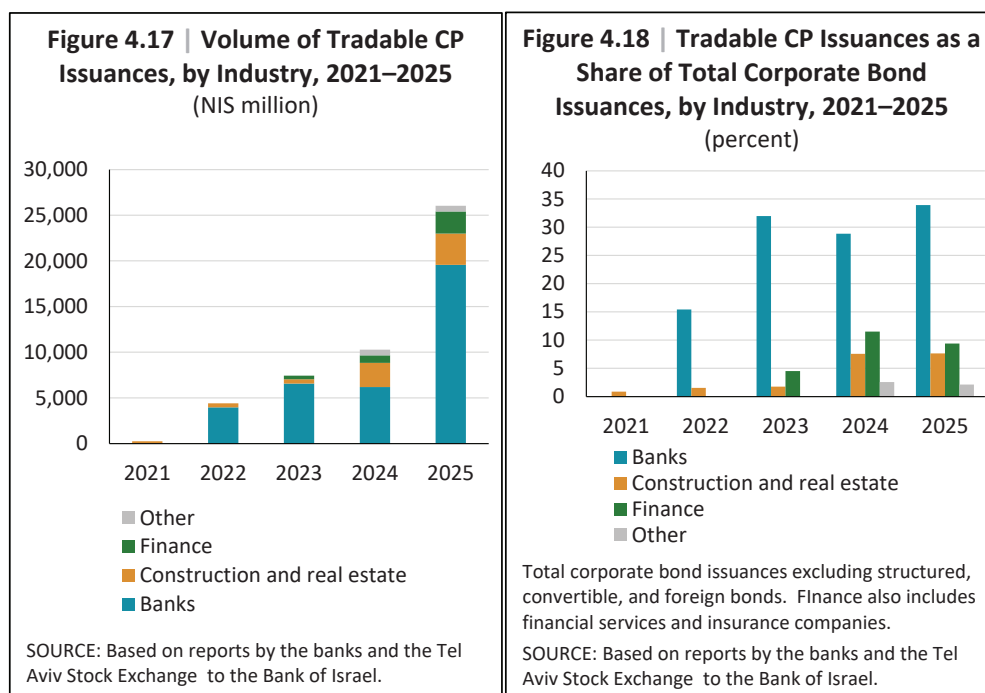
In 2025, the banking system recorded a particularly sharp increase in CP issuance—from an average of about NIS 6 billion in 2023 and 2024 to more than NIS 17 billion in 2025. The banking system's strong demand for debt issuance in 2025 was due to several factors. The sharp increase in the bank credit portfolio, alongside only moderate growth in public deposits and equity—including against the background of increased profit distributions—raised banks' need for external funding and increased the share of debt issuance in their liability structure. This was compounded by the termination of the monetary loans program, which increased demand for debt issuance in the capital market.

Part of the increase in the banking system's CP issuance in recent years may be explained by money market funds' demand for placements in the banking system, against the background of the restrictions applying to the volume of nontradable

¹⁶ In addition, during the period the volume of money market funds' holdings of deposit bonds increased markedly.

¹⁷ In a rising/high interest rate environment, firms will often seek to shorten the duration of their debt in order to reduce the increase in financing costs and allow greater flexibility in rolling over debt, partly due to expectations of future interest rate declines.

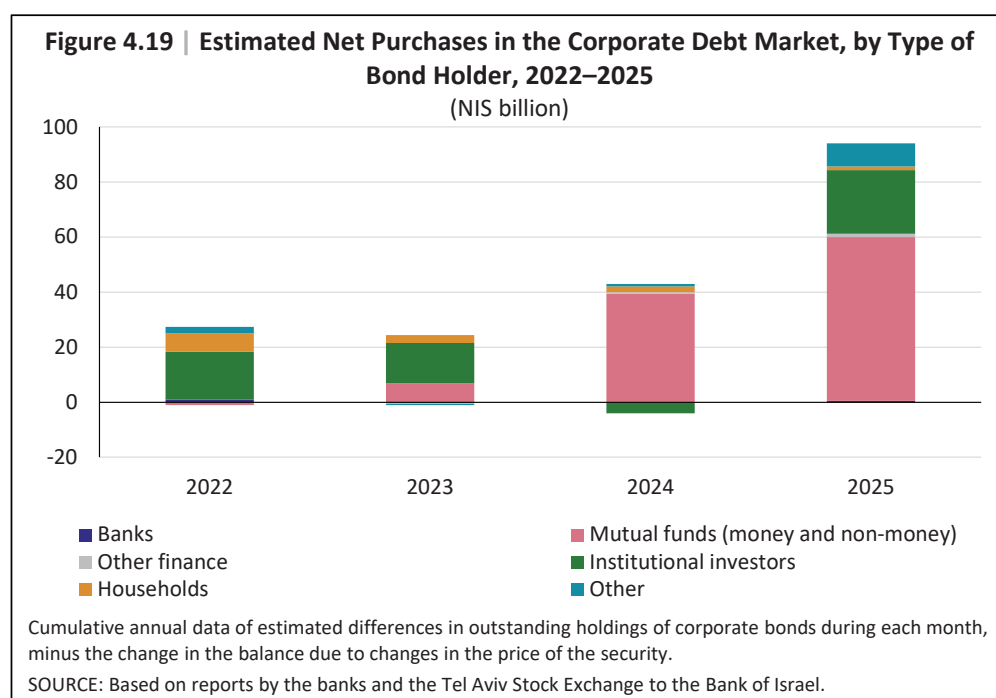
assets they are permitted to hold. This may have increased banks' incentive to expand issuance through this channel. However, this explanation does not appear sufficient in the context of the particularly sharp increase in 2025, when accumulations in money market funds were relatively low compared with 2023 and 2024. In practice, the sharp increase in the banking system's CP issuance in 2025 was accompanied by a marked increase in issuance of standard corporate bonds as well. As shown in Figure 4.18, despite the sharp increase in CP issuance, its share of the banking system's total bond issuance did not rise markedly in 2025. That is, 2025 appears to have been characterized by exceptionally strong demand by the banking system for debt fundraising in the capital market more generally.



The domestic debt market managed to absorb high demand for bank debt issuances.

More broadly, the domestic debt market's ability to absorb the sharp increase in the banking system's demand, alongside the continued expansion of issuance in other industries—chief among them construction and real estate—was supported to a large extent by the injection of demand from money market funds and non-money-market mutual funds.

Figure 4.19 presents an estimate of net purchases in the corporate bond market—that is, the monthly change in outstanding balances resulting from actual purchases and sales, including purchases in the primary market (issuance) and in over-the-counter (OTC) transactions—broken down by the main segments active in the market. The figure shows the large weight of mutual funds (money market and non-money-market) in positive net purchases in 2024 and 2025. These findings therefore indicate that mutual funds were among the main factors behind the injection of demand into the corporate market from the end of 2023 in general, and in 2025 in particular.



e. Summary and Comparison with Global Developments

In conclusion, the substantial accumulations in mutual funds in general, and in money market funds in particular, appear to have been among the key variables driving the injection of demand into the bond market in 2025. This trend contributed to an expansion in the supply of nonbank credit and improved financing access for nonfinancial firms. In particular, the findings in this section indicate that the expansion in the supply of financing in the bond market was among the main factors supporting the continued activity of firms in the construction and real estate industry despite the slowdown in demand in the housing market over the past year. It should be noted that the expansion of nonbank credit through the capital market may also affect patterns of bank credit. Firms' improved access to the capital market creates competition for the banking system and may support an expansion in the supply of bank credit or an improvement in its terms for these groups, particularly for large and highly rated firms.

Many of the trends described in this chapter were also observed in global markets. In many countries, corporate bond spreads declined in 2025¹⁸, alongside a shift of household savings from traditional banking channels toward money market funds, in view of a high interest rate environment and relatively weak pass-through to deposit rates.¹⁹ At the same time, it is important to emphasize that the institutional,

The expansion of nonbank financing improved access to business credit in general, and to benefit construction companies in particular.

¹⁸ For example, in September 2025, corporate bond spreads in the United States reached a 27-year low.

¹⁹ See, for example, an IMF review from July 2025, which found that in 9 advanced economies, yield spreads between money market funds and bank deposits since 2023 were among the prominent factors behind the sharp increase in accumulations in these funds: <https://www.imf.org/en/publications/wp/issues/2025/07/25/money-market-fun4.growth-during-hiking-cycles-a-global-analysis-568763>

regulatory, and financial structure of debt markets and savings instruments differs across countries. As such, the mechanisms described in this chapter, which primarily reflect the conditions of the Israeli economy, cannot be fully generalized. Nevertheless, similar features—such as partial pass-through to deposit rates, sharp growth in money market fund assets, and households’ search for yield—suggest that developments in Israel form part of a broader trend also taking place in global markets.

3. USE OF HOUSING CREDIT BY YOUNG HOUSEHOLDS

In the past decade-and-a-half, home prices in Israel increased more rapidly than household income.

Between 2010 and 2025, housing prices in Israel increased by more than 130 percent, while households’ net monetary income rose by only about 65 percent.²⁰ This section examines how the increase in housing prices relative to income affected households’ use of housing credit, with a focus on young households and first-time homebuyers, who are the group most exposed to rising housing prices and financing constraints.²¹ Unlike homeowners, whose wealth is at least partly linked to housing prices, first-time homebuyers are more exposed to changes in housing prices relative to their income. At the same time, during the previous decade Israel, like other countries, implemented a series of macroprudential measures aimed at reducing systemic risks and strengthening the banking sector’s ability to absorb shocks.²²

Households wishing to purchase a dwelling can cope with rising housing prices partly by increasing the loan-to-value ratio, particularly during periods of low real interest rates, as prevailed during most of the previous decade. However, households without sufficient equity may be constrained in their ability to increase leverage and may therefore be pushed out of the housing market. Young households, whose income is lower on average than that of other households, and whose equity is generally smaller, are likely to be more constrained in their ability to increase leverage in order to purchase a dwelling. Consistent with this, there has been a decline in recent years in the share of young families living in owner-occupied housing.²³

Previous studies found that tighter financing conditions and rising prices affect not only the ability to obtain credit, but also the structure of loans—partly through an

²⁰ Estimate of the growth in income from the Central Bureau of Statistics Household Expenditure and Income Survey.

²¹ Credit to first-time homebuyers constitutes the main component of housing credit extended by banks (an average of about 60 percent of monthly new mortgage borrowing in recent years).

²² In particular, in 2012 and 2013 a series of restrictions came into effect, including: a loan-to-value (LTV) limit, a payment-to-income (PTI) limit, a limit on the share of variable-rate mortgages, and a limit on the term to repayment (up to 30 years).

²³ The share of young families living in owner-occupied housing has declined over the past two decades, and is low relative to other OECD countries, even though the overall homeownership rate is not low by international comparison. For further discussion, see Chapter 7 of the *Bank of Israel Annual Report for 2024* and Adi Brender and Michel Strawczynski (2014). [“Government Support for Young Families in Israel,”](#) Discussion Paper Series 2014.02, Bank of Israel Research Department.

increase in the payment-to-income ratio²⁴, an extension of the repayment period²⁵, and purchases in lower-demand areas.²⁶ This raises the question of whether such effects were also observed over the past decade, and whether they were more pronounced among young couples from among those who did take out a mortgage.

Figure 4.20 presents the credit characteristics of mortgages for the purchase of a first dwelling among young households²⁷ compared with older households between 2015 and 2025. In general, young households take out mortgages with higher average leverage, a higher payment-to-income ratio, and a longer repayment period. In both groups, there is a clear upward trend over the period in the loan-to-value ratio and in the payment-to-income ratio. The repayment period increased between 2015 and 2023, with a change in trend in 2023. In addition, there was a notable increase in the share of new mortgages taken out with a payment-to-income ratio above 30 percent and a loan-to-value ratio above 60 percent. Although both groups recorded an upward trend, particularly from the end of 2019 onward, the increase appears sharper among young households. This finding indicates that a growing share of young households has had to combine long repayment periods with high leverage and high payment burdens in order to purchase a first dwelling. Moreover, there was a clear increase in loan amounts among both groups, consistent with the rise in housing prices and the increase in leverage.

The increase in housing prices may also be reflected in distributional terms, through a change in the income composition of the households that succeed in purchasing a dwelling.²⁸ Figure 4.20f also presents the share of households in each group whose net income falls within the top two quintiles of the income distribution in Israel. Naturally, young households are more heavily represented in the lower quintiles, since their income at the beginning of their economic life cycle is relatively low. Nevertheless, in both groups there was an increase in the share of mortgage borrowers belonging to the top two income quintiles²⁹, and this trend was particularly pronounced among young households—from 43 percent in 2015 to about 66 percent in 2025. This development points to two complementary processes. While affluent households, which in the past could purchase a dwelling while relying on relatively

Young households take out mortgages with high leverage and for longer repayment periods.

²⁴ Golan Benita and Ziv Naor (2013). "[Borrower Risk in the Mortgage Market: Historical Development and Assessment Under Several Scenarios](#)," Periodic Papers 2013.8, Bank of Israel Research Department.

²⁵ Yoav Friedman and Sigal Ribon (2014). "[Where Does the Money Come From? Home Purchases and Their Financing: An Analysis Using Household Expenditure Survey Data, 2004 to 2011](#)," Periodic Papers 2014.05, Bank of Israel Research Department.

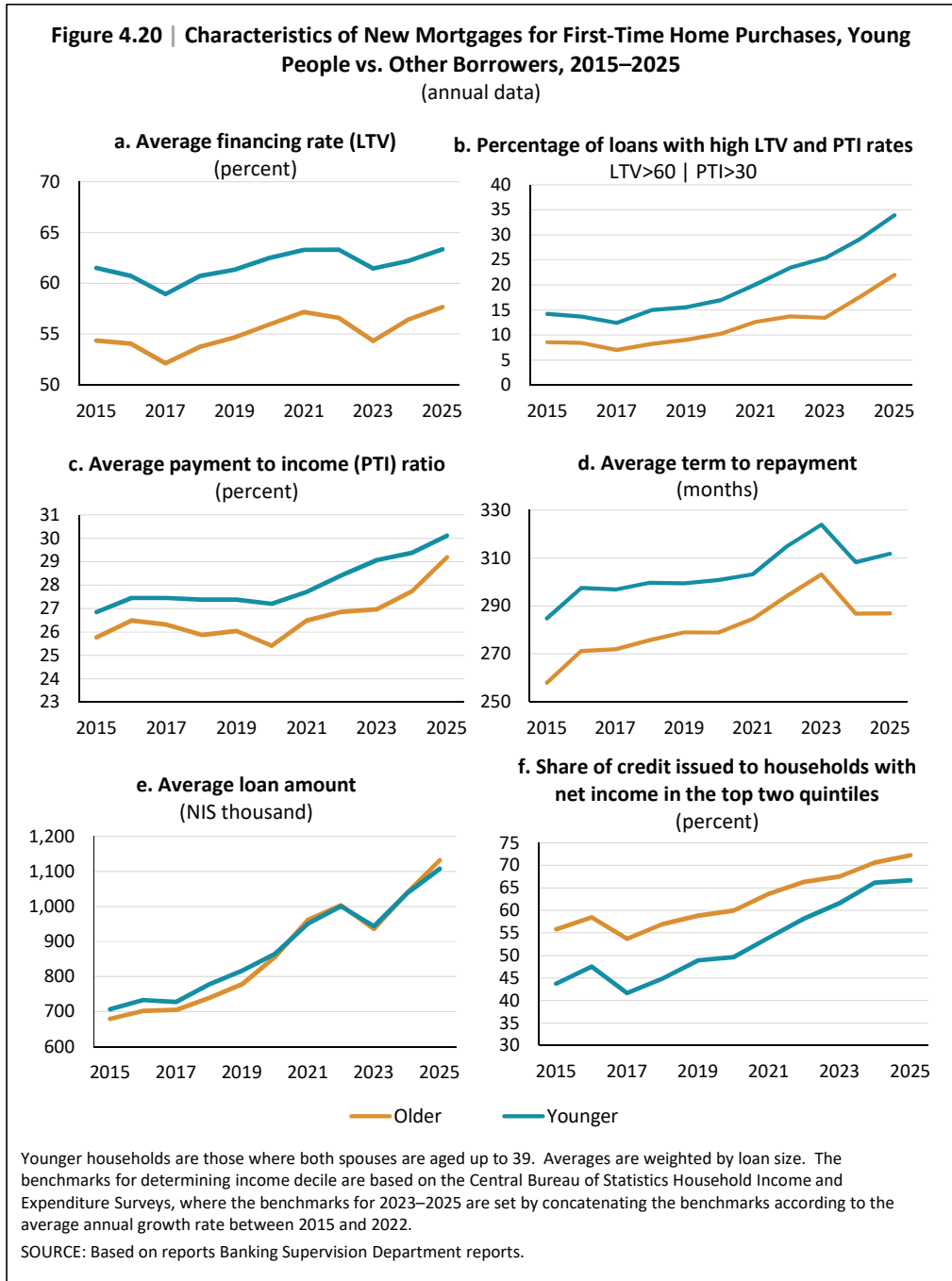
²⁶ Nitzan Tzur-Ilan (2017). "[The Effect of Credit Constraints on Housing Choices: The Case of the Loan-to-Value Limit](#)," Discussion Paper Series 2017.03, Bank of Israel Research Department.

²⁷ Households in which both spouses are under age 40.

²⁸ Vicky Rubashevski Banit (2019). "Changes in the Proportion of First-Time Home Buyers Among Young Families According to Level of Income During the Years 2007–2017," Selected Research and Policy Analysis Notes, Bank of Israel.

²⁹ This finding is consistent with the general trend of an increase in the share of housing loans taken by households with relatively high income. See, for example, [Box 5.2 in the Banking Supervision Department's Survey of Israel's Banking System for 2022](#).

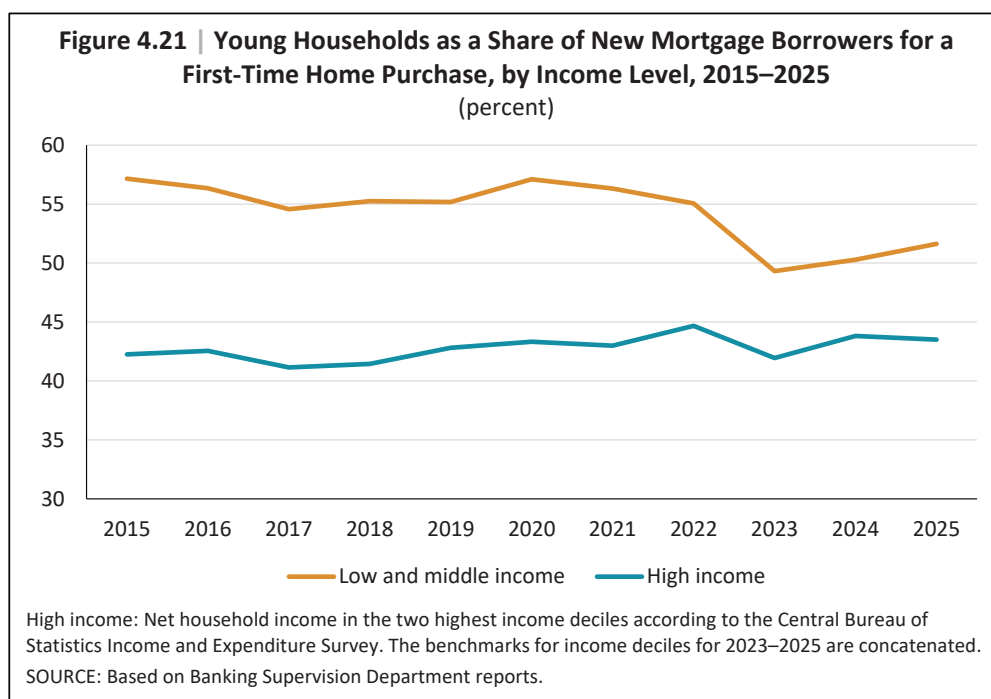
low leverage, increased the amount of credit they took on, young households with lower income were pushed out of the housing market.



The sharper increase in the share of high-income young households among mortgage borrowers, relative to the rest of the population, may also reflect a relative increase in young households' income over the period. That is, it is possible that the number of young households belonging to the top two income quintiles increased, and hence their weight among mortgage borrowers rose relative to older households.

To examine this possibility, Figure 4.21 presents the share of young households among all mortgage borrowers, broken down between high-income households (the top two quintiles) and low- and middle-income households (the bottom three quintiles). The figure shows that in recent years the share of young households with high incomes among all mortgage borrowers remained stable, while young households with low and middle income levels accounted for a declining share of mortgage borrowers. That is, the sharper increase in the share of credit extended to high-income young households does not appear to be a result of an increase in the weight of young households within the high-income group, but rather is due to a decline in the weight of young households within the groups of homebuyers with low and middle income. This phenomenon strengthens the hypothesis that over the period purchasing a home became more complex for low- and middle-income young families.

In recent years, young couples with low and mid-level incomes account for a lower share of mortgage borrowers.



In conclusion, it appears that over the past decade, against the background of rising housing prices, several parallel processes took place. First, the share of young couples among mortgage borrowers for the purchase of a first dwelling declined. This finding is consistent with the downward trend in the share of young families living in owner-occupied housing. Second, leverage ratios, payment-to-income ratios, and loan maturities increased among all groups of first-time home mortgage borrowers, with higher levels among young couples than among older couples. Finally, there is evidence of a process in which purchasing a home has become more challenging for lower-income households, with a stronger effect on young couples.

BOX 4.2: AN INDEX OF COMPETITION IN ISRAEL'S BANKING SYSTEM IN COMPARISON WITH OECD COUNTRIES

- **The return on equity of Israeli banks has remained high since 2020 and has risen relative to the rest of the world. This increase was not accompanied by a rise in concentration, and it coincided with a temporary decline in competition indicators, which have since returned to the median level.**
- **Although the number of banks in Israel is low relative to other OECD countries, concentration and competition levels in the banking sector are broadly in line with international comparison and, for most of the period, were around the median of the comparison countries.**
- **The analysis indicates that stronger competition need not be accompanied by a decline in return on equity in the short term.**
- **In the long term, higher concentration and less competition are both positively associated with higher return on equity.**

a. Introduction

Historically, the return on equity of Israeli banks was close to the OECD median, but beginning in 2021 it rose sharply, bringing Israel to around the 75th percentile of the comparison countries, where the metric also rose sharply (Figure 1).

This box examines whether this trend reflects an increase in concentration indicators and a decline in competition in the banking sector.

Concentration indicators and competition indicators are not equivalent. Concentration describes the structure of the market (the number and size of participants), whereas competition reflects the actual intensity of competitive pressure.

In order to examine the effect of these variables on bank profitability, we first estimated a panel regression, the findings of which indicate that in a more concentrated and less competitive market, return on equity is higher.¹ These findings are consistent across all regression specifications, including

¹ Concentration indices: HHI and CR3. Competition indices: Lerner and Boone. Further details on these indices appear below. The panel regressions were estimated separately for each index and for all indices jointly.

when controlling for macroeconomic variables (such as growth, the real interest rate, and population size). Among the indicators examined, the Lerner index exhibits the strongest and most statistically significant association. The analysis also found a positive relationship between concentration and the competition indicators.

b. Data

The international comparison is conducted using countries with advanced economies, according to the IMF and OECD definitions, excluding the G7 countries.² The data are based on the BankFocus database (Moody's) for the years 2013–2024 and include commercial banks, cooperative banks, and savings banks. The data were collected in accordance with the reporting format used by banks in Israel.

Table 1 presents the number of banks in each country in 2024, and shows that Israel has the lowest number of banks per million inhabitants.

To examine whether the low number of banks in Israel is reflected in high concentration, we used two concentration indices commonly employed in the literature: the CR3 index, which measures the market share of the three largest banks in each country (Figure 2), and the HHI index (Figure 3), which is calculated as the sum of the squared market shares of all banks in the sector and ranges from 0 (perfect competition) to 1 (absolute concentration).

These indicators show that concentration in Israel is similar to the OECD median, and has remained at that level throughout the past decade.

Hence, despite the relatively small number of banks, Israel is not exceptional in its level of concentration. Accordingly, this index does not explain the sharp increase in return on equity in recent years. It should be noted that international comparisons of the number of banks may reflect structural differences among banking systems, which mainly affect the interpretation of concentration indices.³

² Several papers argue that the Lerner index may be biased for banks with extensive off-balance-sheet or investment activity (Wheelock and Wilson, 2018; Shaffer and Spierdijk, 2020). We therefore excluded the G7 countries, where such activity is substantial.

³ Concentration indices may be biased due to structural differences among banking systems, including the absence of public banks and branches of foreign banks (three countries in each case), and the prevalence of interconnected cooperative banks (six countries). By contrast, these differences do not materially affect the observed results for the Lerner index and return on equity among the banks in the sample.

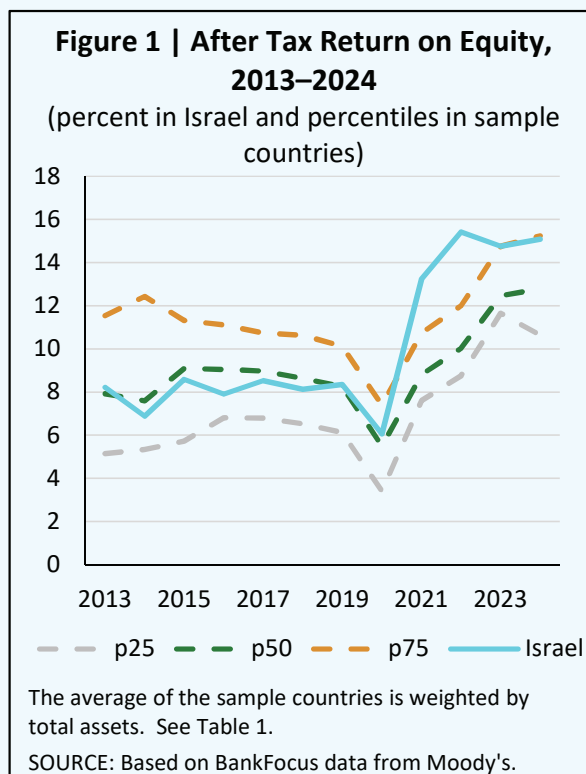


Table 1 | Number of banks per country and per million residents, 2024

Country	Banks in the sample	Banks per million residents
Israel	6	0.6
Greece	9	0.9
S. Korea	47	0.9
Lithuania	3	1.0
Netherlands	18	1.0
Czech Rep.	14	1.3
Slovakia	8	1.5
Belgium	20	1.7
Spain	91	1.9
Australia	56	2.1
Ireland	11	2.0
New Zealand	21	3.9
Slovenia	7	3.3
Latvia	9	4.8
Estonia	7	5.1
Sweden	74	7.0
Denmark	43	7.2
Portugal	85	7.9
Iceland	6	15.6
Norway	93	16.7
Finland	102	18.6
Switzerland	282	31.2
Austria	362	39.4
Luxembourg	30	45.7

The sample includes commercial, cooperative, and savings banks at the consolidated reporting level (and nonconsolidated where there is no consolidated reporting). It does not include foreign banks with local branches, government-owned or public-owned banks, banks controlled by another domestic bank, holding companies, banks with fewer than 7 observations, or banks for which the most recent observation was before 2020, or observations with no data on total assets or deposits.

SOURCE: Based on BankFocus data from Moody's.

c. Competition index — The Lerner Index

Since concentration indices focus only on the structure of the system and may be subject to bias, an additional index is required in order to examine the actual level of competition.

For this purpose, the economic literature commonly uses the Lerner index.⁴ This index estimates a bank's ability to set a price above marginal cost, and thus reflects the intensity of competitive pressure. The index is calculated for bank *i* at time *t* according to the following equation:

$$Lerner_{i,t} = (P_{i,t} - MC_{i,t})/P_{i,t}$$

To calculate the index, we estimate the two components of the equation as follows: the price (*P*) is estimated using the bank's average revenue (interest income and income from other activities divided by total assets). The marginal cost (*MC*) is estimated using a cost function based on the prices of the bank's various inputs, including interest paid on deposits, wage expenses, and other operating expenses. The resulting value of the index ranges from 0 to 1; the higher the value, the greater the bank's market power and its ability to charge a price substantially above its marginal cost of production. In addition, we validated the findings using the Boone indicator, which examines the extent to which operational efficiency is rewarded.⁵

d. Results and International Comparison⁶

The Lerner index of Israeli banks rose between 2013 and 2022 and then declined (Figure 4). The solid line in Figure 4 presents a weighted average based on each bank's share of total assets in the banking system. The international comparison indicates that these trends are not unique to Israel. A gradual increase in the index through 2022, followed by a reversal thereafter, is also observed in the comparison countries (Figure 4).

These findings strengthen the argument that regulatory changes, macroeconomic conditions, and global technological processes affect the Lerner index in a similar manner worldwide. With that, it appears that from 2018 to 2022 the Lerner index in Israel rose at a faster pace than in the comparison countries, in a manner that is partially consistent with the increase in return on equity beginning in

⁴ For a broad review of the advantages of using this measure, see the Report of the Committee for Examining Competition in the Credit Market (the Strum Committee, 2021). In recent years, the literature has presented several attempts to improve the measure, but most of these refinements do not alter the main findings (Spierdijk and Zaouras, 2018; Igan et al., 2021; Wheelock and Wilson, 2018; Carbo et al., 2009; Shaffer and Spierdijk, 2020).

⁵ Boone indicator values in Israel are low and remain below the 25th percentile of the comparison countries throughout the period. This finding points to a high level of competition in the market. The gap between the findings based on the Lerner index and those based on the Boone indicator is due to the fact that the two measures capture different aspects of competition. The Lerner index focuses on pricing relative to cost, whereas the Boone indicator examines the extent to which operational efficiency is rewarded. In the initial panel regression examining the relationship between competition and concentration measures and return on equity, no statistically significant relationship with the Boone indicator was found once macroeconomic controls (growth, real interest rate, population) were included.

⁶ The results remain robust under alternative definitions, when using Fitch data, and in comparison with the World Bank's Lerner index measure.

2021.⁷ By contrast, the decline in the Lerner index since 2023 (reflecting higher levels of competition) is not directly reflected in return on equity, which has remained high.

Conclusion

This analysis finds that the marked increase in the profitability of Israeli banks, to a high level relative to other advanced economies, was not accompanied by an increase in concentration. It was, however, associated with a temporary decline in the degree of competition as measured by the Lerner index. In recent years, the level of competition appears to have returned to its historical range, with Israel's position in the international distribution reverting to around the median, while return on equity has remained high.

Between 2014 and 2023, the efficiency of banks in Israel improved (see the Banking Supervision Department Surveys), partly reflecting the transition to digital operations and broader technological improvements—a process that may explain parallel increases in both return on equity and competition indicators.⁸ Against the background of this improvement in efficiency, credit activity in Israel also expanded in the past decade, as reflected in an increase in the debt-to-GDP ratio, in contrast to the trend in many other countries (Figure 4.1). This expansion may also have contributed to higher return on equity through increased activity volume. Finally, return on equity is also affected by the level of leverage, which has risen since 2022 (according to the Banking Supervision Department Surveys). Higher leverage tends to raise the return on equity, but may mechanically lower the measured Lerner index.⁹

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In Hebrew:

Bank of Israel and Ministry of Finance. Report of the Committee to Examine Competition in the Credit Market.

⁷ An examination of the components of the index indicates that both the price component (P) and the marginal cost component (MC) rose in Israel at a relatively rapid pace. However, beginning in 2023, both components show a stabilizing trend, with the stabilization in the price component (P) being more pronounced. This development leads to a decline in the Lerner index.

⁸ In the Lerner index, an increase in efficiency and a reduction in expenses may, in the short term, be reflected in a decline in the level of competition even in a competitive market. Lower costs reduce MC and thereby raise the index.

⁹ Because the Lerner index does not assign an explicit cost to equity, higher leverage mechanically raises MC for a given income-to-assets ratio, lowering the measured index.

Chapter 5

The Labor Market

- » In 2025, the labor market remained tight, primarily due to significant constraints on the supply of civilian labor, as a result of the continuation of the fighting through most of the year.
- » The labor force participation rate remained below its prewar level, with most of the decline concentrated among young people. The extensive mobilization of reservists led to the absence of many workers from their jobs, although on a smaller scale than in the preceding year.
- » With the outbreak of the war, the number of non-Israeli workers declined due to the halt in the entry of Palestinian workers. Over the past two years, the number of foreign workers increased gradually. However, the number of non-Israeli workers remained below its prewar level.
- » These supply constraints were reflected in the fact that the number of people employed in the business sector was about 1.5 percent lower this year than in the year preceding the war. This decline, together with rising demand, was reflected in a high job vacancy rate in 2025 (4.5 percent), particularly in industries with a high share of male or young workers.
- » The unemployment rate was low, averaging about 3.0 percent.
- » Real wages in the business sector increased markedly over the course of the year, exceeding even the growth in GDP per worker. In contrast, in the public sector, real wages eroded relative to their prewar level.
- » Negative migration from Israel over the past two years explains only a small part of the decline in labor supply since the outbreak of the war.



The labor market was tight and operated under labor supply constraints



The shortage of workers was due to reserves mobilization and the absence of Palestinian workers



Unemployment was low (3.0%), and the **job vacancy rate** was high (4.5%)

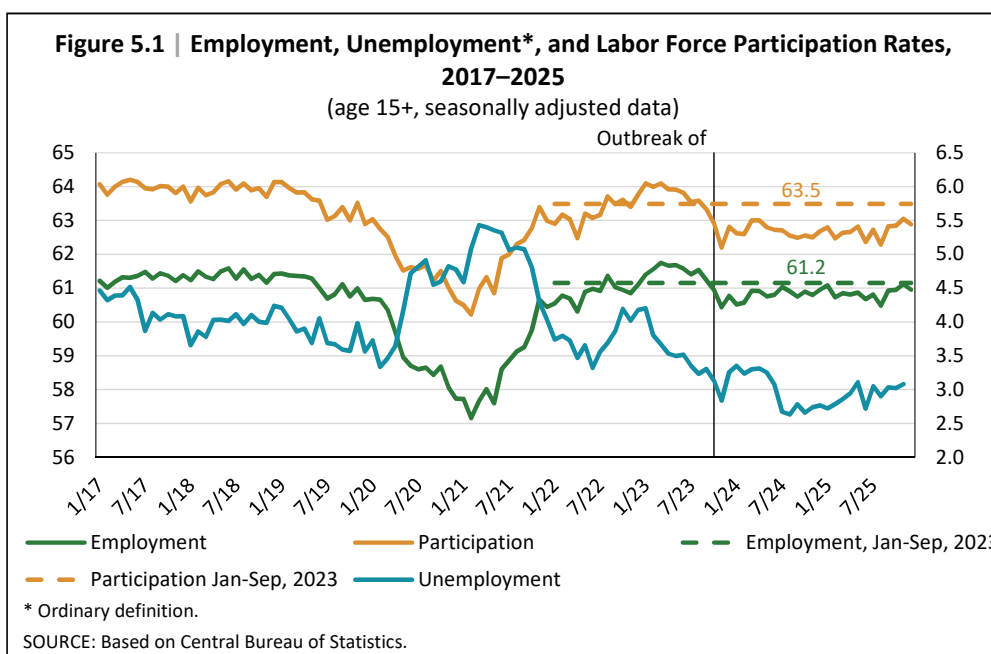


Business sector **wages** increased at an annual rate of **4.2%**, while the increase in the **public sector** was **1.4%**

1. MAIN DEVELOPMENTS

The labor market was tight in 2025 due to a shortage of workers as a result of the continued war.

In 2025, Israel's labor market remained tight, with constraints on the supply of labor in view of continued fighting through most of the year. Many workers were absent due to reserve duty, and the labor force participation rate remained below its prewar level (Figure 5.1 and Table 5.1). The number of non-Israeli workers declined markedly due to the prohibition on the entry of Palestinian workers, although over the past year this shortfall was partially reduced by the entry of foreign workers.



CHAPTER 5 | THE LABOR MARKET

Table 5.1 | Main Labor Market Indicators

	Level ^a	Annual rate of change (percent) ^{b,c}					Change relative to 2023 (percent) ^e	Change relative to the prewar period (percent) ^d
	2025	2016-2019	2020-2022	2023-I-III	2023-IV	2024	2025	2025
Population	10,121	2.0	1.8	3.2	2.8	1.4	1.3	1.4
Working-age population	7,300	2.0	1.9	2.5	2.4	2.0	1.5	1.8
Labor force	4,577	1.8	1.8	3.6	1.0	0.7	1.5	1.1
Labor force participation rate, 15+ (level, percent)	62.7	63.9	62.3	63.8	62.6	62.7	62.7	62.7
Number of employed persons^{e,f}	4,700	2.0	1.8	3.7	-1.4	-0.3	2.5	0.9
Israelis	4,442	2.1	1.9	3.7	2.1	1.2	1.5	1.4
Employed full time	2,956	2.4	1.8	1.0	4.8	1.2	3.4	2.5
Employed part time	1,144	1.4	3.9	12.1	-26.9	5.2	-2.7	-2.4
Temporary absentees	343	2.8	14.5	-0.5	113.2	-10.7	0.3	5.9
For economic reasons (monthly level, thousand)	37	14	175	14	217	35	37	37
Due to reserve military service (monthly level, thousand)	27	2	2	2	147	52	27	27
Employees in the public service industries	1,680	2.4	2.3	3.7	4.3	3.7	1.5	2.7
Employees in the business sector industries^{e,f}	3,019	1.8	1.5	3.7	-4.3	-2.4	3.2	-0.1
Israelis	2,762	2.0	1.6	3.6	0.9	-0.3	1.6	0.7
Nonresidents ^e	209	-2.0	-5.8	6.9	-4.8	11.9	23.2	14.7
Palestinians ^e	48	5.0	9.7	2.1	-93.5	-68.3	26.1	-40.8
Weekly labor input in the business sector^{e,f}	125,439	2.0	2.0	2.7	-9.6	-2.6	3.4	-0.7
Israelis	100,063	2.1	1.9	2.4	-5.9	-1.3	2.1	-0.3
Nonresidents ^e	9,742	-2.8	-5.4	6.5	-5.8	12.9	23.0	15.0
Palestinians ^e	2,018	5.9	9.4	1.5	-92.9	-67.7	26.1	-39.9
Weekly work hours per Israeli employee in the business sector	36.2	0.1	0.2	-1.1	-6.7	-1.0	0.6	-0.9
Job vacancy rate in the business sector (level, percent)	4.5	3.7	3.9	3.9	3.4	4.4	4.5	4.5
Nominal wage per employee post^f	13,918	3.0	4.0	5.7	8.3	4.6	3.4	4.4
Real wage per employee post (2023 average prices)^g	13,074	2.7	2.3	1.1	4.8	1.5	0.3	1.3
In the government sector ^g	12,480	1.3	-0.1	3.3	5.5	0.1	-1.5	0.0
In the private sector ^g	15,244	3.1	3.1	0.0	3.7	2.2	0.8	1.7
Real minimum wage (2023 average prices)	5,974	3.5	-1.7	-1.1	1.7	2.3	3.0	2.5
GDP labor share in the business sector^e		0.9	-2.2	-2.1	-2.5	-0.2	1.8	0.4
Real Unit labor cost in the business sector^e		1.2	0.5	1.4	3.0	5.1	3.8	4.3
Narrow unemployment rate (level, percent)^h	3.0	4.2	4.4	3.5	3.2	3.0	3.0	3.0
Broad unemployment rate (level, percent)^{h,i}	3.8	4.2	8.6	3.8	8.1	3.8	3.8	3.8

^a 2025 average, in thousands, percent, or NIS.

^b Unless otherwise noted in the specific row.

^c Relative to the previous year. The range of years reflects the average growth rate in each year. In 2023, each part of the year is compared to the same period in the previous year.

^d Normalized to annual terms. The comparison period is the year prior to the war: 2022:Q4 to 2023:Q3.

^e National Accounts data.

^f Including foreign workers and Palestinians.

^g Israelis only.

^h Those absent all week. The figure under 2016–2019 is for 2018–2019 only.

ⁱ "Narrow" unemployment (the official definition for unemployment) includes unemployed people who actively searched for work and were available to work. Broad unemployment also includes

SOURCE: Based on Central Bureau of Statistics.

Table 5.2 summarizes the main components underlying the decline in labor supply due to the war in 2024 and 2025. Overall, the impact to labor supply in 2025 as a result of the war was about 3.6 percent of the labor force. About 55 percent of this decline is explained by lower labor force participation rates and by absences from civilian employment among reservists and their spouses. A further 35 percent of the decline is explained by the absence of non-Israeli workers. The remainder of the decline is explained by the increase in the number of residents who emigrated from Israel over the past two years.

The shortage of workers was influenced mainly by the absence of non-Israeli workers, the mobilization of reservists, and a decline in the labor force participation rate.

Table 5.2 | Estimated Decline in the Actual Number of Employed Persons in 2024 and 2025 as a Result of the War

Reason	2024			2025		
	Actual number of employees (thousand)	Percentage of labor force	Percentage of total decline in workers	Actual number of employees (thousand)	Percentage of labor force	Percentage of total decline in workers
Absent due to reserve duty ^a	59	1.2	25	33	0.7	19
Decline in the number of non-Israeli workers ^b	111	2.3	46	59	1.2	35
Decline in participation rates ^c	58	1.2	24	58	1.2	34
of which: Wounded in the war ^d	11	0.2	4	13	0.3	7
Resident of evacuated localities ^e	6	0.1	2	5	0.1	3
Absent spouses of reserve soldiers ^f	3	0.1	1	3	0.1	2
Net migration ^g	9	0.2	4	18	0.4	11
Total	239	5.0	100	171	3.6	100

^a Average number of absentees per months due to reserve duty.

^b Difference in the number of non-Israeli workers between the first three quarters of the year and the first three quarters of 2023.

^c Difference between the actual number of workers per year and the forecast number of workers if the participation rates were similar to the January 2022–September 2023 average.

^d This is calculated by multiplying the total number of disabled IDF veterans and civilian victims of hostilities resulting from the war by the gap in employment rates between disabled IDF veterans and the rest of the non-*Haredi* Jewish population, which is calculated based on a special processing of Central Bureau of Statistics data published in Elmasi and Schwartz (2025). The assumption is that no new civilian victims of hostilities were added in 2025, and that one-third of the IDF casualties were added in 2025, consistent with the decline in the intensity of the fighting during that year.

^e The difference between the number of employed persons in the year and the expected number of employed persons if the participation rates in the evacuated localities would remain the same as in the year prior to the war.

^f The difference between the number of spouses of reserve soldiers who were absent from work or who worked less than usual and the number of spouses of all other employees who were absent from work or who worked less than usual.

^g The difference between the net migration balance in 2023 and 2024 and the net migration balance between 2016 and 2019, multiplied by the employment rate among those aged 15+, minus the return of immigrants from Ukraine who came to Israel temporarily. For details, see Chapter 1 of this Report.

SOURCE: Based on Central Bureau of Statistics.

The constraint on the supply of workers in the civilian labor market was reflected in a high job vacancy rate (4.5 percent) and a low unemployment rate, averaging about 3.0 percent over the year. This constraint was particularly pronounced in business sector industries characterized by a high share of male and young workers. In contrast, in the civilian public services, where women have relatively high representation, labor shortages were more limited, and employment in these services has even expanded since the war.

The tight labor market led to wage increases this year across all business sector industries. By contrast, real wages in the public services declined, partly due to wage reductions as part of agreements for 2025 and 2026 between the government and the Histadrut.

In June 2025, the intense fighting with Iran during Operation Rising Lion caused a temporary shock to the labor market and a sharp increase in worker absences due to Home Front Command directives. As a result of the disruptions during those two weeks, the impact on annual output was on the order of about 0.3 percent (for further discussion, see Chapter 2 of this Report). Following the end of the operation, employment recovered rapidly and in full.

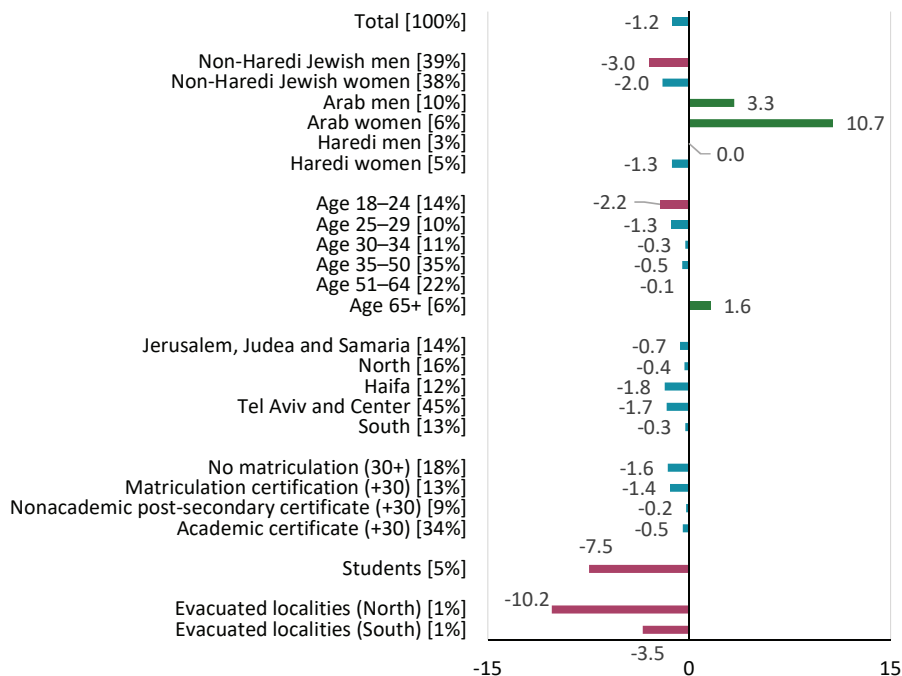
The ceasefire in Gaza came into effect in October 2025, and employment and participation rates increased in the final quarter, though they did not return to their prewar levels. Reserve mobilization at the end of the year also remained elevated relative to the prewar period, and the number of non-Israeli workers (foreign and Palestinian) did not return to its previous level.

2. THE LABOR SUPPLY

The labor supply in 2025 remained markedly below its prewar level. The labor force participation rate among Israelis averaged 62.6 percent in 2025, compared with a monthly average of 63.5 percent in the prewar period (January 2022–September 2023). Figure 5.2 presents the relative decline in participation rates across different population groups. A substantial part of the decline originated among the group of young people aged 18–24, apparently reflecting delayed entry into the labor market due to the extensive reserve mobilization. Frequent reserve service may also reduce young people’s motivation and ability to seek employment over the longer term, even during periods in which they are not actually called up. The decline in participation was particularly evident among non-Haredi Jews, especially men. The most notable population group in which participation has risen in recent years is Arab women. Over the past five years, their employment rate increased from about 30 percent to about 40 percent (and from 37 percent to 50 percent among those in the prime working ages). This is a positive long-term development in view of the challenges facing the economy. (For further discussion, see Chapter 1 of this Report.)

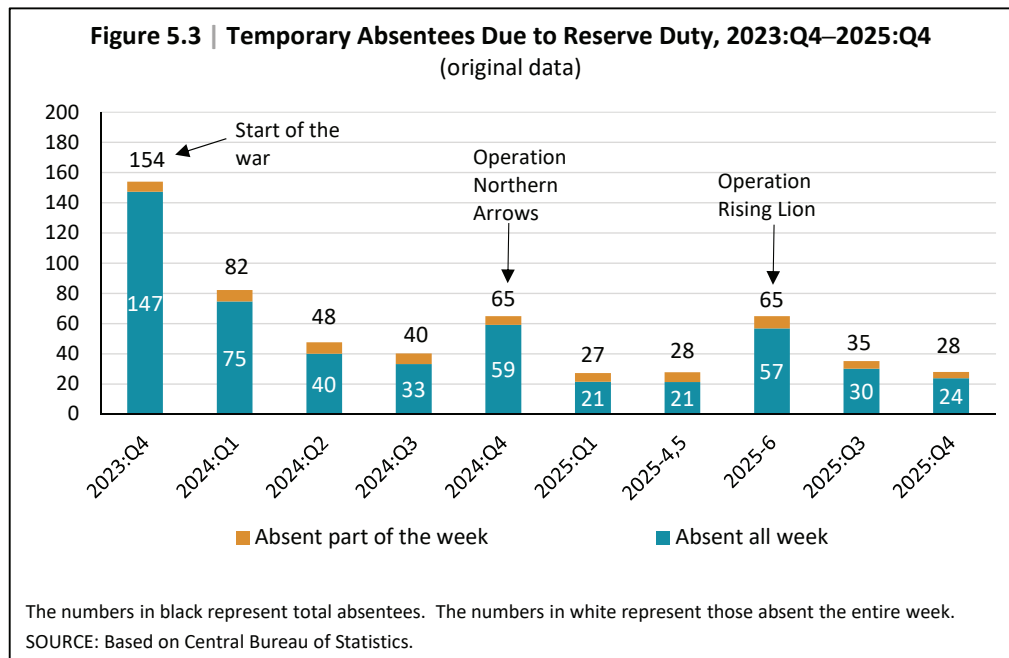
The decline in the participation rates was prominent among non-Haredi Jewish workers and young people.

Figure 5.2 | Change in the Labor Force Participation Rate in 2025 Relative to January 2022–September 2023
(by population group, age 15+, original data, percent)



Square brackets indicate the group’s relative share of the labor force in the year preceding the war. Green bars indicate an increase of 1 percentage point or more relative to the participation rate in January 2022–September 2023. Burgundy bars indicate a decline of more than 2 percentage points in the participation rate. A student is defined as an individual aged 21 or older (among non-Haredi Jews) or 18 or older (among Arabs) who reports in the Labor Force Surveys that they were enrolled in studies at the time of the survey.

SOURCE: Based on Central Bureau of Statistics.



The labor force participation rate declined among residents of evacuated localities in the north and those injured in the war.

Participation rates were also markedly lower among residents of evacuated localities, particularly in the north, where they were about 10 percent below their prewar level. Whereas most residents of the south returned to their localities during 2024, most residents of the north returned home only during 2025. As of September 2025, about 87 percent had already returned to their places of residence. However, even after returning, the resumption of full employment is not immediate. Since these residents account for a relatively small share of the total population, and based on the decline in their participation rates, the number of missing workers in this group relative to the prewar period is estimated at only about 6,000 workers, or 0.1 percent of the labor force.

Another population group whose participation rates declined is those injured in the war. Since the outbreak of the war, about 22,000 wounded IDF personnel receiving treatment through the Rehabilitation Department and about 24,000 civilians injured in hostile acts have been added to this group. The precise decline in employment among them is unknown. Assuming it is similar to the employment gap observed between disabled IDF veterans and the rest of the non-Haredi Jewish population, the effect is on the order of about 0.3 percent of the labor force.

Mobilization of reservists continued to influence the shortage of workers in the civilian labor force.

Due to reserve mobilization associated with the continuation of the war, an average of about 30,000 workers were absent from their workplaces (excluding June, during Operation Rising Lion; Figure 5.3). This represents a marked decline relative to 2024, when the average was 30,000 workers, but it still amounts to a non-negligible share of about 0.6 percent of the labor force. Although these workers are included in the official statistics as participants in the labor force, in practice they are not available to their civilian employers.

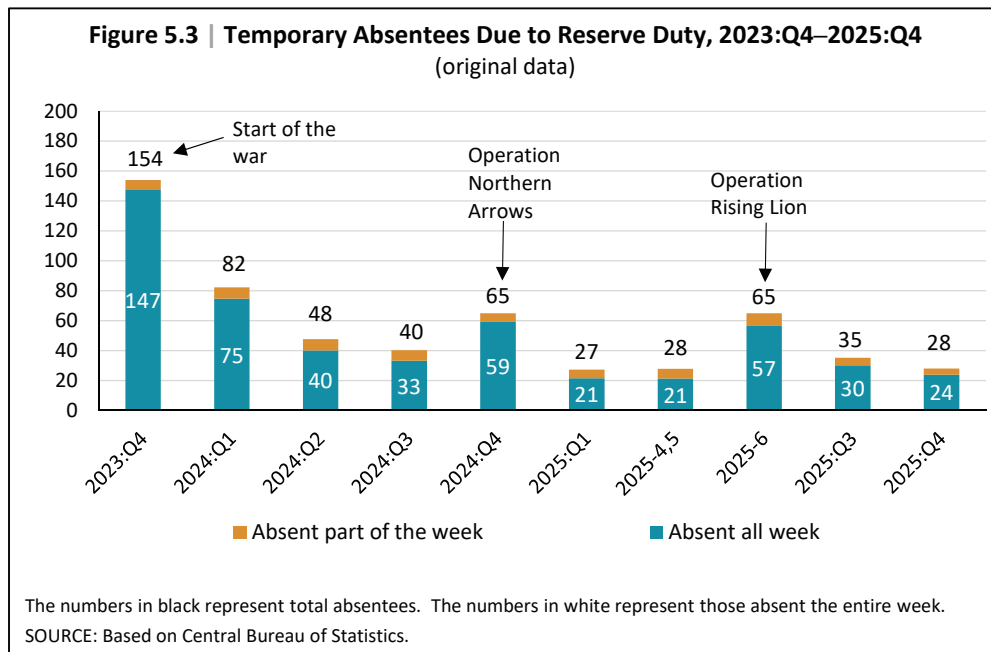
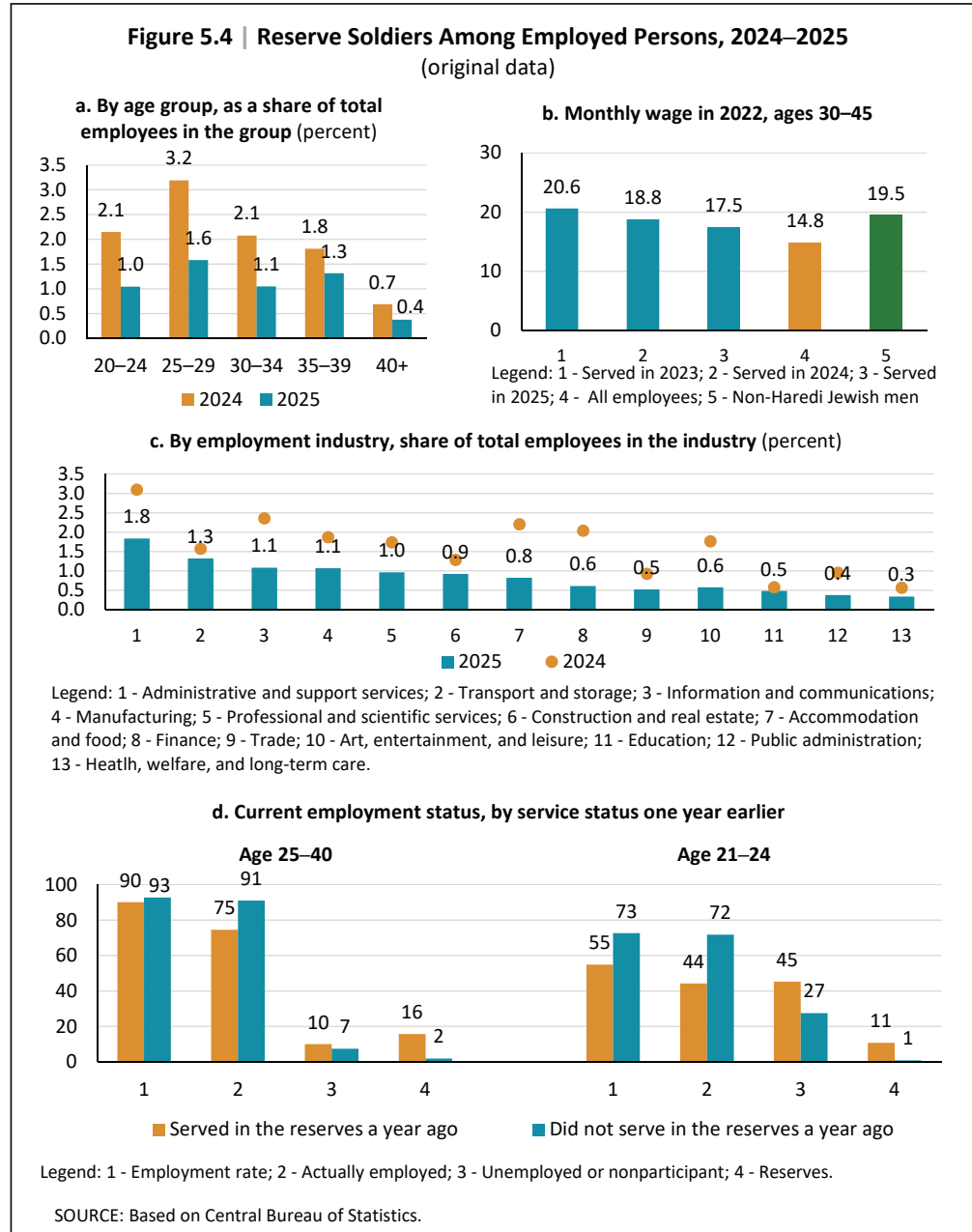


Figure 5.4 examines the profile of workers absent due to reserve service. Figure 5.4a shows that among young workers, aged 20–34, absences due to reserve duty were substantial. Moreover, these data do not capture an additional group of individuals—particularly young people—who were in reserve service and not employed. Figure 5.4b shows that the prewar monthly wages (in 2022) of those who were reservists during the war were higher on average than the economy-wide average wage, and that over time the composition of those absent from work due to reserve service shifted from higher-wage workers toward lower-wage workers, although their wages still remained above the average wage of workers in the economy (Figure 5.4b).¹ This phenomenon may partly reflect the declining share of reservists from the information and communications industry, most of whose workers are employed in the high-tech sector (Figure 5.4c). This suggests that the adverse effect of reserve mobilization on economy-wide productivity was smaller this year than in the previous year. Another pattern evident in the figure is that the share of reservists is much lower in the public services industries—education, health, and public administration—than in industries belonging to the business sector, due to the relatively low share of men in those industries, as discussed below. Among people aged 25–40 who were absent from work in 2024 or in the final quarter of 2023 due to reserve service, 10 percent were not employed in the following year², compared with 7 percent among those who did not serve, and a notable share (16 percent) were again absent from work due to

¹ Average wage data are from the Israel Tax Authority for 2022, for all employed individuals sampled in the Labor Force Survey during 2023–2025. These data represent each individual’s total wages across all jobs in which he or she was employed.

² 2025, or the final quarter of 2024.

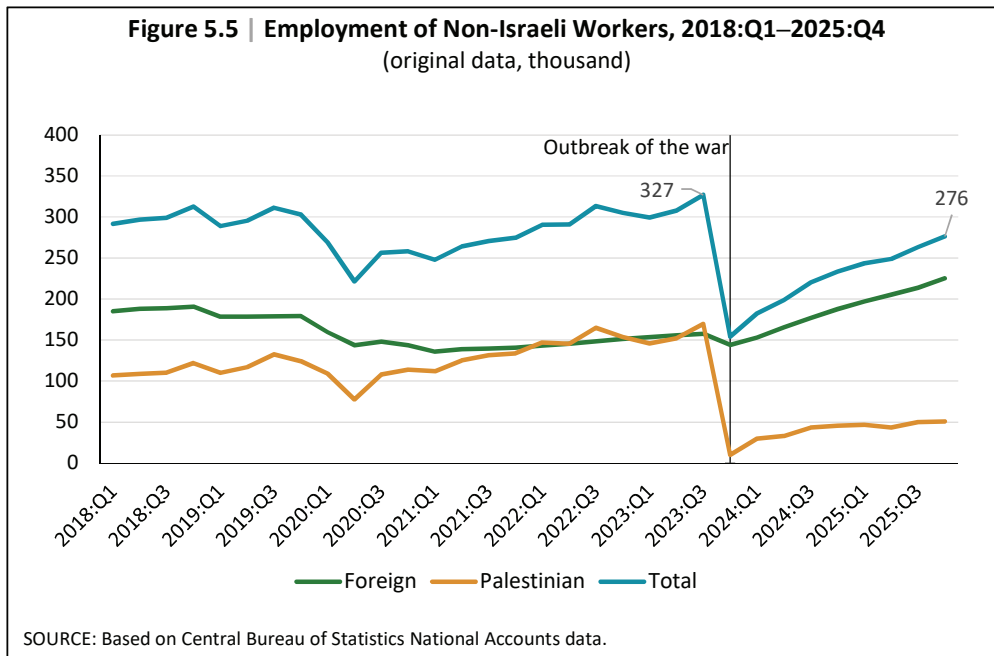
reserve service. Among workers called up at particularly young ages (21–24), civilian non-employment in the following year was especially pronounced—45 percent, compared with 27 percent among other workers.



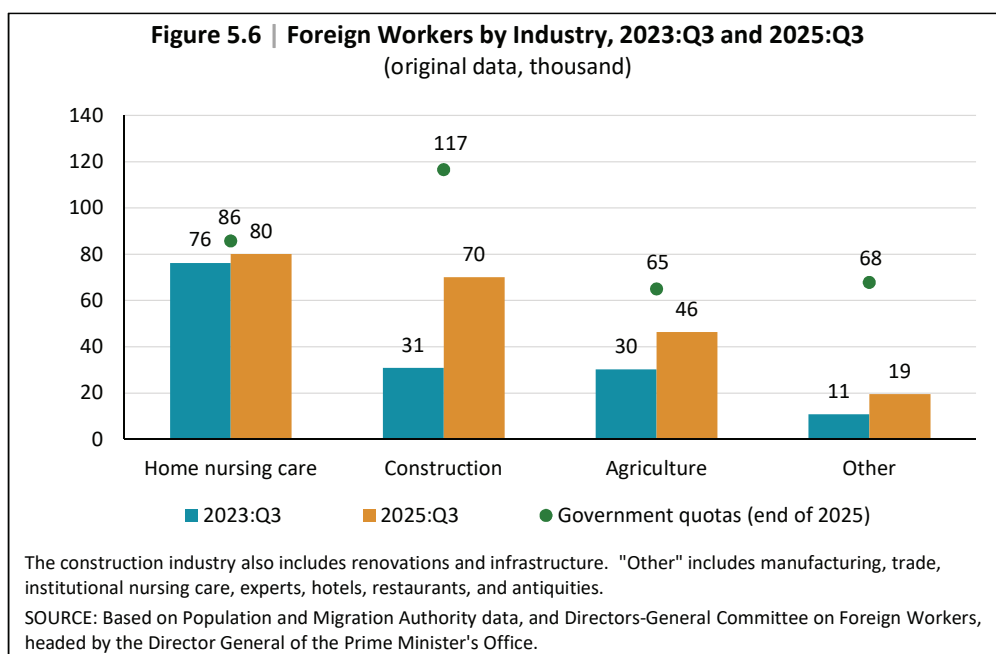
Some spouses of reservists also reduced their employment. About 20 percent of them (compared with 10 percent among other spouses of employed persons) worked less than usual during 2025, and an average of about 13 percent were temporarily absent from their workplaces, compared with about 8 percent among other spouses of employed persons. The excess decline in employment among spouses of reservists relative to other spouses of employed persons amounts in total to about 0.1 percent of the labor force.

Another factor contributing to the labor shortage was the decline in the number of non-Israeli workers. This decline occurred immediately upon the outbreak of the war, when the entry of most Palestinian workers was halted, causing the number of non-Israeli workers to fall immediately by about 110,000 relative to the third quarter of 2023 (Figure 5.5). Over the past two years, this decline was partially and gradually offset by an increase of about 70,000 in the number of foreign workers. A substantial share of the foreign workers who arrived were employed in construction, where the immediate shortage was concentrated. At the same time, quotas and permits were also expanded in industries that had previously employed almost no foreign workers, such as services and retail.³ Overall, the number of foreign workers in industries other than construction, caregiving, and agriculture increased this year by about 8,000 (Figure 5.6).

The number of foreign workers increased, but it still does not compensate for the decline in the number of Palestinian workers due to the war.



³ For example, under the July 2024 decision by the Directors General Committee on Foreign Workers, the trade and services industries were allocated a quota of up to 6,400 foreign workers, similar to the number of Palestinian workers in that industry before the war. This quota was later expanded to 12,800 foreign workers in February 2025 and to 25,000 in August 2025.



Assuming that the number of foreign workers continues to increase at a pace similar to that of the past two years, the number of non-Israeli workers is expected to return to its prewar level during 2027. Moreover, if all currently approved foreign worker quotas are fully utilized, the number of non-Israeli workers in the long run will be about 20 percent higher than on the eve of the war.

Expanding the quotas for foreign workers signifies a shift in policy.

This increase in foreign worker quotas reflects a shift in employment policy, which in the past had generally favored maintaining a relatively low number of foreign workers. Expanding the quotas has a clear advantage in alleviating the immediate labor shortage and reducing the Israeli economy's sensitivity to security shocks that impair the supply of Palestinian labor, particularly in construction. In addition, while the previous period in which Israel admitted a large number of foreign workers—at the beginning of the 2000s (Bank of Israel, 2024)—was a period characterized by high unemployment and concern about competition with Israeli workers, especially those less educated, in recent years the labor market has been tight and unemployment low. Accordingly, this consideration is now less central.

Expanding the quotas for foreign workers is easing the shortage, but may come with future costs.

At the same time, increasing the number of foreign workers also entails costs. For example, the entry of foreign workers weakens the labor market's standard adjustment mechanism in times of shortage—namely, rising wages for Israeli workers. Accordingly, such a policy may reduce incentives for efficiency gains, technological adoption, and productivity improvement, and is also likely to diminish the attractiveness of these industries to Israeli workers. These costs are particularly salient when the expansion of foreign labor takes place in industries that did not previously rely extensively on Palestinian labor, such as trade and services, where the

introduction of foreign workers may “lock in” a labor-intensive, low-wage business model, precisely after the productivity gains achieved in these industries at the end of the previous decade (Bank of Israel, 2023). A policy of increasing the cost of employing foreign workers—for example, by raising the levy—could help ensure that the main rationale for employing such workers is a shortage that is difficult to bridge, together with the workers’ high value added, rather than the provision of cheap labor that delays improvements in technological productivity. Another potential cost of the entry of foreign workers—who, unlike Palestinians, reside within Israel—is increased demand for local housing services and, consequently, upward pressure on rents.

A further constraint on net labor supply was reflected over the past year in slower growth of the working-age population due to negative migration from Israel. Part of this negative migration reflects the unusually large inflow of immigrants in 2022 and 2023 following the Russia–Ukraine war, and the subsequent departure of some of those immigrants to their countries of origin or to other countries. However, even excluding these immigrants, there was excess emigration from Israel over the past two years (relative to the 2016–2019 average), estimated at about 17,000 employed persons, or about 0.4 percent of the labor force (see the extended discussion in Chapter 1).⁴ It is still too early to assess whether this phenomenon signals a persistent change that will constrain the economy’s labor supply over time.

Negative migration in the past two years has created a further constraint on the supply of labor.

3. THE DEMAND FOR LABOR

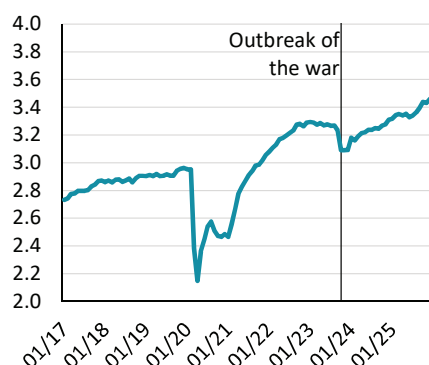
Demand for labor in the business sector, defined as the sum of filled and vacant positions, continued to increase during 2025. In the final quarter of the year, labor demand was 5 percent higher than on the eve of the war (Figure 5.7a). Nevertheless, the number of people employed in the business sector remained about 1 percent below its prewar level. This gap—between labor demand and the supply constraints described in the previous section—was reflected in a historically high job vacancy rate in the business sector, of about 4.5 percent (Figure 5.7b), alongside a low unemployment rate. Accordingly, in the final quarter of 2025, labor market tightness, as reflected in the ratio of vacancies to unemployed persons, declined only moderately relative to the corresponding quarter of the previous year (1.07, compared to 1.13), and remained high by historical standards. This was because the increase in labor demand this year acted as a countervailing force to the increase in labor supply resulting from the arrival of foreign workers and the release of reservists, as discussed above.

The demand for workers increased this year.

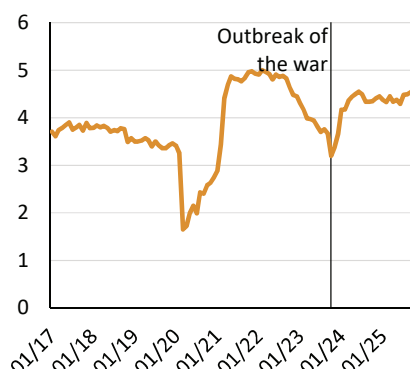
⁴ If one also includes immigrants who arrived in Israel in 2022–2023 and left during the past two years, and assumes an employment rate similar to that of the general population, then excess negative migration doubles in volume and is estimated at about 34,000 employed persons. This is an upper bound on the volume of decline in employment, since these immigrants, who stayed in Israel for only a short period, likely worked less than other Israelis.

Figure 5.7 | Demand for Labor in the Business Sector, and Job Vacancy Rate, January 2017–December 2025
(seasonally adjusted data)

a. Total demand for labor in the business sector
(filled and vacant posts, million)



b. Job vacancy rate



Total demand for labor is defined as the sum of job vacancies and filled positions in the Central Bureau of Statistics Job Vacancy Survey.

SOURCE: Based on Central Bureau of Statistics.

Most of the increase in job vacancies was in industries with a high rate of male employees or of young employees.

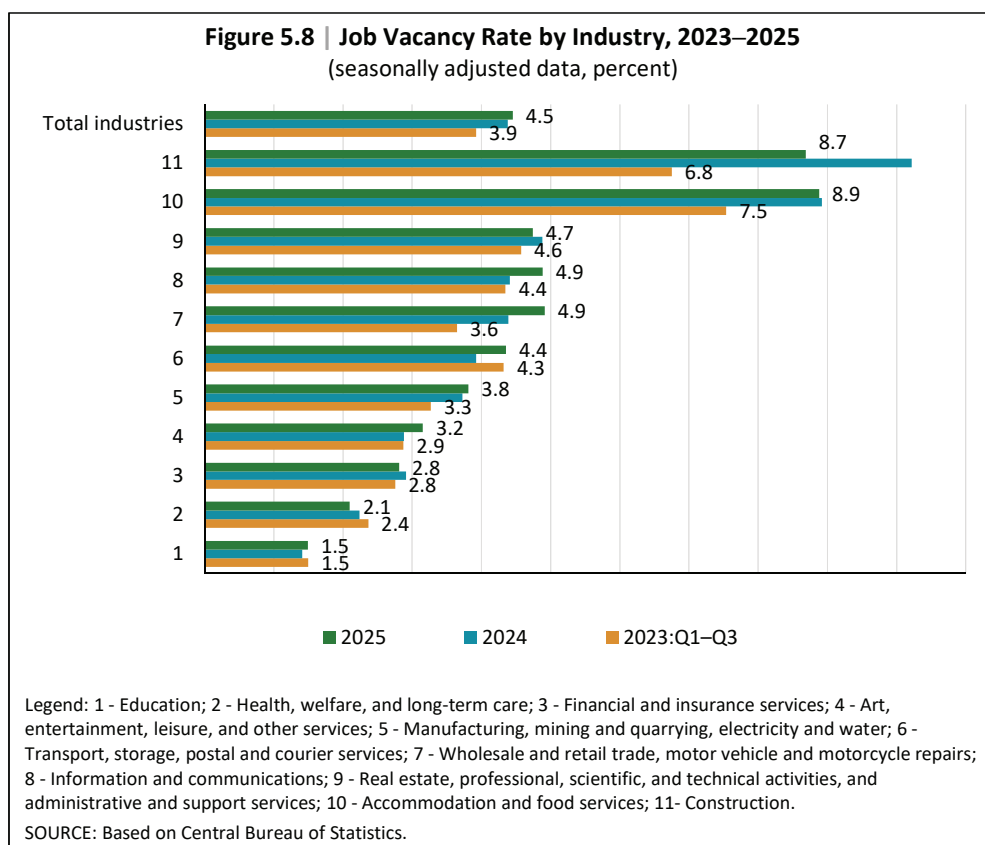
Employment and job vacancies in high tech increased this year, and there is no indication that artificial intelligence has led to a reduction in the number of high-tech workers.

The sharpest increase in vacancies following the outbreak of the war was in construction. However, the vacancy rate in that industry declined in 2025, due to partial staffing by Israeli and foreign workers. In addition, the trade, accommodation, and food services industries showed marked increases in vacancies over the past two years relative to the prewar period (Figure 5.8). These industries are characterized by a high share of young and male workers, whose shortage was particularly pronounced against the background of the extensive reserve mobilization. Figure 5.9 presents the positive correlations—of about 0.5—between these characteristics and the increase in the number of vacancies since the outbreak of the war.⁵

Demand for workers in the high-tech sector recovered, and after two years of continuous decline, the vacancy rate in the sector increased this year. Employment in high-tech rose moderately, by about 1 percent—a change from the stagnation in the number of workers that had prevailed since the end of 2022 against the background of weaker global demand for technology. At present, there is no clear empirical indication that part of this stagnation also reflected job cuts due to the increased use of artificial intelligence. First, the stagnation in high-tech employment is already evident in employee-post data from September 2022, about three months before the public launch of large-scale AI models. Second, in two dedicated surveys of the high-tech sector conducted separately by the Central Bureau of Statistics and the Israel Innovation Authority, fewer than 10 percent of high-tech firms reported

⁵ These correlations also reflect the representation of young people and men both among reservists and among foreign workers. To net out the effect of foreign workers, we excluded the construction industry, which reduces the correlation to 0.3 for men and raises it to 0.7 for young people.

employment reductions due to the adoption of AI tools.⁶ At this stage, there is still no clear evidence that artificial intelligence is having an effect on the scale of employment in high-tech.

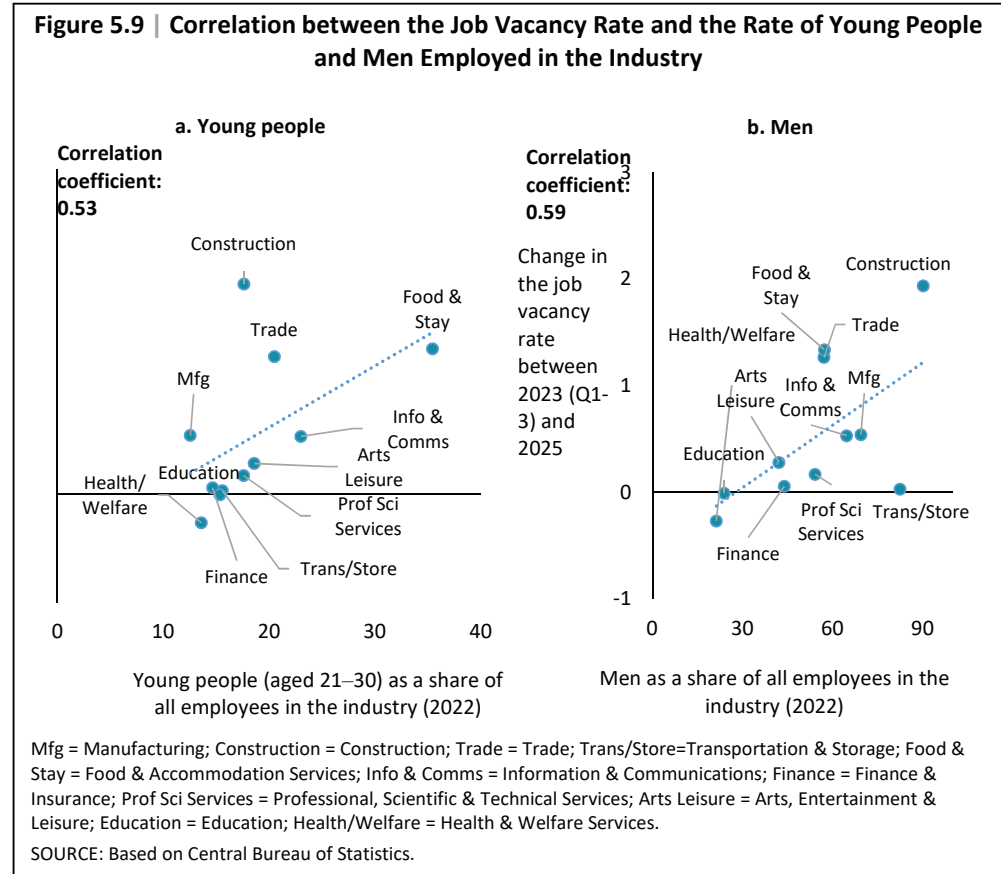


However, international studies have found that AI is changing the nature of tasks in high-tech toward those requiring less basic programming and more supervision and oversight of code generation through software tools and agents. It therefore requires high-tech workers to adapt to the changing environment and to realign their skills with these new tasks (Humlum and Vestergaard, 2025; Ranganathan and Ye, 2026). More broadly, there are assessments that artificial intelligence is expected to affect employment in various industries in the future, particularly in occupations with a high share of tasks that it can replace, such as customer service, clerical work, and sales, as reviewed in Box 5.1 of the Bank of Israel Annual Report for 2024 (Bank

⁶ In the CBS Business Tendency Survey (June 2025), 91 percent of high-tech firms reported that the adoption of artificial intelligence had not, to date, led to a decline in the number of employees, even though most firms in the sector reported increasing use of AI for routine tasks. In an additional survey conducted by the Israel Innovation Authority (2026) in cooperation with Zviran, only 5 percent of firms reported downsizing or closing departments due to the implementation of AI, and only 3 percent reported hiring fewer workers because AI tools had been integrated into work processes.

of Israel, 2025). Artificial intelligence is also expected to contribute positively to labor productivity and economic growth in the coming years, particularly if adequate public resources are invested in appropriate infrastructure and in the creation of suitable regulatory frameworks, as discussed in Box 1.2 in Chapter 1 of this Report.

Figure 5.9 | Correlation between the Job Vacancy Rate and the Rate of Young People and Men Employed in the Industry

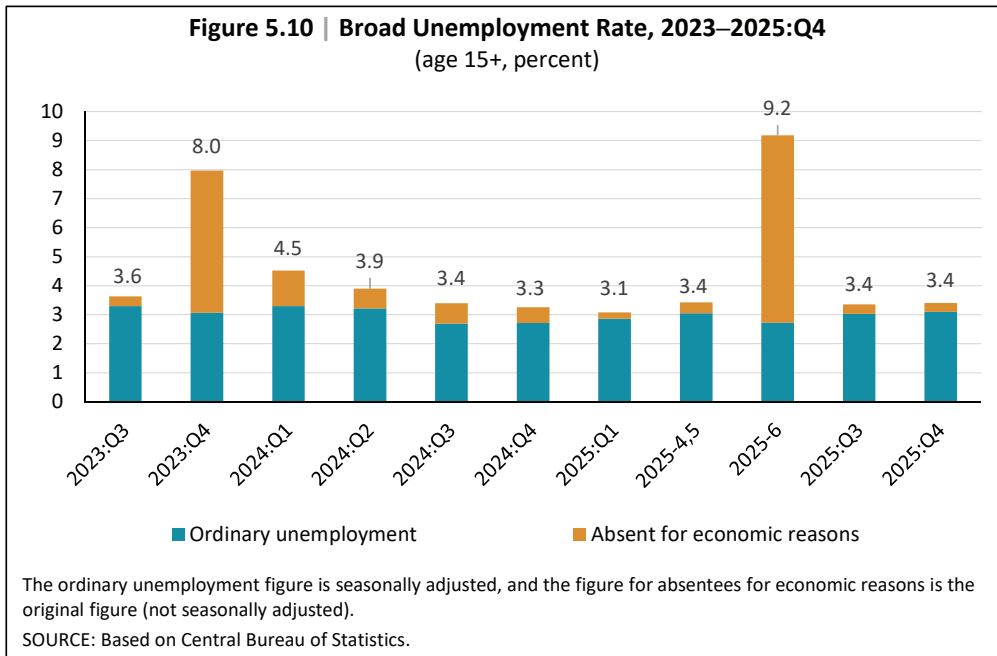


4. UNEMPLOYMENT AND EMPLOYMENT

The unemployment rate this year was low by historical comparison, at about 3 percent.

Excess demand for workers relative to the supply constraints was reflected in a historically low unemployment rate of about 3.0 percent (Figure 5.10). Broad unemployment, which also includes persons absent for economic reasons (on unpaid leave), stood at 3.3 percent this year, apart from a temporary increase to 9.2 percent in June 2025 due to workers being placed on unpaid leave during Operation Rising Lion.

Total employment increased this year by about 3.0 percent, and the number of employee posts increased by about 2.6 percent (annual average). From a two-year perspective, since the outbreak of the war, total employment (in terms of employee posts) has been about 0.5 percent higher than in the prewar period, though with



substantial divergence between the business sector—where the number of posts remained 1 percent below its prewar level—and the public services sector, where employment expanded over the past two years (Figure 5.11a). Employment growth was recorded across all public service industries: public administration, healthcare, and education (Figure 5.11b).

This divergence between the business and public sectors is related to two main factors. First, staffing positions in the business sector has been more difficult due to the extensive reserve mobilization, since the share of reservists in business sector industries is much higher than in public services industries (see Figure 5.3 above). Second, the economy’s shortage of 60,000 non-Israeli workers is concentrated in the business sector—particularly in construction and agriculture—and is not a major factor in the public services industries.

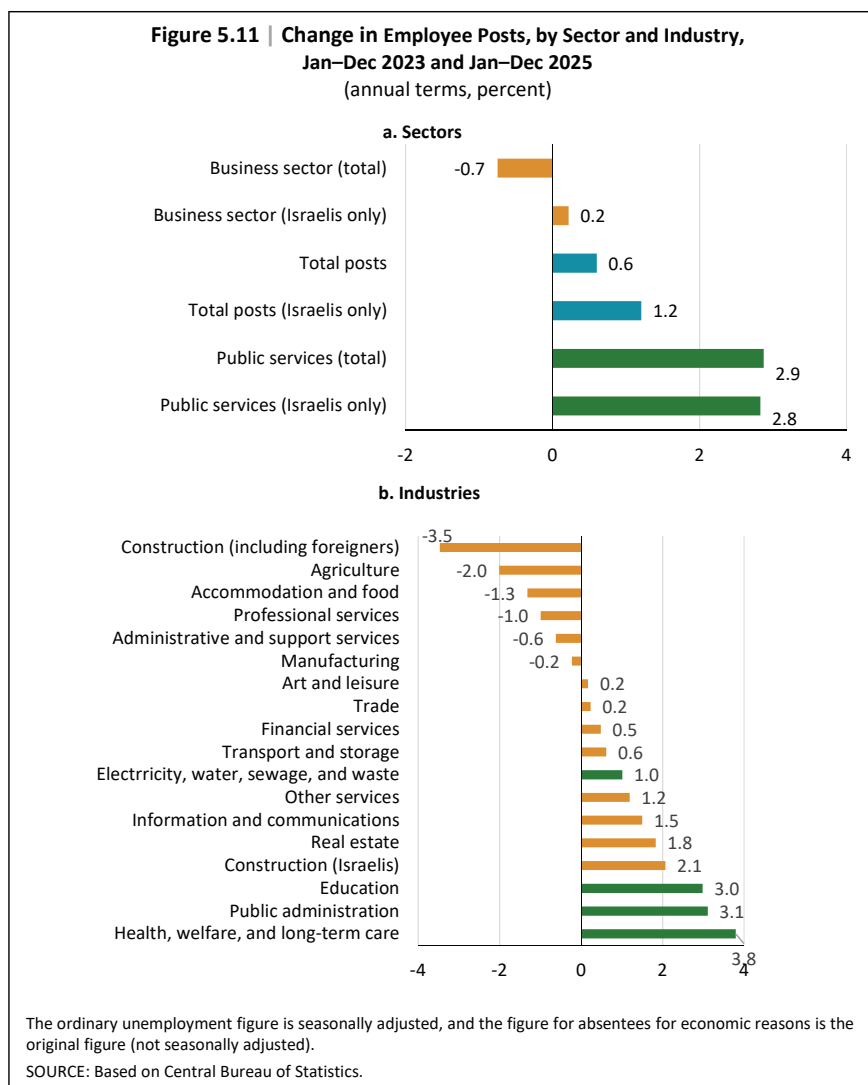
Within the business sector, the industries showing the largest decline in the number of posts relative to the prewar period are construction (due to the shortage of Palestinian workers), agriculture, and accommodation and food services. By contrast, employment in information and communications increased by about 1.3 percent relative to the prewar period, reflecting the recovery in demand in the high-tech sector.

In addition, there was a marked increase in the employment of Israelis in the construction industry. This development has positive aspects, as it helped address the labor shortage in the industry created by the war and also points to dynamism and adaptability in the labor market. However, quantitative estimates of this increase since 2023 vary widely—from about 10,000, according to administrative data on

While the public services sector expanded, employment in the business sector did not return to its prewar level.

In the past two years, the employment of Israelis in the construction industry has grown.

employee posts (both mid-year and year-end), to about 30,000 on an annual average basis and 60,000 at the end of 2025, according to Labor Force Survey data.⁷



⁷ Part of this gap may reflect an increase in the number of jobs held by workers who were employed in construction before the war but for whom this was not their main job, and who therefore were not previously classified in the Labor Force Survey as construction workers. However, in terms of orders of magnitude, this assumption cannot fully explain an increase of 60,000 salaried workers over such a short period, since according to National Insurance Institute data there were at that time only about 125,000 men in Israel holding more than one job. Another explanation could be that employee posts declined among workers who had previously held multiple jobs, and that this decline masked the increase in the number of employees in construction. In practice, however, the total number of men in Israel holding multiple jobs declined by only about 6,000 between 2023 and 2025. A further possible explanation is that part of the increase reflects unauthorized workers who reported themselves as employed in the Labor Force Survey but do not receive formal pay slips.

5. WAGES AND THE COST OF LABOR

Labor supply constraints, alongside rising demand for workers, led to wage increases in the economy and to a rise in GDP labor share. Wage developments in the business sector and in public services are shown in Figure 5.12. In the fourth quarter of the year, nominal wages were about 3.3 percent higher than in the corresponding quarter of the previous year, while in the business sector the increase was 4.2 percent.⁸ For business sector employees this amounted to a real wage increase of about 1.7 percent. By contrast, from the employers' perspective, the real wage increase was even larger—3.9 percent—since the business sector output price index rose by only 0.3 percent this year. This trend led to an increase in labor compensation as a share of output (GDP labor share). Figure 5.13 presents the development of wages and of the GDP labor share in recent years. The figure indicates that since the outbreak of the war, the decline in GDP labor share in the business sector that had characterized previous years came to a halt, and over the past year the share even increased—a dynamic consistent with a tight labor market.

There were wage increases across all industries in the economy. However, contrary to the expectation that industries characterized by the most severe labor shortages would exhibit stronger wage growth, there was actually an opposite (negative) correlation between the change in the job vacancy rate at the industry level and wage growth. Particularly in the trade, construction, and accommodation and food services—industries in which vacancies increased markedly during the war—wages rose at a slower pace than the average. Even so, in industries where wage growth was below the average, there was still cumulative nominal wage growth of between 6 and 9 percent over a two-year period—that is, an increase in real wages.

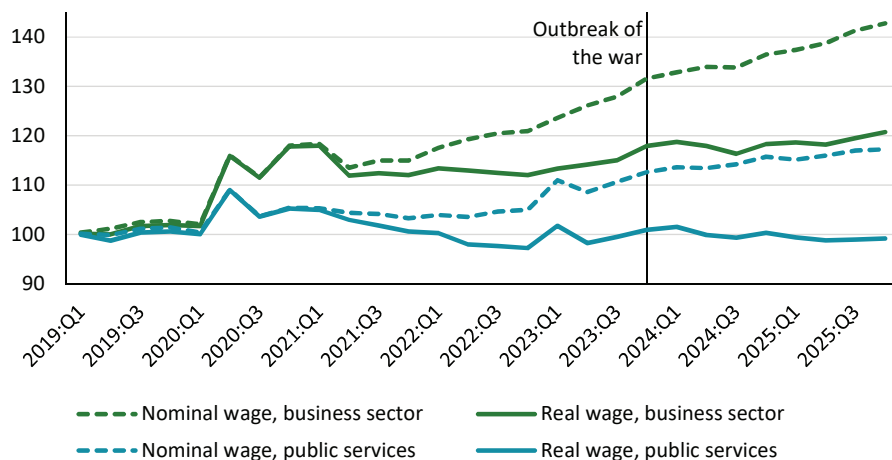
One possible explanation for this variation is that wages increased more markedly in industries in which employment is more concentrated among large employers (Figure 5.14). Such employers have larger financial buffers or greater market power with which to respond to labor shortages through wage increases. By contrast, in industries characterized by a large number of small businesses, such as trade and accommodation services, cash flow constraints and low profit margins may limit the ability to address labor shortages through large or rapid wage increases. These findings are also consistent with the economic literature, which has found more frequent wage adjustments among large firms, whereas wages in small firms tend to be more rigid (Schaefer and Singleton, 2023; Grisby et al., 2021). Wage rigidities in some industries may also help explain the negative correlation between changes in vacancies and changes in wages, since the direction of causality may in fact run the other way: Industries that find it harder to raise wages in line with market conditions may face longer recruitment periods, which are reflected in higher vacancies.

The tightness of the labor market was reflected in an increase in real wages and in the business sector GDP labor share.

Wage increases in the business sector encompassed all industries, particularly those with large businesses.

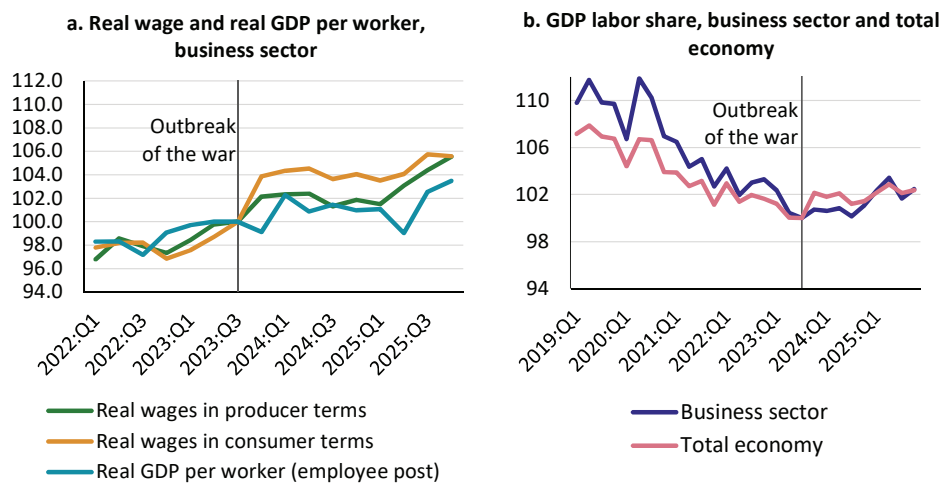
⁸ In the third quarter, the increase relative to the corresponding quarter of the previous year was even more pronounced, at 4.8 percent.

Figure 5.12 | Index of the Average Wage per Employee Post in the Business Sector and the Public Services, Real and Nominal, 2019:Q1–2025:Q4
(seasonally adjusted, Israelis, index: 2019:Q1=100)



SOURCE: Based on Central Bureau of Statistics.

Figure 5.13 | Real Wages, Real GDP per Worker, and GDP Labor Share
(seasonally adjusted data, index: 2023:Q3=100)

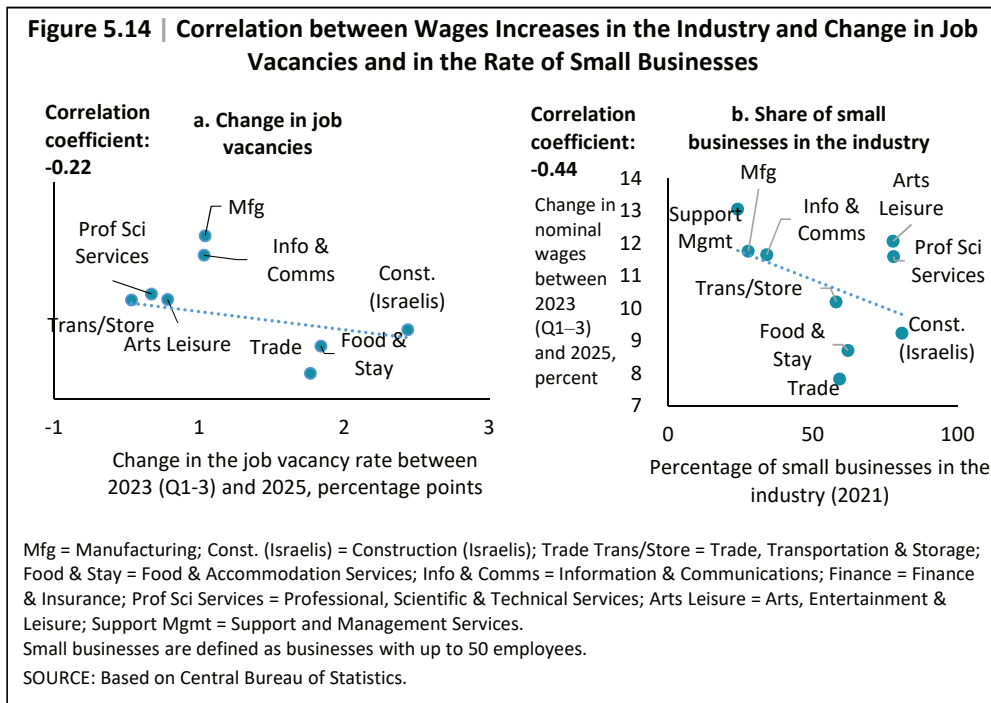


SOURCE: Based on Central Bureau of Statistics.

Real wages in the public services declined this year. This was due in part to a 3.3 percent wage reduction for public sector employees, implemented from April 2025 under an agreement between the Histadrut and the government. In 2026, this reduction will expire and be replaced by a reduction of 1.2 percent. From a longer-term perspective, real wages in the public sector are currently at the same level as in

2019, compared with a parallel increase of 18 percent in the business sector. Such a markedly different trend path between the public and private sectors may, over time, lead to a decline in the quality of human capital in the public sector and, as a result, impair the quality of services provided to the public.⁹ It is therefore important that future wage agreements take into account the need to recruit skilled workers to this sector. (For further discussion, see Chapter 6 of this Report.)

Real wages in the public sector did not increase relative to their 2019 level, while wages in the business sector increased by 18 percent.



⁹ Mazar (2025) found a decline in the level of basic skills among public sector employees over the past decade.

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Chapter 6

The Public Sector and its Financing

- » The central government's budget deficit in 2025 amounted to 4.7 percent of GDP. The general government deficit totaled 6.5 percent of GDP—a decline from 9.0 percent in the previous year—while the debt-to-GDP ratio rose slightly, from 67.6 percent to 68.5 percent.
- » The budget deficit was broadly in line with the original target (4.9 percent of GDP), as the expenditure overrun was offset by a positive revenue surprise.
- » Defense expenditures in 2025 were only slightly lower than in 2024, despite the lower intensity of the war during most of the year. The fiscal cost of the war that began on October 7, 2023 is estimated at approximately NIS 350 billion over the years 2023–2026 (excluding decisions adopted since the beginning of Operation Roaring Lion—the military campaign against Iran that began in late February 2026), of which about NIS 116 billion were spent in 2025.
- » Roughly half of the war-related costs were financed through debt issuance. The share of debt financing declined during the year, reflecting an increase in tax revenues, which was largely due to tax measures amounting to about 1.5 percent of GDP that came into effect in 2025. The government also implemented expenditure-reducing measures, including a temporary freeze on public sector wages.
- » The adjustment programs approved alongside the supplementary 2024 budget and the original 2025 budget contributed significantly to strengthening market confidence in the government's capacity and commitment to address large-scale security shocks, particularly in view of the uncertainty prevailing at that time.
- » The structural deficit—which reflects the government's medium-term policy decisions and expectations regarding future measures—remains somewhat larger than the level necessary to stabilize the debt (around 3.2 percent of GDP), and certainly above the level needed to reduce it.
- » Following the war, Israel's debt-to-GDP ratio increased relative to that of the group of small, open, and advanced economies to which Israel was comparable on the eve of the COVID-19 crisis. The ratio of interest payments to GDP—which was already in the upper third among advanced OECD economies prior to the war—also rose.
- » The events of recent years have underscored Israel's exposure to global and domestic shocks that could sharply raise the debt-to-GDP ratio. It is therefore essential to restore orderly budgetary processes and to redefine fiscal targets, accompanied by credible measures aimed at reducing the debt-to-GDP ratio to a level that would provide Israel with the fiscal space needed to cope with future shocks.

350
billion shekels

The estimated **fiscal cost** of the war



Tax increases contributed to lowering the deficit this year to 4.7 percent of GDP

↑ 68.5%

The debt to GDP ratio **increased** due to the war



The deficit path for the coming years is **higher** than what is necessary to reduce the debt

1. MAIN POINTS

The fiscal cost of the war that began on October 7, 2023 is estimated at approximately NIS 350 billion.

The war that began on October 7, 2023 imposed a heavy fiscal burden on Israel. The defense and civilian fiscal costs of the war—estimated at NIS 350 billion—led to an increase in the deficit. As a result, the debt-to-GDP ratio, which stood at 60.5 percent at the beginning of 2023, rose sharply to 68.5 percent by the end of 2025, exceeding the OECD median of about 57 percent. In addition to the war-related expenditures already incurred, it appears that a substantial permanent increase in the defense budget will be required, the magnitude of which has yet to be determined, alongside civilian rehabilitation expenditures and higher interest payments resulting from the increase in debt.

The deficit declined, and was close to the original target, but remains higher than what is necessary to reduce the debt to GDP ratio.

Defense expenditures in 2025 were similar to those in 2024, despite the lower intensity of fighting during most of the year, and civilian expenditure also remained at its elevated level following last year's increase. Both the rise in defense spending and the increase in civilian expenditure included a temporary component, reflecting the war, and a structural component, related to the war's long-term implications and other structural factors. Consequently, the deficit remained higher than what is necessary to reduce the debt-to-GDP ratio, even though the general government deficit declined from 9.0 percent of GDP in the previous year to 6.5 percent in 2025. The decline in the deficit was supported by the government's decision, as part of the 2025 budget, to implement tax measures amounting to about 1.5 percent of GDP. Both these measures and the adjustment programs approved as part of the 2024 budget contributed significantly to strengthening market confidence in the government's capacity and commitment to address large-scale security shocks, particularly in view of the uncertainty prevailing at that time.

The uncertain security situation made it difficult to plan expenditures.

The year 2025 was characterized by high security and economic uncertainty, due to volatility in expectations regarding the duration, intensity, and implications of the fighting. This uncertainty made fiscal management and the assessment of required

expenditures particularly challenging. The materialization of the risk of security escalation required the use of the reserve allocated for 2025 and an update, in September 2025, of the expenditure framework and deficit ceiling. The use of the reserve (NIS 10 billion) increased the expenditure framework to NIS 619 billion, and it was subsequently expanded to NIS 650 billion (an addition of about 1.5 percent of GDP) due to Operation Rising Lion (the campaign against Iran in June 2025) and the continued fighting in Gaza. This was the fifth expansion of an approved budget framework since the outbreak of the war, reflecting the difficulty of planning expenditures under conditions of prolonged security uncertainty. Nevertheless, the 2025 deficit was similar to the level planned when the budget was approved by the Knesset (March 2025), as revenues were also higher than expected due to stronger-than-anticipated direct tax collection.

Despite the higher-than-expected expenses, the deficit remained close to what was planned thanks to surprising revenues.

Beyond the budgetary additions themselves, fiscal management in 2025 differed from the practices that prevailed prior to the war and the COVID-19 crisis. The 2026 budget process was delayed and conducted with limited transparency: the budget proposal was approved by the government only in early December, instead of at the end of August as would be optimal; the proposal that decision-makers submitted to the government left considerable uncertainty regarding the framework on which ministers would vote; and even after government approval, no detailed breakdown of civilian ministry expenditures was published. In addition, the budget passed its first reading in the Knesset only at the end of January 2026, a situation that required operating under an interim budget, limited in scope, during the first months of the year. At that time, Operation Roaring Lion (the campaign against Iran that began in late February) broke out, and the government was required to expand the 2026 budget framework before its approval by the Knesset. Furthermore, the payment mechanism for military reserve days without actual service, intended to encourage continued participation, was expanded in view of the heavy reserve duty burden on those serving.

The repeated expansions of the budget framework since the COVID-19 crisis and the war were received with acceptance by the markets, as reflected recently in the decline of the risk premium to levels close to those that prevailed before the war. This was partly due to the fact that the expansions were accompanied by permanent adjustment measures that offset a significant portion of the permanent expenditure increases. Nevertheless, it is important to prepare for potential future shocks. To support this, it is essential to return to institutional budgetary procedures and optimal approval processes, to redefine medium-term fiscal targets, and to establish a reliable multiyear planning framework that will lead to a gradual reduction in the debt-to-GDP ratio.

It is essential to return to institutional budgetary procedures and credible fiscal targets.

Budget Approval and Management Procedure

The budget preparation process in Israel is designed to enable informed decision-making, consistent fiscal planning, and parliamentary oversight. The process is based on the Basic Law: The State Economy (1975), on the fiscal rules formulated following the 1985 Economic Stabilization Program, and on the Deficit Reduction Law (1992), which for the first time established multiyear deficit targets and fiscal frameworks as a binding basis for budget preparation.

However, for several years—beginning with the sequence of biennial budgets and frequent elections at the end of the previous decade, through the COVID-19 pandemic, and up to the war years that began on October 7, 2023—Israel has not operated a regular and timely budgetary process. The orderly process, illustrated in the diagram below, begins with a discussion of the macroeconomic forecast, followed by a discussion of the budgetary frameworks, including the deficit target and the expenditure ceiling, which serve as anchors for budget planning. Subsequently, a detailed budget proposal is formulated in cooperation with the government ministries and submitted for government approval. The approved proposal is then presented to the Knesset for debate in the plenary and committees and for approval through the legislative process. The approved budget is binding on the government throughout the fiscal year, without ad hoc additions, except in exceptional circumstances (as indeed required in recent years).



Approval of the Budget Law – second and third readings
(during December)



Implementation, reporting, and monitoring during the fiscal year in
accordance with the approved budget
(during the fiscal year)

The economic literature that developed in the 1990s (for example, Von Hagen and Harden, 1995) emphasized that the establishment of binding fiscal frameworks at the outset of the budget approval process is a key condition for restraining excessive expenditure and improving fiscal performance. It transforms the resource constraint into a hard budget constraint, requiring ministries to align their demands with a predetermined framework that reduces “fiscal illusion”—that is, the tendency of ministers to overestimate the benefits of their ministries’ activities. This insight is consistent with more recent recommendations, including the International Monetary Fund’s Fiscal Transparency Handbook (IMF, 2018), which highlights the need for a clear distinction between the determination of the fiscal framework and the allocation of specific resources. The report also stresses the importance of adhering to the budget timetable, since without it, resources are allocated according to rules that have not been properly debated and with limited transparency. Both empirical research and international recommendations therefore indicate that an early and clearly defined framework is not merely a procedural component, but an essential institutional mechanism for strengthening fiscal discipline, enhancing transparency, and improving the credibility of fiscal policy and the efficiency of budgetary resource allocation.

Table 6.1 | The main components of the government's revenue and expenditures, 2015–2025

	percent of GDP						
	2015– 2019	2020	2021	2022	2023	2024	2025
Central government - budget definition							
Total public revenue	25.4	22.5	26.1	26.6	23.3	24.2	26.2
Total public expenditures	28	33.9	30.5	26.0	27.4	30.9	30.9
<i>of which</i> : Defense expenditures	5.3	5.0	4.7	4.2	5.2	8.4	7.8
Civilian expenditures	20.3	26.7	23.7	19.8	20.3	20.5	20.7
Initial deficit	0.3	9.3	2.3	-2.5	2.2	4.7	2.4
Interest expenditures	2.3	2.1	2.1	1.9	1.9	2.0	2.3
Total deficit	2.6	11.4	4.4	-0.6	4.1	6.7	4.7
General government - National Accounts definition							
Total public revenue	36.5	34.6	36.9	37.4	34.5	35.8	38.5
<i>of which</i> : Income from property	0.5	0.4	0.5	0.6	0.7	0.8	0.9
Total taxes	30.9	29.6	32.2	32.6	29.4	30.4	32.9
Indirect taxes on domestic production	12.3	11.5	12.5	12.2	10.5	11.1	11.7
Indirect taxes on civilian imports	2.8	2.7	2.8	2.8	2.5	2.6	2.4
Direct taxes, fees and levies	10.6	10.2	11.9	12.6	11.3	11.8	13.5
National Insurance Institute revenue	5.2	5.2	5.0	5.0	5.0	4.9	5.3
Grants	1.3	1.0	1.0	1.1	1.2	1.5	1.4
Other ^a	3.8	3.6	3.3	3.2	3.2	3.2	3.3
Total public expenditure^b	39.6	45.8	42.1	39.2	41.6	44.8	45.0
Current expenditure	36.8	42.5	39.3	36.2	37.9	41.0	41.3
Civilian expenditure on services and in-kind transfers	19.5	20.7	19.5	18.7	19.1	19.4	19.6
Domestic defense consumption	4.6	4.4	4.1	3.9	5.0	6.8	6.5
Defense imports	0.3	0.3	0.4	0.2	0.3	0.8	0.7
Direct subsidies	0.8	4.0	3.0	1.0	1.1	1.1	1.1
Transfer payments on current account	9.5	11.2	9.5	9.0	9.4	9.7	9.7
Interest payments ^c	2.2	2.0	2.8	3.4	2.9	3.1	3.6
Transfer payments on capital account ^d	0.6	0.5	0.6	0.8	1.3	1.4	1.0
Investments of the general government including investment grants ^b	2.2	2.8	2.2	2.2	2.5	2.5	2.8
<i>of which</i> : Net civilian investment	1.9	2.6	2.0	1.9	2.1	1.5	1.7
Primary civilian expenditure^b	32.4	39.0	34.6	31.4	33.0	33.1	33.1
Total deficit of the general government^{b,e}	3.1	11.3	5.1	1.8	7.1	9.0	6.5
Current deficit of the general government	1.7	9.4	4.3	0.7	4.7	6.5	4.3
Total cyclically adjusted deficit using international definition ^b	3.1	8.5	5.1	2.8	7.1	7.8	5.2
Net public debt ^{f,g}	58.0	67.0	64.1	58.3	59.2	64.9	66.4
Gross public debt ^f	60.8	71.1	67.8	60.5	61.3	67.6	68.5

^a Includes transfer payments from the public on the current and capital accounts, imputed pensions, civilian sales, capital transfers from abroad, and transfers from abroad to National Institutions and nonprofit organizations.

^b Excludes the reduction of expenses financed by the sale of land. Beginning with the 2022 statement, the recording of defense investments was moved from defense consumption and imports to government investments. Depreciation of defense fixed capital is recorded in domestic defense consumption.

^c Interest expenses are calculated on a cumulative nominal basis plus indexation differentials on the public debt.

^d Includes mortgage subsidies, discounts on state land, and transfers on the capital account to nonprofit organizations and businesses, including compensation from the property tax fund.

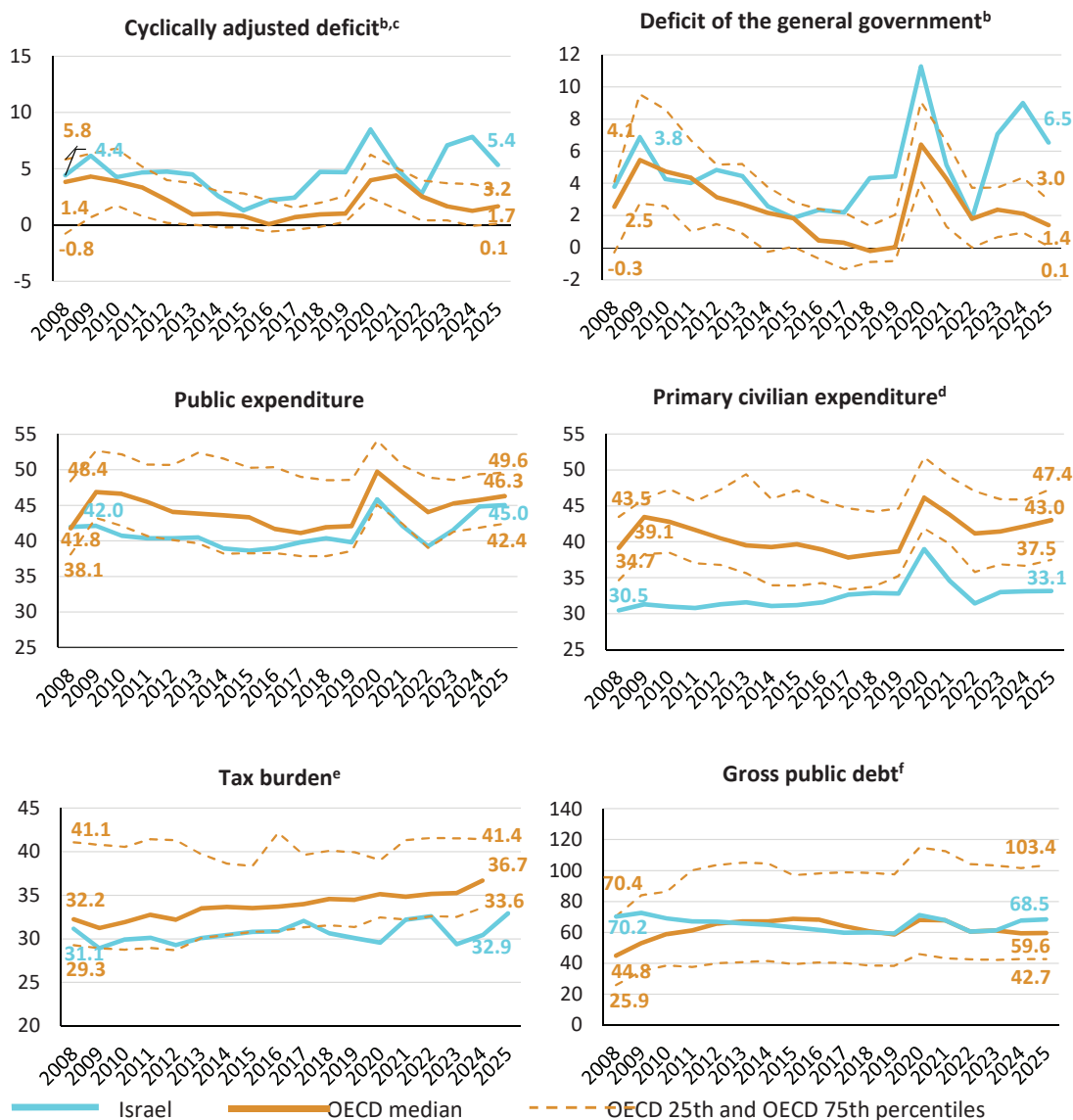
^e The general government's deficit is calculated in accordance with the National Accounts definitions, which differ from those used in calculating the central government's budget deficit.

^f Excluding municipalities' debts to the government.

^g Net public debt equals the gross public debt minus active loans minus government deposits with the Bank of Israel.

SOURCE: Based on Central Bureau of Statistics.

Figure 6.1 | The Fiscal Aggregates in Israel Compared to the OECD^a, 2008–2025
(percentage points)



^a Data for OECD countries are based on all member countries for which there are data.

^b According to the international definitions, excluding revenue from the sale of land.

^c The OECD estimates are as of February 2026.

^d Due to a lack of up-to-date data, defense expenditures in 2025 are equal to defense expenditures in 2023 for all countries, except for Israel.

^e The graphs are presented up to the last year for which there are data in the OECD systems (2024), except for Israel, for which there are data for 2025.

^f The data are in line with the International Monetary Fund's definition, and are taken from the IMF systems.

SOURCE: Based on Central Bureau of Statistics data, OECD data (*Economic Outlook* 118, Dec. 2025, and Revenue

2. FISCAL AGGREGATES AND POLICY: CURRENT ANALYSIS

a. Public expenditures

Public expenditure remained about 3 percent of GDP higher than before the COVID-19 pandemic.

General government expenditure (according to the international definition of the national accounts¹) amounted to 45 percent of GDP—similar to the previous year (Table 6.1). In 2025, central government expenditure (net, according to the budget definitions²) totaled NIS 650 billion, equivalent to 31 percent of GDP. This ratio is similar to that of the previous year and is 3 percentage points higher than the average ratio during 2015–2019, mainly due to the war’s impact on defense spending and on various civilian expenditure items.

(1) Defense Expenditure

The cost of the war and its financing

Defense expenditures in 2025 declined only slightly compared with their level in 2024.

In 2025, defense expenditure declined only slightly compared with 2024 (Figure 6.2). This followed an addition of NIS 31 billion to the 2025 budget, approved by the Knesset in September. The addition financed Operation Rising Lion and the continuation of the fighting in Gaza beyond what had been anticipated when the original budget was approved. The high level of defense expenditure reflected an increase of about 6 percent (in current prices), and as a percentage of GDP, in the government’s domestic defense procurement. Both the rise in domestic government procurement and the higher payments to reserve soldiers represent a significant contribution of government activity to aggregate demand in the economy. (For further discussion, see Box 6.1 in this Report.)

The increase in the defense budget is expected to weigh on the budget in coming years.

Additional government expenditures resulting from the war are expected to total approximately NIS 350 billion for the years 2023–2026 (Table 6.2). This amount is considerably higher than the estimates made in the early stages of the war, which were reflected, for example, in the initial additions to the 2023 and 2024 budgets—about NIS 40 billion and NIS 70 billion, respectively. The escalation in cost is due to the war’s extension beyond expectations, the emergence of additional fronts, and a reassessment of the security challenges and the resulting need for ongoing military buildup. The increase in expenditure was gradual and manifested in four expansions of the budget frameworks during 2023 and 2024, as well as an addition to the 2025 budget. A substantial portion of the burden (about NIS 250 billion) was reflected in the defense budget, which grew beyond the original plan in each year of the war

¹ The general government comprises the central government, the National Insurance Institute, local authorities, and nonprofit institutions (such as health funds, universities, and religious seminaries) whose main source of income is the government, as well as the national institutions (the Jewish Agency, the Jewish National Fund, and the World Zionist Organization). Its activity is measured according to the national accounting definitions, which differ from those used in the state budget. Among other purposes, the definition of general government is used for international comparison.

² Central government expenditure (net) excludes expenditures that are conditional on revenues, such as defense assistance from the US.

(Figure 6.2). The increase in defense expenditure also includes the costs of military buildup, a significant part of which will weigh on the state budget in the coming years. Some of the civilian rehabilitation expenditures are also expected to persist in the medium term.

While most of the war expenditure in 2023 and 2024 was financed through the issuance of debt, the share of debt financing declined markedly in 2025, mainly due to tax increases and positive revenue surprises.

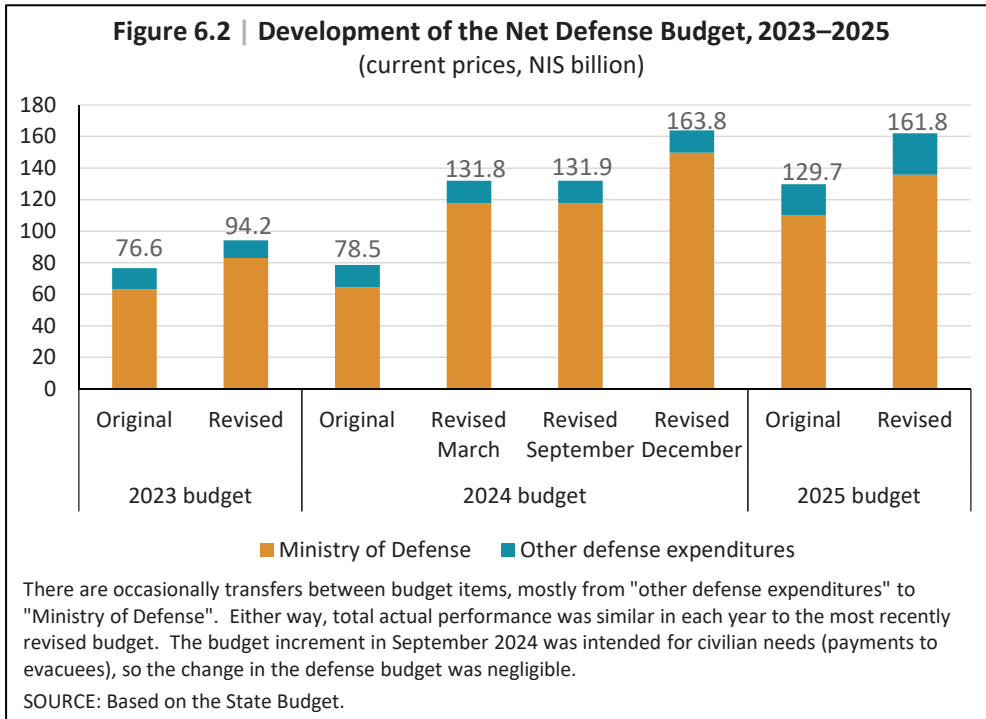


Table 6.2 | Government expenditures due to the war that began on Oct 7, 2023, and their financing

	NIS billion				
	2023	2024	2025	2026	Total
Costs					
Gross expenses increment	34	133	116	69	352
<i>of which:</i>					
Gross defense expenditures ^a	17	99	84	49	249
<i>of which:</i> Permanent increment to the defense budget ^b		10	28	29	67
Property tax fund: Compensation for direct and indirect damage	5	14	11	3	33
Other civilian expenditures ^c	12	19	15	11	57
Increase in interest payments on the government debt		1	6	6	13
Financing methods					
Tax increases		4	30	30	64
Anomalous taxes		32	30	10	72
Expenditure cuts			10	10	20
Special grant from the US		13	6	6	25
Total additional gross income and expenditure cuts		49	76	56	181
Debt and other (remainder) ^d	34	84	40	13	171

^aThe increase in defense expenditures includes all budget increments for the defense establishment beyond the multiyear agreement that was in place before the war, without the ability to separate between current budgeting and intensification budgeting. The increase does not include additional expenses that the government approved following the outbreak of Operation Roaring Lion, or the direct and indirect damages resulting from it.

^bThe permanent addition to the defense budget reflects an estimate based on the budget amount as part of the budget revision for 2023 and 2024 to the multiyear increment of NIS 82 billion until 2031, the increment required for rehabilitation of the disabled as a result of the war (NIS 3 billion in 2025 and NIS 4 billion in 2026), and an assumption that the government will adopt the Nagel Committee recommendations.

^c"Other civilian expenditures" includes the financing of evacuations, temporary reinforcement of internal security, expenses related to Operation "Rising Lion", and permanent increases due to the war, including internal security, mental health, rehabilitation and renewal programs in the north and the south, and expanded National Insurance expenditures for victims of war and terrorism.

^dThe "debt and other" component is a remainder component that includes the increase in debt, erosion of the nominal debt, diversion of expenditures from one year to the next, and other differentials.

SOURCE: Based on Ministry of Finance.

Developments in Payments to Reserve Soldiers

In 2025, according to National Insurance Institute data, reserve service compensation payments totaled NIS 21 billion, compared with NIS 26 billion in 2024. The decline in the volume of payments reflects the reduced intensity of the fighting.

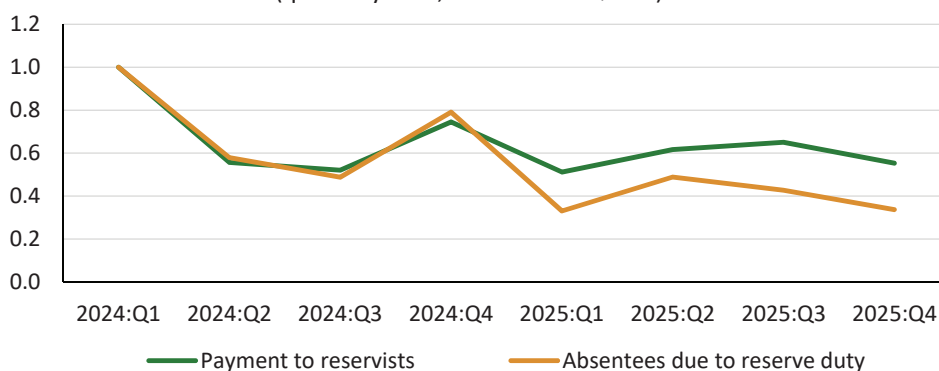
However, it appears that the decline in the total payments to reserve soldiers in 2025 was more moderate than the decline in the actual number of reservists, which can be estimated using the share of employees absent from work due to reserve duty, based on the Labor Force Survey (Figure 6.3).³ Although the Labor Force Survey data on the number of reservists do not cover the entire population of those serving, it is reasonable to assume that they reliably reflect the trend in this number. Therefore, the data as a whole suggest an expansion in the use of payments to reservists even during periods that did not include actual service.

³ It is not possible to identify all reservists in the Central Bureau of Statistics Labor Force Survey. In addition to those absent from work due to reserve duty, there are reservists who were not employed beforehand and therefore do not report absence from work, including regular soldiers who continued directly into reserve or career service as a result of the war.

Payments to reservists declined, but less than the decline in the actual service volume.

Figure 6.3 | Payment to Reservists^a, and Number of Work Absentees Due to Reserve Duty^b, 2024–2025

(quarterly data, index: 2024:Q1 = 1)



^a Payments to reservists are calculated using the Wage payments in the defense sector item from the National Accounts data. In each quarter since the beginning of the war, we deducted the average prewar wage payment for 2023, since the difference mainly reflects the increase in the volume of reservists due to the war.

^b The absentee number used to calculate the index includes absentees each week or part of a week due to reserve duty, from the Labor Force Survey.

SOURCE: Based on Central Bureau of Statistics.

Alongside the regular payments, the government also approved targeted grants and benefits intended to ease the financial burden resulting from prolonged service. As part of the extension of the “Reservists Program” for 2025, approved in December 2024, a total budget of approximately NIS 6 billion was allocated to finance monthly grants, family support, expanded mental health services, and additional benefits. These measures reflect recognition of the exceptional burden placed on reservists and the growing difficulty of relying on a limited supply of manpower under conditions of sustained demand for reserve forces. In the absence of a decision to increase the daily compensation rate, part of the response was provided through payments for days without actual service—a mechanism that lacks transparency and complicates reliable budget planning and oversight. In the medium term, reducing the exceptional burden on current reservists and the need for extraordinary compensation measures to offset it require an expansion of the regular army, alongside a transparent arrangement of compensation mechanisms for reserve soldiers.

(2) Civilian expenditures

In 2025, the general government’s primary civilian expenditure amounted to approximately 33 percent of GDP, similar to 2024, and 0.6 percent of GDP higher than the average during 2015–2019. Figure 6.4 provides a breakdown of the main components and aggregates of government expenditure. While most of the increase in total government expenditure compared with the pre-COVID-19 period was due

to the sharp rise in defense spending, civilian expenditure as a share of GDP also increased during this period. The increase reflects civilian war-related expenditures, primarily those of the “Reconstruction Administration,” which are expected to continue in the coming years. Excluding war-related expenditures, civilian spending (as a share of GDP) remained unchanged, with an increase in social insurance and welfare spending alongside a decline in education expenditure.

Civilian expenditures remained higher than in the years preceding COVID-19 and the war.

The stability of civilian expenditure relative to GDP (and its increase compared with the pre-COVID-19 years) occurred despite wage restraint in the public sector. As part of the fiscal consolidation measures due to the war, the government and the Histadrut agreed on steps that effectively froze across-the-board wage increases in this sector. This measure reflected the economy’s resilience, given the cooperation between the government and the Histadrut in addressing fiscal challenges. However, it also widened the wage gap between public sector employees and those in the business sector, where wages continued to rise rapidly (Figure 6.5). This gap may make it more difficult for the government to recruit high-quality employees. Moreover, the difficulty in reducing civilian expenditure relative to GDP, even when resources are needed for urgent purposes, reflects the fact that civilian expenditure in Israel is already very low by international comparison.

The difficulty in cutting civilian expenditures reflects their low level by international comparison.

Despite the increase in civilian expenditure relative to the pre-COVID-19 years, government civilian investment as a share of GDP has declined in recent years (Table 6.1). This trend has occurred despite population growth and the economy’s structural needs, and despite the importance of public investment as a foundation for long-term economic growth. Over the years, Bank of Israel reports have emphasized the contribution of public investment to increasing growth potential, as well as the persistent difficulties in implementing investment programs. The Bank of Israel has recommended considering the exclusion of investment in major infrastructure projects from the annual expenditure ceiling, alongside multiyear budgetary allocations for such investments, which would enable continuous planning and execution of projects.⁴ The erosion of public sector wages and the size of civilian public expenditure (particularly the scope of government investment) are among the structural challenges facing the government, which will be discussed further below.

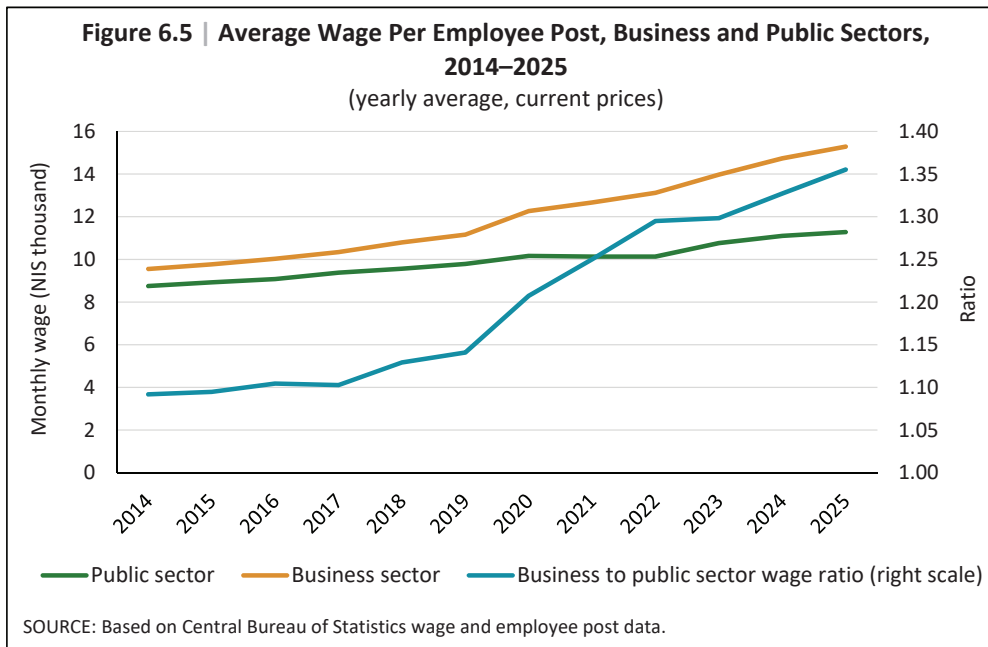
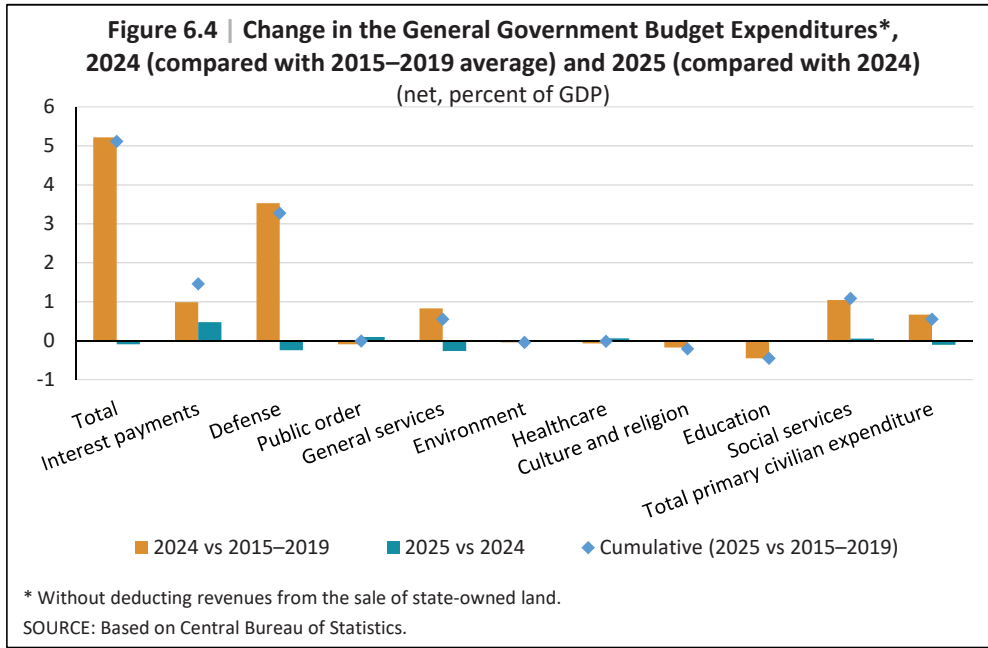
The government’s civilian investment has eroded, despite development needs and the increase in the population.

From the beginning of the war until the end of 2025, the Property Tax Fund paid compensation totaling approximately NIS 30 billion to those affected by direct and indirect war damage. A significant portion of these payments in 2025 was allocated to compensation for damages from Operation Rising Lion, estimated at about NIS 4 billion.⁵ The payments from the Property Tax Fund are reflected in the “Economic

⁴ See extensive discussion of this issue beginning on page 228 of the Bank of Israel Annual Report for 2021.

⁵ Some of the claims related to the operation are expected to be paid only in 2026, bringing the total amount to approximately NIS 6 billion. An additional portion of the damages from Operation Rising Lion was financed as part of the NIS 1.5 billion increase in the budgets of civilian ministries in 2025 in view of the operation.

services” item in Figure 6.4. They increase the general government deficit and contribute to the rise in the public debt-to-GDP ratio.



b. Revenues

Government revenues increased compared to the previous year.

General government revenue increased in 2025 both relative to 2024 (by 2.7 percent of GDP) and compared with the years 2015–2019—prior to the sharp fluctuations associated with the COVID-19 pandemic, the subsequent recovery, and the war that followed (Table 6.1). This increase largely reflects the tax hikes that came into effect at the beginning of the year, amounting to about 1.5 percent of GDP.

(1) Revenue-Side Measures Implemented in 2025

The tax increases that took effect explain a significant part of the increase in revenues.

In 2025, fiscal consolidation measures on the revenue side came into effect, totaling an estimated NIS 30 billion (Table 6.3). The main measures included: an increase in the VAT rate, effective January 2025, by one percentage point to 18 percent; the imposition of a tax on undistributed profits; the freezing of income tax brackets; and an increase in the rate of National Insurance contributions.⁶ Box 6.1 discusses the implications of these measures for the distribution of income.

Table 6.3 | Revenue-Side Measures that Took Effect in 2025

(NIS million in annual terms)

	2025	Full maturation ^a
Indirect taxation measures		
VAT increase by 1 percentage point to 18%	7,000	7,000
Direct taxation measures		
Taxation of undistributed profits in personal service	9,200	4,300
Increase in National Insurance premium rates	4,200	-
Freeze in the ceiling of the reduced National Insurance	1,800	3,200
Freeze in income tax brackets and credit points	2,600	7,300
Dividends from government corporations	2,000	-
2% surtax on capital gains above NIS 700,000	1,000	1,500
Other	2,600	3,800
Total	30,400	27,100

^a Full maturation - Expected receipts in the new permanent situation, after all legislative components take effect.

SOURCE: Based on Ministry of Finance budget booklet for the 2025 fiscal year.

⁶ For further discussion of the taxation of undistributed profits, see page 170 (Chapter 6) of the Bank of Israel Annual Report for 2024.

BOX 6.1: DISTRIBUTION OF THE TAX BURDEN ARISING FROM LEGISLATIVE CHANGES DURING THE WAR ACROSS INCOME QUINTILES

- » Several legislative changes to taxation were introduced during the war to assist in financing its costs. More than half of the additional burden was imposed on the top income quintile—higher than its share of total income.
- » The share of the additional tax burden borne by the two highest quintiles is slightly lower than their share of total tax payments prior to the war.

Several legislative changes to taxation were introduced during the war to help finance its costs, including various measures that increased taxes on consumption, labor, and capital gains. The overall tax increase amounted to about 1.5 percent of GDP. This box analyzes the distribution of the additional tax burden arising from all legislative changes that came into effect at the beginning of 2025 across income quintiles, defined based on total gross income per equivalized household member.

Table 1 describes about 85 percent of the total additional tax revenue associated with these legislative changes, for which a quintile breakdown can be performed. For the remaining measures, reliable data for such a breakdown are unavailable. Therefore, they are discussed qualitatively, alongside a sensitivity analysis of the estimates. The analysis is based on the revenue forecasts for each measure as estimated by the Ministry of Finance in the Numerator published in June 2025. We chose to rely on forecasted rather than actual revenues—both to better reflect policymakers’ intentions and because it is difficult to attribute excess actual revenue to specific measures based on available data. Moreover, a household’s avoidance of additional tax payments through behavioral changes, such as reduced consumption, does not imply that no additional burden was imposed on that household. The main measures analyzed are as follows¹:

Increase in VAT to 18 percent – The additional revenue from the one-percentage-point increase in VAT is estimated at about NIS 7 billion.² We assume that the burden of the VAT increase was distributed among quintiles according to each quintile’s share of total VAT-liable consumption, calculated using the Central Bureau of Statistics (CBS) 2022 Household Expenditure Survey. In this calculation, we assume—consistent with the research literature—that the increase in the VAT burden falls mainly on consumers rather than on producers and retailers (Benedek et al., 2015; Benzarti et al., 2020; Buettner & Madzharova, 2011). To the extent that part of the burden does fall on producers and retailers, this would likely increase the burden on the higher quintiles.

Taxation of Undistributed Profits (“Trapped Profits”) – This legislative change imposes an annual 2 percent tax on “trapped profits”—accumulated profits of companies that choose not to distribute them

¹ The findings reported here do not change significantly when using actual revenue estimates as published in the 2026 Budget Book.

² Part of the VAT is paid by the government. Reliable data on this share are unavailable, but we estimate it at about NIS 1.3 billion—approximately 18 percent of the total additional VAT payments—based on 2025 National Accounts data on public purchases and private consumption. We omit this amount from the analysis, but an alternative assumption that allocates the government’s VAT payments among quintiles according to the prewar distribution of tax payments does not materially change the results.

as dividends in order to defer tax payments and that are not used for real investment to expand the business.³ Unlike previous “dividend campaigns,” which generated one-off tax revenues at the expense of future collections, this measure creates a permanent source of revenue for the state budget. For further discussion, see Chapter 6 of the Bank of Israel Annual Report for 2024.

The total additional revenue from this measure is estimated at NIS 9 billion in 2025—NIS 5 billion of it permanent and the remainder one-off, resulting from the advancement of tax payments that would otherwise have been received several years later. We add one-quarter of the advanced amount to the permanent component, so that in the analysis we attribute an additional NIS 6 billion to the tax burden in 2025.

The phenomenon of deferred tax payments is common mainly among holding companies—legal entities that own other companies without additional real activity of their own—and among professional corporations whose profits derive from the services provided by the controlling owner. Ownership of such companies is highly concentrated among affluent groups, which use these structures as a means of tax deferral and savings. Accordingly, we attribute the entire tax burden arising from this legislation to the top income quintile.

National Insurance and Health Tax – The income brackets on which these taxes are calculated are indexed to the average wage in the economy. As part of the legislative changes, it was decided to freeze these brackets and to raise the health tax rate by 0.17 percentage points. The total expected revenue from these changes in 2025 amounts to NIS 5.3 billion. The distribution of the tax burden among quintiles for this measure was calculated according to labor income reported in the 2022 Household Expenditure Survey. Since these taxes are paid only up to a maximum wage of about NIS 50,000, with income above that threshold exempt, the distribution across quintiles is less progressive than that of other income taxes.

Freezing of Tax Credits and Income Tax Brackets – Similarly, the income tax brackets indexed to the Consumer Price Index were frozen this year. The impact of this freeze is estimated at NIS 2.5 billion, and we estimate its distribution among quintiles in the same way, based on labor income reported in the 2022 Household Expenditure Survey.

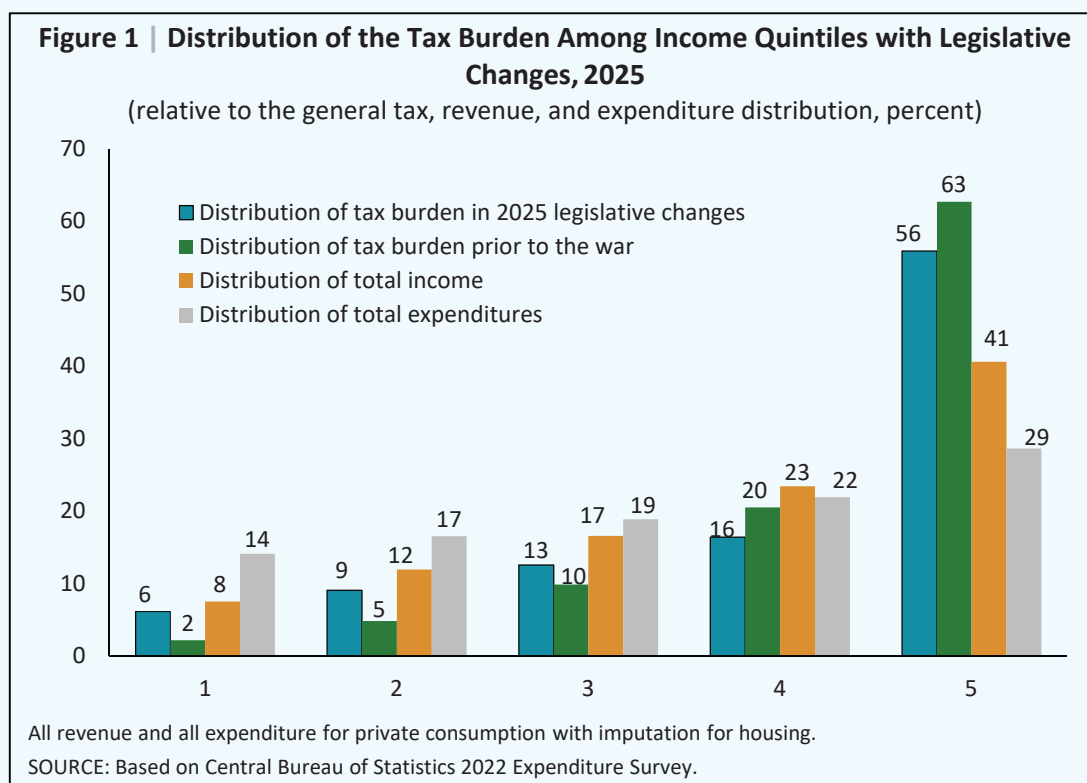
Increase in the Surtax on Capital Gains – The surtax on capital gains, with expected revenue of NIS 1.5 billion, is by definition levied on those at the very top of the income distribution and can therefore be attributed entirely to the top quintile.

Reduction in Convalescence Payments – Under an agreement between the Histadrut and the government, similar to that in 2024, it was agreed that for each employee entitled to convalescence days, the employer would pay the value of one convalescence day as tax instead of paying it to the employee. In addition, the value of the convalescence day was frozen. This measure was expected to increase tax revenue by NIS 1.1 billion. We distribute this cost among quintiles according to each quintile’s share of total employees in the survey, adjusted for the differing value of convalescence days in the public and private sectors.

³ In many cases, these profits are used to generate returns for controlling shareholders through passive investments in real estate or the capital market.

The distribution of the additional tax burden based on all the measures discussed here is presented in Table 1 and compared with the distribution of total income, total expenditure, and total tax payments prior to the war in Figure 1. The main additional tax burden was borne by the upper quintiles. In particular, the top quintile's share of the total additional burden is significantly higher than its share of total income or of total private consumption expenditure, while the shares of the other quintiles are lower than their shares of total income and expenditure. The combined share of the two highest quintiles is similar to, and only slightly lower than, their share of total tax payments prior to the war. By international comparison, the tax burden in Israel is relatively low for the third and fourth quintiles and high for the top quintile (see Box 6.2 in this Report). The legislative changes approved this year do not narrow these gaps.

Other measures not discussed here are mainly various vehicle-related tax changes, most of which involve the cancellation of benefits for electric vehicles and the reduction of the diesel subsidy in transportation (NIS 1.5 billion). We are unable to allocate these measures accurately.⁴



⁴ The taxation of banks, for which it is also difficult to determine the distribution across quintiles, was implemented in 2024, while the analysis here focuses on legislative changes enacted in 2025.

Table 1 | Distribution of tax burden among income quintiles due to legislative measures during the war

Quintile	Trapped profits	VAT increase	National insurance and health tax	Freezing credit points and income tax brackets	Surtax	Convalescence payments	Total
1	0	14	9	0	0	10	6
2	0	16	15	4	0	16	9
3	0	19	22	13	0	22	13
4	0	22	27	26	0	25	16
5	100	29	28	57	100	27	56
Total, NIS billion	6.0	5.7	5.3	2.5	1.5	1.1	22.1

SOURCE: Based on Central Bureau of Statistics 2022 Expenditure Survey and Ministry of Finance numerator.

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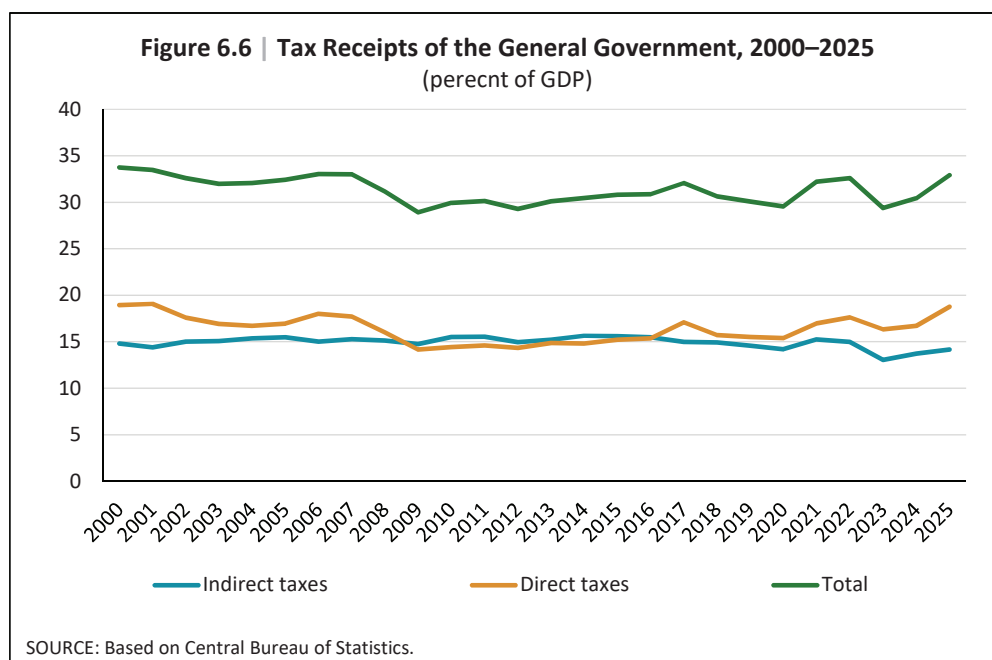
(2) Analysis of Tax Revenues and Surprises Relative to the Annual Forecast at the Time of Budget Submission

Tax revenues surprisingly exceeded the effect of legislative changes.

Tax revenues were pleasantly surprising from two perspectives. First, general government tax revenues were higher by 2 percent of GDP than the average during 2015–2019—a period that, as explained at the beginning of the revenue section, serves as a convenient reference point. Of this 2-percentage-point gap, 1.5 percentage points reflect the expected increase in tax revenues resulting from legislative changes, while the remainder reflects a positive surprise.

The surprise in revenues was mainly due to direct taxes, particularly corporate taxes.

As shown in Figure 6.6, the increase in the tax burden in 2025 mainly reflects higher revenues from direct taxes due to the government's measures. An analysis of the components of direct tax revenues indicates that the unexpected increase in direct tax receipts reflects higher corporate tax revenues, primarily in the financial, insurance, and information and communications industries. Indirect tax revenues rose by 0.6 percent of GDP, likely due mainly to the 1-percentage-point increase in the VAT rate—which was expected to yield about 0.4 percent of GDP—as well as the gradual increase in the tax on electric vehicles.



The second perspective concerns the surprise relative to the estimates made during budget preparation. Revenues exceeded those estimates by NIS 30 billion, equivalent to about 1.5 percent of GDP. An analysis using the Bank of Israel’s tax model (Brender and Navon, 2010) indicates that roughly two-thirds of the surprise relative to the forecast at the time of budget preparation (January 2025) came from better-than-expected economic performance—the nominal GDP was slightly higher than projected—and especially from a much sharper-than-expected increase in the general stock market index on the Tel Aviv Stock Exchange. In the Research Department’s tax model, this variable captures both the impact of the capital market on corporate and household capital gains and the business and consumer sentiment in the economy, partly through the wealth effect of a stock market boom on private consumption. The remaining third of the surprise reflects an unexplained residual, which may be related to behavioral changes following the taxation of undistributed profits or to other factors, such as the increase in profits of financial institutions, whose effective tax rate is higher than that of the rest of the business sector.

Following the Economic Efficiency Law (the “Arrangements Law”) for 2023–2024, the “Israel Invoices” model was implemented beginning in 2024, aimed at reducing the phenomenon of fictitious invoices. Under this model, which became mandatory in January 2024, the Tax Authority issues allocation numbers for tax invoices through an online system, and these numbers are required as a condition for input-tax deduction on transactions above a defined threshold. The threshold was reduced from NIS 20,000 in 2025 to NIS 10,000 in January 2026, and will be lowered further to NIS 5,000 in June 2026. These measures contribute to fairness and tax collection, but so far no exceptional increase has been observed in VAT revenues, as their growth is consistent with the VAT rate increase and the nominal expansion of economic activity.

c. The deficit

The general government deficit declined from 9.0 percent of GDP in 2024 to 6.5 percent in 2025, and the central government budget deficit fell from 6.7 percent of GDP to 4.7 percent between those years.^{7,8} The budget deficit reflects a primary deficit (the overall deficit excluding interest payments) of about 2.5 percent of GDP and interest expenditures of about 2.2 percent of GDP.

Despite the decline in the deficit, it remains higher than the level that would stabilize the debt to GDP ratio.

The reduction in the deficit resulted from three main factors: the fading of one-off war-related expenditures; the contribution of fiscal consolidation measures that came into effect at the beginning of 2025, particularly on the revenue side; and an improvement in the security and economic environment, which supported faster growth in tax revenues. Despite the decline, the budget deficit this year remained larger than the level necessary to stabilize the debt-to-GDP ratio (around 3.2 percent in the medium term; for a description of the calculation, see Section 3.d later in this chapter). Thus, although the fiscal contraction relative to the previous year—reflected in the decline in the deficit—was significant, the government still diverted resources from the private sector to the public sector compared with the prewar period, financing part of this shift through debt issuance.

3. THE FISCAL AGGREGATES FROM A STRUCTURAL PERSPECTIVE

a. Structural defense expenditure – The new normal and ongoing uncertainty

It appears that defense expenditure will remain significantly higher in the medium term than it was in the prewar period, although the precise magnitude is still unclear. In 2024, the “Committee to Examine the Defense Budget and Force Building” (the Nagel Committee) was appointed to determine Israel’s medium-term defense needs and to recommend a multiyear budgetary framework. At the beginning of 2025,

⁷ According to Central Bureau of Statistics (CBS) data, the general government deficit under the National Accounts definitions amounted to 5.2 percent of GDP. In this chapter, we refer to the central government budget deficit (4.7 percent) and to the general government deficit under the National Accounts definitions, with an adjusted calculation (6.5 percent). The reason for the gap between the CBS figure and the one presented here is that the CBS deducts the revenues from land sales (for housing purposes) from public investment, since the interpretation of the National Accounts rules is that land sales constitute negative government investment. An examination of OECD data in recent years shows that in most member countries such revenues are very small (about 0.05 percent of GDP on average), and that the deduction from investment reflects activities such as the sale of improved agricultural land or the purchase and renovation of public housing units and their sale to eligible households. In contrast, in Israel these revenues derive from the sale of land historically owned by the state—that is, from the realization of assets—and in 2025 they amounted to 1.3 percent of GDP. Since asset realization is essentially a financing transaction, we present public expenditure without this deduction and treat land sales as a financing item that moderates debt growth.

⁸ The sharper decline in the general government deficit (about 0.5 percentage points more) mainly reflects definitional differences, particularly regarding the timing of the recording of various transactions.

the committee submitted its recommendations. However, the government did not discuss them and did not adopt a clear multiyear budgetary path for defense. In parallel, in November 2025, the Prime Minister instructed that the defense budget be increased by NIS 250–350 billion over the coming decade (in addition to previously approved decisions)—an instruction that has not yet been formalized by a government resolution. A clear government decision is required regarding the scope of the permanent mediumterm defense budget, which would serve as an agreed basis for multiyear fiscal planning. Among other factors, this should take into account the economic and social implications of crowding out civilian budgets or raising taxes, as well as the uncertainty regarding the scope of US defense assistance in the coming years.

The increase in total expenditure, presented in Figure 6.7 in Section 3.d below, reflects the assumption that, in addition to the defense budget increases already approved in the 2024 and 2025 budgets, further defense expenditures will be added in line with the Nagel Committee’s recommendations (about NIS 13.5 billion per year). Under this assumption, defense expenditure during 2026–2030 will amount to approximately 5.5 percent of GDP—1.5 percentage points higher than the prewar estimate for those years. Defense expenditure could be even higher if, for example, the government adopts the Prime Minister’s proposed path for an additional increase in the defense budget.

b. Long-term trends in civilian expenditure and possible implications of its erosion

The government’s structural civilian expenditure is expected to increase in the coming years for two main reasons. The first is the financing of rehabilitation needs in the southern and northern regions affected by the war, budgeted at NIS 30 billion through the end of 2029, as well as compensation for civilian war victims. The second is accelerated growth in social assistance. Expenditure on the National Insurance Institute’s long-term care benefit has risen sharply beyond the growth rate of the elderly population, due to expanded eligibility following changes in the implementation of benefit entitlement rules, as discussed in the Bank of Israel Annual Report for 2024 (Chapter 7).

When defense spending, rehabilitation needs, and long-term care costs increase without full adjustment on the revenue side, debt is expected to rise. Under current circumstances, this indeed appears to be the case, despite the government’s revenue-side consolidation measures and the positive revenue surprise. The government therefore faces two undesirable alternatives. The first is to continue increasing the public debt-to-GDP ratio. This would lead to higher interest payments, which in turn come at the expense of other expenditure items (or generate further debt growth,

Civilian rehabilitation expenditures are expected to further pressure the budget in the medium term.

in a self-reinforcing cycle).⁹ Interest payments during 2026–2030 are expected to average about 2.5 percent of GDP—an increase of 0.5 percentage points compared with 2023—due to both the growth in the stock of debt and the rise in interest rates on the debt. The latter mainly reflects the global interest rate environment in recent years, but also, to some extent, the increase in Israel’s risk premium. Box 6.3 below discusses the challenge of reducing the debt-to-GDP ratio in the current interest rate environment.

The second alternative is to reduce civilian expenditure. Israel already has low civilian expenditure relative to GDP compared with the average in other advanced economies, including in growth-enhancing areas such as education, infrastructure, and research and development.¹⁰ This is despite the fact that Israel’s stock of public capital is low relative to those countries and its population growth rate is higher. The decision to freeze public sector wages in 2025–2026 in order to finance part of the cost of the war is an example of the potential cost of excessive restraint in civilian spending. Alongside the phenomenon of public sector wage erosion over the past decade (Figure 6.5), there has been a decline in the quality of human capital among younger public sector employees (Mazar, 2025). Prolonged wage restraint may exacerbate the difficulty of attracting and retaining skilled professionals—such as teachers, physicians, engineers, scientists, economists, and lawyers—in the public sector, with implications for the quality of services in key areas such as education, healthcare, planning, regulation, and enforcement.

Chapter 1 of this Report expands on the multidimensional dilemma facing the government: the need to reduce the debt-to-GDP ratio while simultaneously increasing the defense budget, addressing the economy’s development needs, and maintaining the public’s standard of living and the quality of public services.

c. Tax policy in view of the structural challenge

The positive surprise in taxes this year is not an alternative to a structural fiscal solution.

The positive surprise in tax revenues this year was concentrated in corporate tax receipts in certain industries. Such one-off surprises have occurred in the past, but over time, the ratio of tax revenues to GDP is stable in the absence of changes in tax rates and rules. For example, in 2021 and 2022, tax revenues increased due to significant expansion in high-tech activity, a boom in the capital market, and a surge in the housing market. However, in 2023 (even before the war), tax revenues declined and returned to the level that characterized the 2015–2019 period (about 22.5 percent of GDP).¹¹

The consolidation measures approved on the revenue side raise tax revenues by 1.5 percent of GDP in the medium term, but this increase is insufficient to offset the

⁹ The Chief Economist at the Ministry of Finance has addressed such implications of rising debt. See Gilad Brand and Gal Katz (2026), *The Implications of Stabilizing at a Higher Debt-to-GDP Ratio versus Reducing It*, Chief Economist Department, Ministry of Finance, February 2026.

¹⁰ For details, see Box 6.2 in the Bank of Israel Annual Report for 2024.

¹¹ See discussion on pages 180–181 of the Bank of Israel Annual Report for 2023.

structural increase in expenditures. Moreover, the decisions to raise the exemption threshold for personal imports to US\$ 130 and to widen income tax brackets—expected to reduce state revenues by about NIS 5 billion per year—precisely when further adjustments are needed to reduce the structural deficit, are inconsistent with the effort to rebuild the fiscal buffers that were eroded during the war.

Research by Brender and Politzer (2018) shows that, because tax changes affect economic activity in the short term, a tax increase yields, in that period, about 70 percent of the revenue that would be expected under a static calculation that does not account for changes in activity following the change in the tax rate. In contrast, the longer-term effect (three years and beyond) is roughly similar to the static estimate. More broadly, the research literature on fiscal multipliers of tax changes—the rate of decline of GDP growth in response to a one-percentage-point increase in the tax burden—presents a wide range of estimates, from 0 to 1 percent of GDP in studies using structural models (for example, Blanchard & Perotti, 2002) to about 3 percent of GDP after several years in studies examining exogenous tax changes in specific situations (for example, Romer & Romer, 2010). However, a comprehensive survey by Alinaghi and Reed (2021) found a much more moderate effect, consistent with the findings of Brender and Politzer: A one-percentage-point increase in the tax burden reduces the annual GDP growth rate by about one-tenth of a percentage point.

The tax increases that were approved are not sufficient to offset the structural increase in expenditures.

BOX 6.2: DISTRIBUTION OF THE TAX BURDEN BY INTERNATIONAL COMPARISON

- » The burden of indirect taxation—that is, tax payments relative to household income—in Israel is high by international comparison across all income deciles. In addition, it declines as income rises, and this decline is steeper in Israel than in the comparison countries.
- » The overall tax burden, comprising both direct and indirect taxes, is lower in Israel than internationally in Deciles 5–8, but is similar to, or higher than, that in the comparison countries in the remaining deciles.

During 2024–2025, a number of tax increases were legislated, each affecting the various income deciles differently and therefore influencing the distribution of income. As a basis for examining these measures, it is necessary to present a picture of the distribution of the tax burden¹ in Israel prior to the war, and particularly how it compares with that in other advanced economies. Box 6.2 of the Bank of Israel Annual Report for 2024 showed that the direct tax burden borne by income deciles 5 through 8 prior to the war was lower than that of their counterparts in most advanced economies.² By contrast, in the other

¹ Tax payments by a decile relative to its income.

² For the purpose of comparison, we selected OECD member countries in Europe and North America, as well as Australia. In our assessment, these countries are suitable comparators in terms of welfare policy and inequality on the one hand, and economic growth on the other. In addition, they are representative of the OECD as a whole with respect to relevant macroeconomic variables, such as direct and indirect tax revenues as a share of GDP, measures of inequality, and per capita private consumption.

income groups in Israel, the direct tax burden was similar to, or higher than, that in the comparison countries.³ The box also showed that the marginal tax rate in the top decile is very high relative to that in the comparison countries. This box expands the findings with regard to the overall tax burden.

The components of total taxation in Israel differ markedly in their levels. While in 2019 direct tax revenues as a share of GDP in Israel were more than 3 percentage points lower than the OECD average (15.8 percent, compared with 19.2 percent, respectively), indirect tax revenues as a share of GDP were, by contrast, higher in Israel by half a percentage point (10.2 percent, compared with 9.7 percent, respectively).

In order to estimate the distribution of indirect tax payments—taxes on consumption (VAT), purchase taxes (on alcohol and tobacco), excise taxes, and import and customs duties—we first examine, for each consumption category, the distribution of consumption across income deciles.⁴ This distribution is then used as an estimate of the distribution of the tax collected on that category in each comparison country.^{5,6} Detailed data on consumption and indirect tax receipts for the comparison countries were available only for 2019. However, that year was found to be similar to 2023 in terms of tax rates and the aggregate volume of tax collection and consumption, both for Israel and for the comparison countries.⁷

Formally, the methodology used to calculate the distribution is described in Equation (1). For each country, we calculated the total annual expenditure on consumption (C) of goods and services of type J by decile i , and divided this amount by total economy-wide consumption of that type (the sum across all deciles, 1 through 10). We then multiplied the ratio obtained in the parentheses in Equation (1) by total net tax receipts (T) from households in that economy for consumption of type J . Thus, T_{ij} represents the total tax payments of decile i for consumption of type J . Thereafter, Equation (2) sums, for each decile i , its tax payments on all types of consumption ($j=1, \dots, 12$), and divides that amount by the decile's total annual economic income (income from capital and labor, plus income from private transfers) (Y).

$$(1) T_{ij} = \left(\frac{C_{ij}}{\sum_{i=1}^{10} C_{ij}} \right) T_j \quad (2) Tax Burden_i = \frac{\sum_{j=1}^{12} T_{ij}}{Y_i}$$

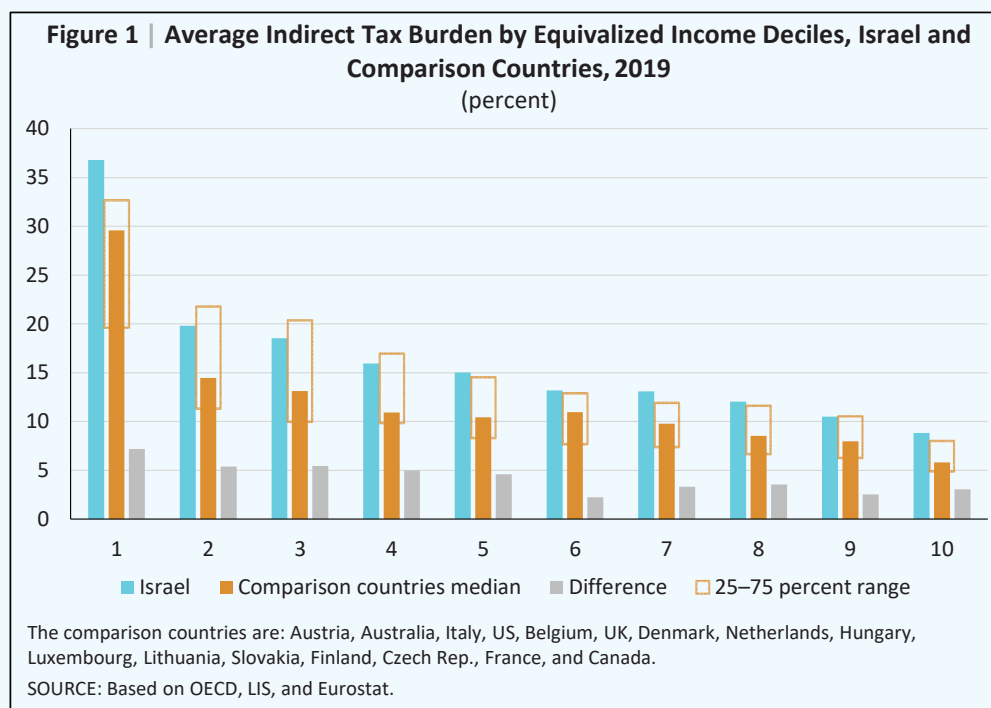
³ The analysis was based on 2019 data from the Luxembourg Income Study (LIS). An examination of more recent data for the period immediately preceding the war indicated that the findings of last year's box remain valid.

⁴ The deciles are ranked by equivalized per capita income. Specifically, the decile ranking is based on the OECD equivalence scale, which takes into account both the number of children in the household and their ages.

⁵ We used household consumption and income data from several sources: LIS, Eurostat, and additional national statistical agencies. For indirect tax receipts, we used the OECD's Supply and Use Tables (SUT) and Revenue Statistics databases, which include net taxes by product and tax revenues by tax type, respectively. Consumption is classified according to the COICOP classification of individual consumption by purpose.

⁶ The SUT database does not include Israel. Accordingly, for Israel we used revenue data from Revenue Statistics (RS), together with the estimated household share therein, in order to allocate tax payments.

⁷ Indirect tax revenues as a share of GDP declined between 2019 and 2023 in the comparison countries by about half a percentage point on average (SD=0.63), and in Israel by only 1 percentage point. The distribution of indirect taxes also appears not to have changed materially, in view of the following findings: Average per capita household consumption relative to the OECD average remained unchanged between 2019 and 2021; the distribution of consumption across purposes is generally stable over time (Eurostat data for 2005–2020); and the standard statutory VAT rates remained stable between 2019 and 2023, both in Israel and on average in the OECD (OECD, 2024).



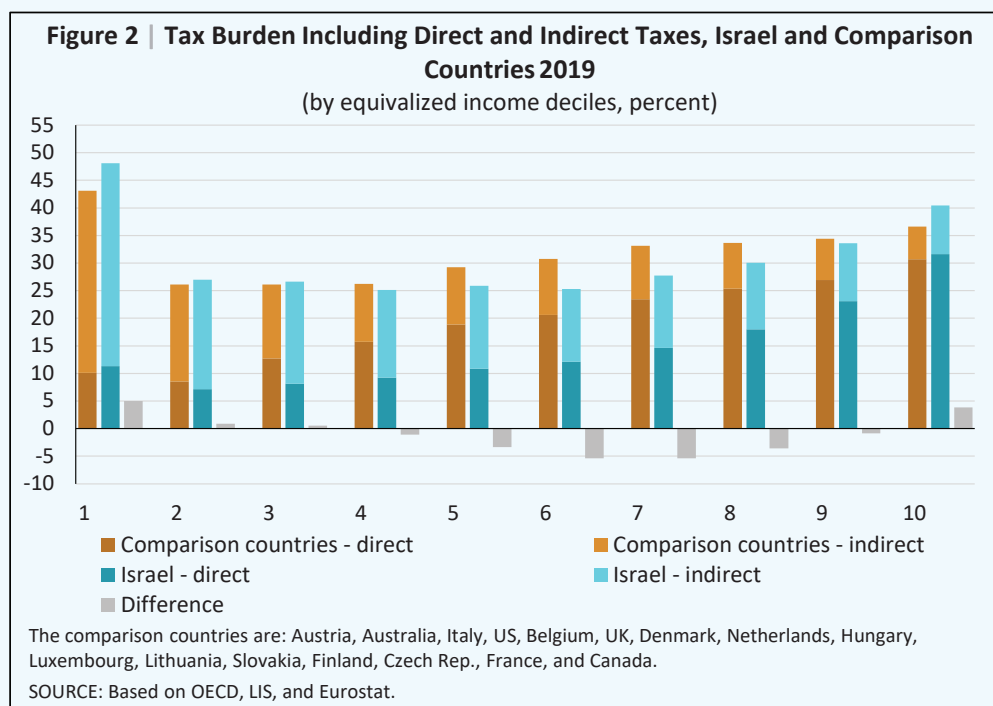
The findings of this analysis are presented in Figure 1. The burden of indirect taxation declines as income rises, both in Israel and in the comparison countries.⁸ The burden of indirect taxation in Israel is higher than in the comparison countries across all income deciles. However, the gap (shown in gray) is larger in the lower deciles. This finding in itself suggests that the substantial additional burden borne by the lower deciles in Israel should be taken into account when raising the VAT rate. Beyond that, the above analysis serves as the basis for our examination of the distribution of the overall tax burden.

Since the variation across deciles in the burden of indirect taxation is smaller than that observed for the direct tax burden, the distribution of the overall tax burden—including both direct and indirect taxes (Figure 2)—is similar to that found for direct taxes alone. In Israel, Deciles 5–8 pay less, relative to their income, than the median for those deciles in the comparison countries, with the gap reaching a trough of more than 5 percentage points (below zero) in Deciles 6 and 7.⁹ By contrast, the overall tax burden in Israel in the remaining deciles is similar to, or higher than, that in the comparison countries. These findings are largely maintained even when transfer payments are taken into account as a negative tax.

⁸ In this analysis, we assume that the burden of indirect taxation is fully borne by the consumer. However, adopting an assumption of only partial pass-through to the consumer—for example, in line with the estimates reported by Benedek et al. (2020)—yields an almost identical comparative picture.

⁹ For the comparison countries, each bar represents the median overall tax burden in a given income decile. It is important to note that this value is not necessarily equal to the median direct tax burden plus the median indirect tax burden. Accordingly, for each decile in each country, we first calculated the ratio between the direct taxes and the indirect taxes paid by that decile. We then calculated the median of this ratio for decile across all countries. The resulting value is therefore the ratio according to which direct and indirect taxes were allocated in the figure for the bar representing decile.

In general, the relative tax burden in Israel (that is, the gap) rises across all deciles—particularly in the lower deciles—but remains negative in Deciles 6–8, with the minimum in Decile 7.



Recently, the Israel Tax Authority published income estimates based on administrative data, which differ to some extent from those of the Central Bureau of Statistics (Israel Tax Authority, 2025). Nevertheless, the main discrepancies in the data relate to extreme values within the top decile and do not alter the principal conclusion regarding the gaps in the middle deciles—indeed, they sharpen it.¹⁰ In any event, an international survey contributes substantially in this context by maintaining consistency in definitions and reporting methods across countries, thereby supporting a reliable comparative analysis.

References

- Benedek, D., R.A. De Mooij, M. Keen, and P. Wingender (2020). “Varieties of VAT Pass Through”, *International Tax and Public Finance*, 27: 890–930, <https://doi.org/10.1007/s10797-019-09566-5>
- Congressional Budget Office. (2021). “Revisiting the Extent to Which Payroll Taxes are Passed Through to Workers”, (Working Paper No. 2021-06). Congressional Budget Office.

¹⁰ We examined how these data, which include direct taxes, affect the distribution under review. In general, the tax burden declines across the upper half of the distribution and rises in the lower half, mainly because of the difference in the income distribution according to the Tax Authority data, which is considerably less equal and therefore affects the denominator. However, these changes mainly deepen the tax-burden gaps in Deciles 6–8, reaching a trough of more than 9 percentage points below zero in Decile 7.

Greisas, A., O. Raz-Dror, N. Ben-Tovim, and U. Grupel (2025). “Revenue of Israel’s Residents”, Planning and Economy Division, Israel Tax Authority. [in Hebrew]

OECD (2024), “Consumption Tax Trends 2024: VAT/GST and Excise, Core Design Features and Trends”, OECD Publishing, Paris, <https://doi.org/10.1787/dcd4dd36-en>.

d. The structural deficit

The structural deficit reflects the gap between expected expenditures and revenues in the coming years, based on government decisions and other factors that influence spending, revenues, and growth—such as natural population increase and demographic composition. The structural deficit in the central government budget projected for the medium term (2026–2030) stands at about 3.7 percent of GDP. The structural primary deficit is estimated at about 1.3 percent of GDP, with the remainder consisting of interest expenditures.

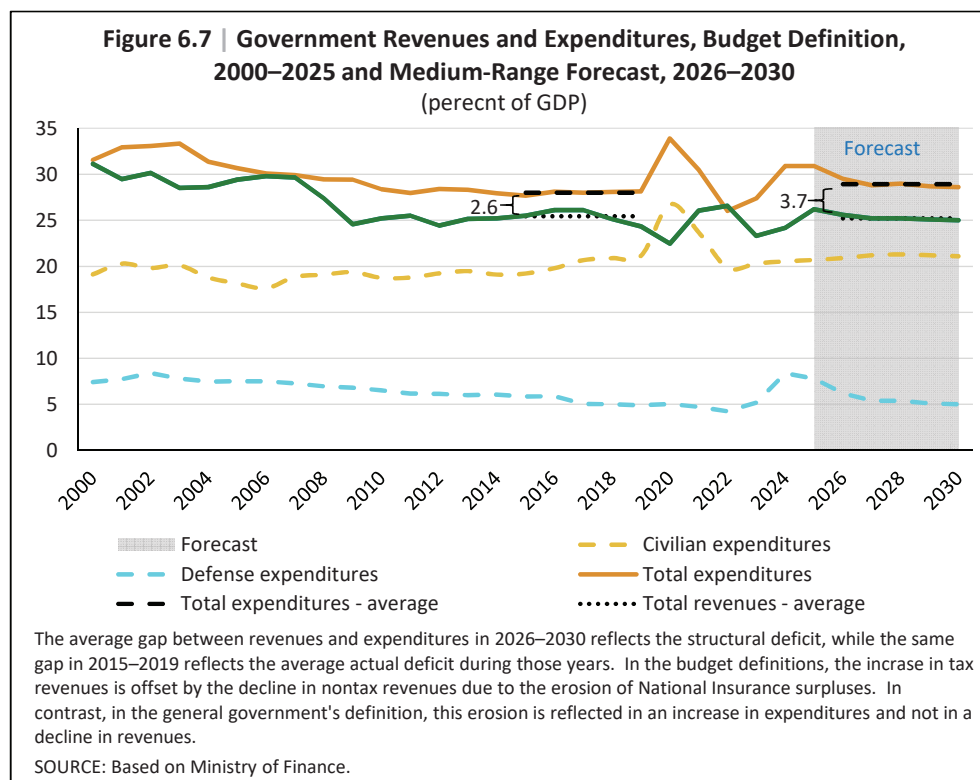
The gap shown in Figure 6.7 between expenditures and revenues in the medium term (2026–2030) represents the structural deficit. The increase in the projected medium-term deficit is primarily a result of the rise in total public expenditure relative to the 2015–2019 average, mainly due to a 0.5-percent-of-GDP increase in the defense budget. It is important to note that the defense budget prior to the war was on a downward trend relative to GDP, so the expected increase in 2026–2030 compared with prewar forecasts is even larger—particularly since defense spending may rise more sharply still.¹² In addition, civilian expenditures are also expected to grow in the coming years, mainly due to civilian rehabilitation spending following the war, as well as population aging and the easing of eligibility criteria for the National Insurance Institute’s long-term care benefit.¹³ The increase in the structural deficit resulting from higher expenditures is somewhat moderated by the tax increases, most of which took effect in 2025.

In the absence of further fiscal consolidation, the structural deficit is higher than the deficit level necessary to stabilize the debt-to-GDP ratio in the medium term (2026–2030). Under a scenario in which real GDP growth averages 3.5 percent, inflation averages 2 percent, and the government operates under a balanced budget, a debt ratio of about 68 percent of GDP would decline by 2.9 percent of GDP per year (CPI-linked debt erodes only relative to real growth, while shekel-denominated debt erodes relative to both real growth and GDP prices). Moreover, the government receives annual revenues averaging about 0.3 percent of GDP from the surplus income of the Israel Land Authority (which are not included in the deficit calculation but serve as a substitute for debt issuance). This means that the government can

¹² Defense expenditure during 2026–2030 is expected to be 1.5 percent of GDP higher than projected prior to the war.

¹³ For further discussion, see Chapter 7 of the Bank of Israel Annual Report for 2024.

finance a deficit of 3.2 percent of GDP per year without increasing the debt-to-GDP ratio, and that to achieve a sustained reduction in debt, a lower deficit is required.



4. PUBLIC DEBT AND THE POLICY NECESSARY TO REDUCE IT

a. Debt developments in 2025

The debt-to-GDP ratio increased for the third straight year.

In 2025, due to the high deficit (4.7 percent of GDP—about NIS 99 billion), the public debt-to-GDP ratio rose slightly, reaching 68.5 percent of GDP at year-end. This was the third consecutive year in which the debt ratio increased, bringing the cumulative rise over this period to about eight percentage points (Table 6.4).

The cost of financing the deficit declined compared with the peak reached during 2024, as did the spread relative to the government bonds of the United States and Germany (Figure 6.8). The decline in financing costs was particularly notable following Operation Rising Lion. About NIS 64 billion of the deficit was financed through net domestic debt issuance (that is, after deducting principal repayments), and about NIS 15 billion through net external debt issuance. Thus, foreign borrowing accounted for 18.5 percent of total new issuance—slightly higher than in the previous year and than the share of foreign sources in the total stock of debt (both around 15 percent). Part of the deficit was financed through privatization (about NIS 13 billion from land

Most of the financing for the deficit was through debt raised on the domestic market.

sales), and the remainder—about NIS 7 billion—through the use of government deposits at the Bank of Israel. The use of deposits narrowed the gap between gross and net debt (the latter defined as debt net of loans granted by the government and its deposits at the Bank of Israel).

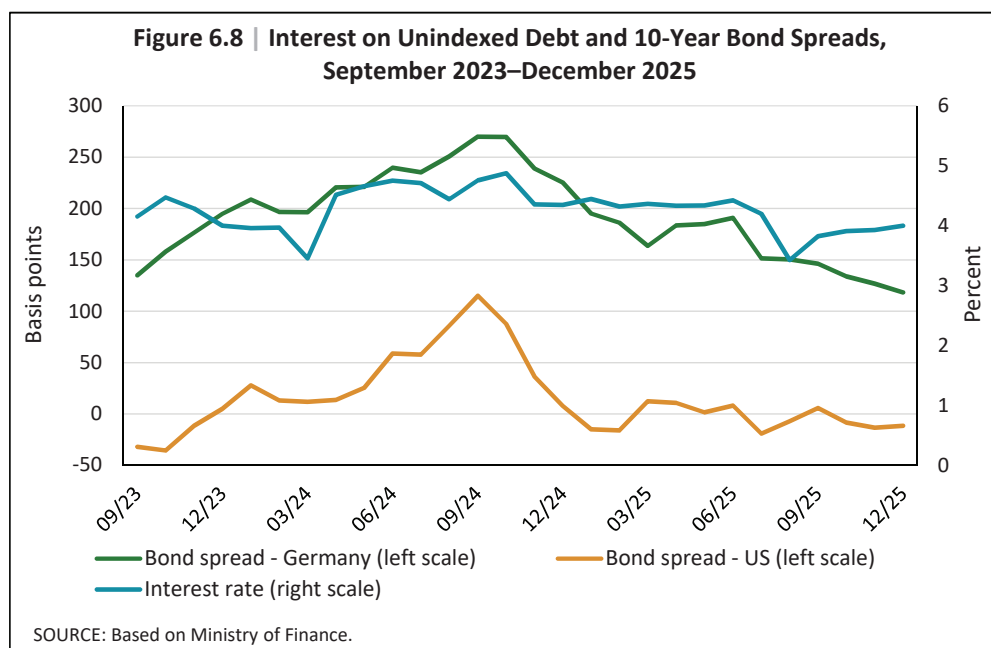


Table 6.4 | Components of the Increase in the Gross Public Debt to GDP Ratio, 2020–2025

	percent of GDP					
	2020	2021	2022	2023	2024	2025
Debt at the end of the previous year	59.3	71.1	67.8	60.5	61.3	67.6
Contribution of the change in nominal GDP to the debt to GDP ratio	0.4	-7.5	-7.0	-3.8	-3.8	-3.3
Net capital inflow	12.8	3.8	-2.7	2.9	8.3	3.7
<i>of which</i> : Government's cash deficit (excluding credit)	11.4	4.4	-0.6	4.1	6.7	4.7
Net repayment of credit by the public ^a	-0.04	-0.04	-0.04	-0.02	-0.04	-0.03
Privatization proceeds	0.0	-0.9	-0.9	-0.6	-0.2	-0.6
Funding beyond the financing deficit ^b	1.6	0.4	-1.2	-0.6	1.7	-0.3
Revaluation of shekel-denominated indexed debt ^c	-0.2	0.8	1.5	0.8	0.9	0.8
Revaluation of foreign currency-denominated debt	-0.4	-0.4	1.0	0.3	0.0	-1.0
Adjustment to issuance costs	-0.4	-0.2	0.1	0.4	0.5	0.1
Remainder ^d	-0.5	0.2	-0.3	0.2	0.4	0.5
Debt at year end	71.1	67.8	60.5	61.3	67.6	68.5

^a Including the provision of credit and principal collection.

^b Funding surplus.

^c Effect of the increase in the Consumer Price Index during the year on indexed debt.

^d As a result of roundings.

SOURCE: Based on Ministry of Finance and Central Bureau of Statistics.

The government also used deposits and land sales to finance the deficit.

The expansion of deposits in 2024 was consistent with the need to maintain a larger cash buffer to enable an immediate response to unforeseen expenditures under the fiscal and security uncertainty that characterized the wartime period. During 2025, the government financed its expenditures using this buffer, so deposits declined again—mainly after Operation Rising Lion and the ceasefire with Hamas, which reduced the risk premium in financial markets.

b. Considerations in determining the desired level and dynamics of public debt

The interest burden on the public debt is higher than in similar countries.

The rapid increase in debt in recent years, due to the need to finance the war, raises two key issues: the desirable level of Israel's debt ratio and its long-term dynamics. There is no definitive rule that determines the precise level of debt that is optimal or the level at which fiscal stability becomes endangered. A recent study by Berk and van Binsbergen (2026) demonstrates that different measures of government indebtedness present entirely different pictures of debt levels and dynamics: While in many countries the debt-to-GDP ratio (a stock-to-flow measure) has reached historical highs, other indicators—such as the ratio of interest payments to GDP (a flow-to-flow measure)—currently show a much more moderate picture and, in some countries, are even below their historical averages.

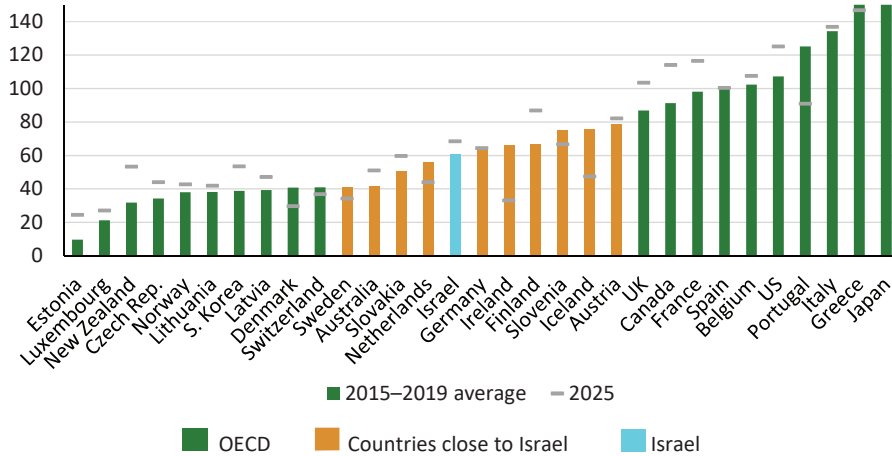
Israel's debt level is not low by international comparison, but is also not excessive.

Regarding the level of debt, Israel's debt-to-GDP ratio is not exceptional in international comparison, although it is higher than the median among advanced OECD economies (Figures 6.1 and 6.9a). However, an examination of the interest-payment burden presents a less favorable picture. Interest payments as a share of GDP in Israel are near the upper end of the distribution among comparison countries (Figure 6.9b). The gap is primarily due to Israel's relatively high risk premium, which was elevated even before the war and increased further during it. Despite the decline following Operation Rising Lion and the ceasefire in Gaza, Israel's risk premium remains higher than its level at the beginning of 2023. In addition, over the past two years, the composition of Israel's debt has also contributed to the rise in interest payments. A large portion of the debt is indexed to the Consumer Price Index (CPI), and under international definitions, interest payments include the revaluation of the indexed principal due to inflation. Although under Israel's budgetary definitions this revaluation is not included in interest payments, it is in practice a cost that must be taken into account—the indexed component of the debt increases with inflation, whereas in countries where only a small share of debt is indexed, inflation erodes the real value of the debt. This factor has become significant in recent years, unlike in the late 2010s, when inflation was near zero.

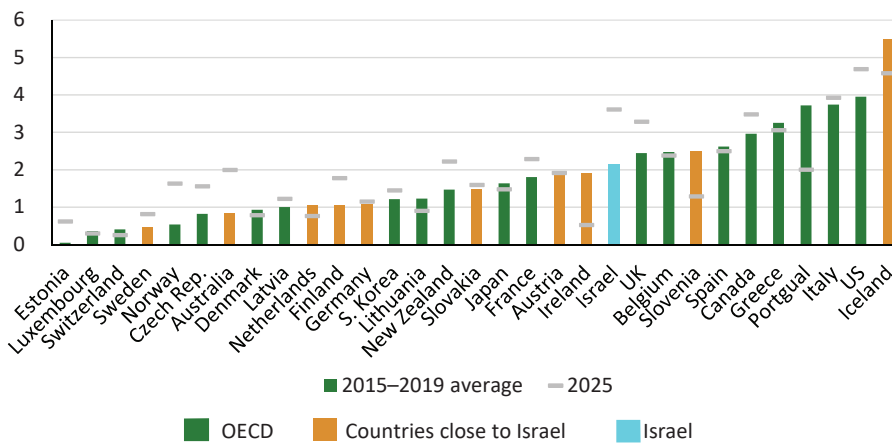
Figure 6.9 | Debt-to-GDP Ratio and Interest Payments, Israel and OECD

(percent of GDP)

a. Public debt (gross)



b. Interest payments (gross) on the debt



Interest rate data are under the National Accounts definitions. Interest payments under this definition include a revaluation of indexed debt. The comparison countries ("close to Israel") are the ten countries with debt-to-GDP ratios that were close to Israel between 2015 and 2019. Debt and interest data for the other countries are IMF forecasts from October 2025 and OECD forecasts from December 2025 respectively.

SOURCE: Based on Central Bureau of Statistics, OECD (Economic Outlook 118, December 2025 and Revenue Statistics, 2025), and International Monetary Fund.

Rising interest payments come at the expense of other government expenditures (or necessitate higher taxes or further debt accumulation). Moreover, financing a large share of war costs through debt means transferring the economic burden to future generations—both through ongoing interest payments and through the eventual need to repay the debt itself. This is therefore also an intergenerational issue: In which cases is it appropriate for the current generation to finance present consumption at

the expense of future generations, as opposed to financing infrastructure investment that will contribute to growth and benefit those future generations.

During 2015–2019, prior to the COVID-19 crisis, Israel’s debt ratio converged to around 60 percent of GDP. The ten countries whose debt-to-GDP ratios were closest to Israel’s during that period (marked in orange in Figures 6.9 and 6.10) consisted mainly of small, advanced economies—such as most Scandinavian countries, Slovakia, and the Netherlands. In general, small and open economies are more vulnerable to external shocks. Israel’s choice during those years to maintain a debt ratio within this range was historically linked to the European Union’s Maastricht Treaty, which limited member states’ debt ratios to 60 percent of GDP, but it was also consistent with Israel’s characteristics as a small and open economy, similar to the other countries in that group.

In addition to exposure to external economic shocks, Israel faces unique and significant security risks, as the war has demonstrated, and it lacks the fiscal-monetary backing enjoyed by the aforementioned countries as members of the European Union. A further increase in Israel’s debt ratio would bring it closer to the levels of larger economies (such as the United Kingdom) or those that have experienced debt crises (such as Spain). Moreover, the interest payment burden in 2024 in some of those countries is lower (for example, France and the United Kingdom, and even more so Japan—Figure 6.9b), as they benefit from more favorable financing conditions and can therefore sustain higher debt-to-GDP ratios.

The second—and perhaps more important—issue is debt dynamics. While the average debt ratio among the small, advanced economies to which Israel belonged in 2015–2019 declined by 2025 to below 60 percent following the shocks of the COVID-19 pandemic and the war in Ukraine (Figures 6.10a and 6.10b), Israel’s debt ratio surged from that level as a result of the war. Figure 6.10b shows that the cumulative change in Israel’s debt-to-GDP ratio since 2022 has been the largest among advanced OECD countries, except for Finland and Canada. The common perception that debt ratios are generally rising worldwide is not entirely accurate. While large economies—which account for a major share of global debt and output—have indeed experienced increases, in most advanced economies, including the group to which Israel previously belonged, the debt-to-GDP ratio has remained stable or even declined in recent years.

It is therefore important to halt the upward trajectory of Israel’s debt ratio and to aim for a return to lower levels, such as those that existed before the war—a debt ratio of around 60 percent of GDP, similar to other small and advanced economies. The events of the past two years have made such a necessity even more relevant now, clearly demonstrating that major security risks can materialize and sharply increase the debt ratio. While the recent rise in the debt ratio has not yet led to a significant increase in the risk premium or to debt divergence, it is impossible to predict how markets would react to a further increase to debt levels that Israel has not experienced in many years. Israel must return to a path of a stable debt ratio at a

Prior to the war, Israel’s debt-to-GDP ratio was similar to other small, open, and advanced economies.

Due to the increase during the war, Israel’s debt-to-GDP ratio diverged from the comparison group.

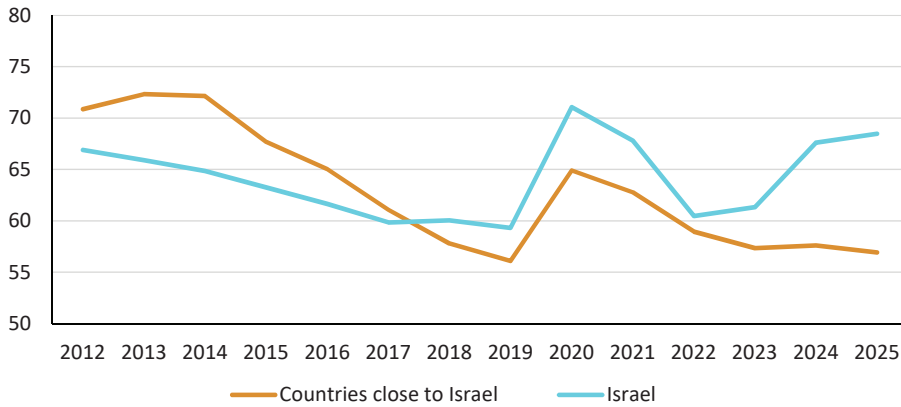
A low debt-to-GDP ratio target is particularly important after the war.

Returning the debt-to-GDP ratio to a downward path is essential for rehabilitating the fiscal security margin.

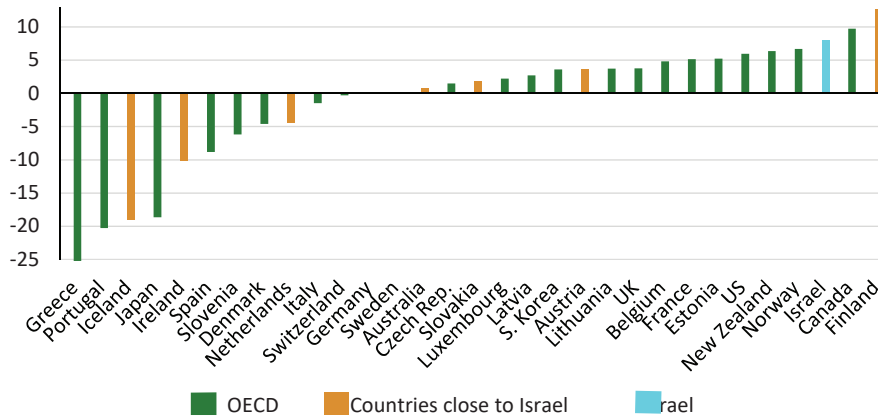
lower level than the current one, thereby reducing the interest payment burden and enabling fiscal flexibility in coping with future security and other shocks.

Figure 6.10 | Dynamics of the Debt-to-GDP Ratio, Israel and OECD
(percent of GDP)

a. Gross public debt, Israel and countries whose debt was close to Israel's between 2015 and 2019, 2012–2025



b. Change in gross public debt, 2022–2025



The comparison countries ("close to Israel") are the ten countries with debt-to-GDP ratios that were closest to Israel between 2015 and 2019 (as in Figure 6.9). Data for the other countries are IMF forecasts from October.

SOURCE: Based on Central Bureau of Statistics and International Monetary Fund.

BOX 6.3: THE CHALLENGE OF REDUCING PUBLIC DEBT IN THE HIGH-INTEREST-RATE ENVIRONMENT

This box defines two complementary diagnostic tools for assessing whether fiscal policy is consistent with stabilizing the debt-to-GDP ratio: (a) the stabilizing primary deficit (excluding interest), that is, the maximum primary deficit consistent with stabilizing the debt-to-GDP ratio, given the interest rate and growth rate; and (b) the fiscal equilibrium interest rate, namely, the effective real interest rate consistent with stabilizing the debt ratio, given the current primary deficit and the growth rate (Bolhuis et al., 2024).

The point of departure is the debt-to-GDP dynamics equation. Formally, the change in the debt-to-GDP ratio can be written as follows¹:

$$\Delta d_t \approx (r_t - g_t)d_{t-1} + pd_t$$

where Δd_t is the change in the debt-to-GDP ratio at time t , r_t is the real GDP growth rate, r_t is the real interest rate, d_{t-1} is the debt-to-GDP ratio in the previous period, and pd_t is the primary budget deficit as a percentage of GDP (expenditure net of interest payments on the debt, minus revenues).^{2,3}

Given equilibrium values for growth g , a target debt-to-GDP ratio d , and the interest rate r , it is possible to calculate the primary deficit that stabilizes the debt-to-GDP ratio, that is, a case in which $\Delta d = 0$:

$$pd^* = (\bar{g} - \bar{r})\bar{d}$$

This yields a useful rule of thumb: A 1-percentage-point increase in the equilibrium real interest rate reduces the primary deficit consistent with debt stabilization by d percent of GDP.⁴

The same condition can also be expressed in terms of the fiscal equilibrium interest rate, denoted as r_f^* , which is the real interest rate consistent with debt stabilization, given the current deficit:

$$r_f^* = \bar{g} - \frac{\overline{pd}}{\bar{d}}$$

¹ This equation is a linear approximation under the assumption that the interest rate and the growth rate are relatively small.

² Here, r denotes the effective real interest rate on the stock of debt, that is, a weighted average of real financing costs across debt instruments. When part of the debt is CPI-indexed, inflation does not erode the principal on the indexed portion. Therefore, indexation does not alter the stabilization formula, but it does affect the way in which the formula is calculated from nominal data.

³ Two additional factors that do not appear in the debt equation are the government's net capital receipts from asset sales (privatization) and debt revaluation resulting from relative changes in debt components, such as exchange rates and GDP prices. For further discussion, see Brender (2020).

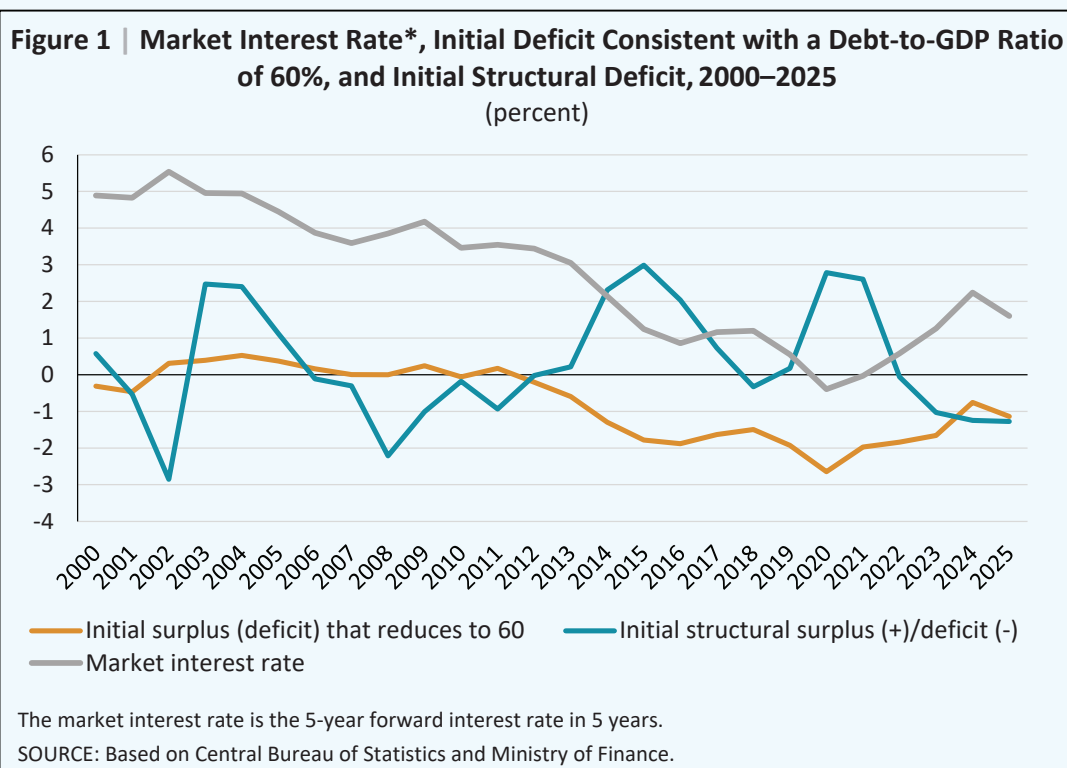
⁴ If the debt ratio is 70 percent of GDP, a permanent increase of 1 percentage point in the real interest rate changes the primary deficit required for debt stabilization by about 0.7 percent of GDP.

The interpretation is straightforward: If the effective real interest rate on the stock of debt is higher than r_f^* , the debt-to-GDP ratio tends to rise relative to the target. If it is lower than r_f^* , the debt ratio tends to decline relative to the target.

Calculating either the fiscal equilibrium interest rate or the debt-stabilizing deficit requires an assumption regarding equilibrium growth. For illustrative purposes, for 2025 we assume long-term real growth of 3.5 percent per year and a structural primary deficit of 1.3 percent of GDP. Under these assumptions, and in order to maintain the current debt-to-GDP ratio (68.5 percent), the implied fiscal equilibrium real interest rate is about 1.6 percent, similar to the prevailing market rate (for the 5–10 year horizon). Similarly, under the same growth assumption, and assuming the market rate is given at its December 2025 level (1.6 percent), the stabilizing primary deficit is:

$$pd^* = (0.035 - 0.016) \times 0.685 = 1.3\%$$

This value is similar to the actual structural primary deficit. The implication is that the gap between the structural primary deficit and pd^* is close to zero. If the effective real interest rate becomes persistently established above r_f^* (about 1.6 percent), fiscal tightening, that is, a reduction in the primary deficit, will be required in order to stabilize the debt ratio. A sustained increase of 1 percentage point in the interest rate above r_f^* would imply the need for tightening of about 0.7 percent of GDP.



As described in Section 4.b of this chapter, over recent decades the Government of Israel has aimed for a debt-to-GDP ratio of 60 percent, and even below that level. Accordingly, we present a historical perspective on the primary deficit required to move toward, or maintain, such a debt ratio, together with an estimate of the structural primary deficit and the market interest rates that prevailed. The decline in real yields globally and in Israel during the previous decade led to a decline in the primary deficit consistent with a 60 percent debt-to-GDP ratio, as emphasized by Blanchard (2019), such that even a primary deficit of 2 percent of GDP (about a 4 percent overall deficit) was consistent with maintaining a debt-to-GDP ratio of 60 percent. However, the increase in the global interest rate environment, alongside an increase in Israel's risk premium, has meant that the primary deficit now consistent with that outcome is about 1 percent of GDP. At the same time, the actual structural primary deficit has increased (that is, the surplus has declined), and now stands at 1.3 percent of GDP, slightly above the level required in order to reduce the debt-to-GDP ratio and bring it to 60 percent.

Debt duration, interest-rate scenarios, and an insight for fiscal policy under uncertainty

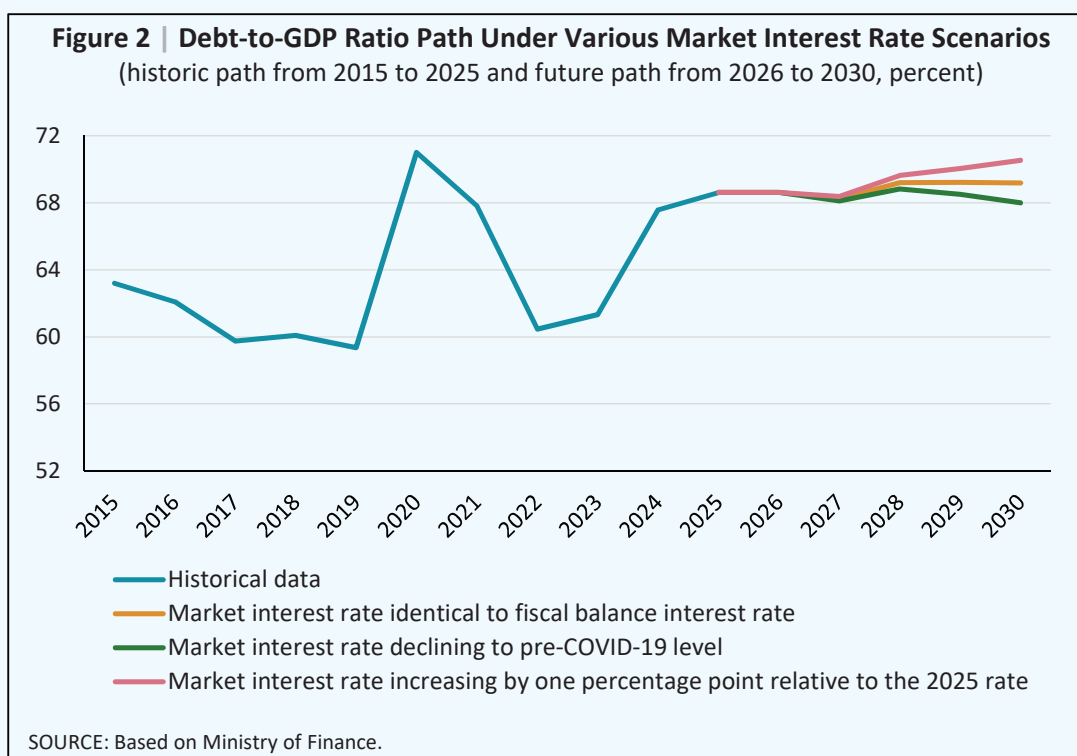
The fiscal equilibrium interest rate is a long-term anchor. In practice, however, government debt is not fully rolled over in each period at the current market rate. The interest rate that affects debt dynamics over the medium term is the effective interest rate on the stock of debt, namely, the average interest rate across outstanding bonds and new issuance.⁵ Because Israel's debt has a relatively long average maturity, about 9 years, the effective interest rate's convergence to the rate on new issuance is very gradual: roughly one-ninth of the stock matures and is refinanced each year.⁶ This is also the reason why the stabilizing primary deficit calculated here differs slightly from the effective stabilizing deficit discussed in the main text of the chapter.

Figure 2 presents three scenarios for the interest rate on new issuance and their implications for the debt-to-GDP ratio under the same primary deficit. In the baseline scenario, the interest rate on new issuance is around the fiscal equilibrium interest rate, and therefore, as the effective interest rate on the stock of debt converges to it, the debt ratio tends to stabilize. In an optimistic scenario, a decline in interest rates or in the risk premium allows for a gradual decline in debt, although it may also reflect expectations of lower growth, which in turn would contribute to an increase in the debt-to-GDP ratio. These were, for example, the conditions that prevailed for many years until the global interest-rate hiking cycle that began in 2022, partly under the influence of central bank bond purchases worldwide, and it does not appear likely that such conditions will return over the foreseeable horizon. In a pessimistic scenario, a persistent increase in the interest rate on new issuance creates upward pressure on debt

⁵ In practice, the interest rate on new issuance is not exogenous. In Israel the public debt-to-GDP ratio has been found to have a positive, statistically significant, and economically meaningful effect of on real yields of government bonds, with the effect stronger the longer the bond's maturity (Brender and Ribon, 2015). The transmission operates through two channels. A higher debt ratio increases the supply of bonds, putting downward pressure on prices and upward pressure on yields, and it also raises the risk premium perceived by investors.

⁶ This can be described approximately using a simple "transition equation": The effective interest rate this year is a combination of last year's effective interest rate and the interest rate on new issuance, where the weight of new issuance is determined approximately by the share of debt rolled over each year. In Israel, with an average maturity of about 9 years, this is on the order of about one-tenth of the stock of debt per year.

as the effective interest rate converges upward. At present, the 5-year real forward rate 5 years ahead is close to the fiscal equilibrium interest rate. Therefore, assuming stable growth and maintenance of the primary deficit at its current level, the debt ratio is also expected to remain around its current level over the medium term. Reducing the debt ratio in order to restore fiscal buffers to the Israeli economy would, under these conditions, require a reduction in the primary deficit. However, the margin of safety is small, and a moderate deterioration could shift the dynamics onto an upward path. Such deterioration could also occur as a result of the increase in the global debt-to-GDP ratio, which contributes to higher interest rates.



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Chapter 7

Welfare Issues

THE MENTAL HEALTHCARE SYSTEM: FROM THE 2015 REFORM TO THE EFFECTS OF THE WAR THAT BEGAN ON OCTOBER 7, 2023

- » In view of the implementation of the 2015 insurance reform and of the COVID-19 pandemic, the number of individuals seeking mental health treatment increased even before the war. There are growing indications that the war will lead to a further significant increase in the number of patients and treatments.
- » Since the outbreak of the war, several measures have been taken to strengthen the mental healthcare system, foremost among them the implementation of the National Mental Health Program (2024), with an annual budget of NIS 1.4 billion.
- » The public mental healthcare system is characterized by long waiting times, partly due to a shortage of therapists and a lengthy training path for therapeutic professions, which causes a delay in adapting supply to the increase in demand.
- » Wages in the therapeutic professions are lower than in other academic occupations, and psychiatrists' wages are lower than those of specialist physicians in other fields. The wage agreement signed with public sector psychologists in 2025 will significantly improve their relative position.



The **mental health system** was dealing with **heavy workloads** even before the war



The war will likely lead to a further marked increase in the number of **mental health patients**

1.4
NIS billion

Annual budget for the **National Mental Health Program** implemented in 2024



Wages in the treatment professions are lower than in other academic professions

1. INTRODUCTION

In the past decade, the mental healthcare system has undergone several significant changes, particularly due to the impact of the war that began on October 7, 2023.

Against the backdrop of the war that broke out on October 7, 2023, and its mental health consequences for Israel's residents, this chapter provides an extensive discussion of the field of mental health. Over the last decade, the mental healthcare system in Israel has undergone several significant transformations: the insurance reform implemented in 2015; the COVID-19 pandemic, which, according to many, increased the number of individuals seeking mental health treatment; the war, which included traumatic events for many Israelis; and the mental health program approved in 2024. This chapter focuses on understanding the main transformations within the system over the last decade, characterizes its state prior to the war, examines how it was affected by the war, and identifies what is required for the system in the coming years.

a. The essentiality of a high-quality mental healthcare system in economic terms

Government investment in an accessible and preventive mental healthcare system can generate a high economic return.

The provision of an accessible and professional mental healthcare system is of significant importance during routine periods, and even more so during times of emergency. Beyond the substantial benefits associated with improving individual mental well-being and quality of life, a high-quality system of mental health care services can also contribute significantly in economic terms. Several studies and reports have found that the return on government investment (ROI) in the mental health field is high (Chisholm et al., 2016; WHO, 2022). This return is due to a reduction in lost workdays, improved efficiency during working hours (Knapp and Wong, 2020; OECD, 2025), a decrease in healthcare expenditures (Altmann et al., 2016), and the prevention of long-term damages resulting from burnout and comorbidity, among other factors. Furthermore, a robust public mental healthcare system also holds significance in terms of reducing social disparities (Vargas Lopes and Llena-Nozal,

2025). Another insight emerging from the literature is the high return on preventive actions and early intervention in mental healthcare, both in relation to labor productivity and in other contexts (McDaid et al., 2019; OECD, 2025).

b. Structure of the Mental Healthcare System in Israel

The treatment of mental health in Israel encompasses a subsidized public system alongside private services. A reform implemented in 2015 transferred the insurance responsibility for mental health treatment from the state to the health funds, thereby establishing them as the central point of contact for receiving psychological and psychiatric care within the public system, either free of charge or with a copayment. In addition to the health funds, the public system includes government clinics, psychiatric hospitals, and specialized frameworks such as day treatment, balancing homes, and resilience centers. In contrast, the private system offers greater availability and significantly shorter waiting times, alongside the option to choose the therapist and treatment method according to personal preferences. However, treatment in the private system involves high costs.

The training process for mental health professionals, particularly psychiatrists and clinical psychotherapists, who constitute the therapeutic core, is lengthy and involves numerous stages. The training of a specialist physician in psychiatry takes approximately 12 years at least. The training process for specialist psychologists typically lasts approximately 10 years and includes, in addition to bachelor's and master's degrees, an additional four years of specialization (on a part-time basis). Similarly, the training of a clinical social worker, while not requiring a period of specialization, typically takes 6-8 years. This lengthy training process in these professions, which often includes specialization in public institutions and under the supervision of qualified personnel, necessitates long-term workforce planning and imposes a significant supply constraint, thereby limiting the ability to address rapid increases in demand.¹

The lengthy and complex training process for mental health professionals requires long-term planning.

2. KEY DEVELOPMENTS IN THE MENTAL HEALTHCARE SYSTEM IN THE DECADE PRECEDING THE WAR

The Insurance Reform (2015) – Until 2015, individuals with mental health conditions who were treated within the public system received treatment in psychiatric hospitals and in clinics affiliated with those hospitals, as well as in clinics belonging to Clalit Health Services. These treatments were the responsibility of the state. During those years, the therapeutic supply and the scope of therapeutic personnel in the public

An insurance reform was implemented in 2015, transferring responsibility for the provision of mental health services to the health funds.

¹ The private system, while capable of absorbing a certain level of demand growth, is also subject to a capacity constraint. The number of private practitioners, or those combining employment in the public and private sectors, is limited, constraining their ability to expand working hours and the scope of employment.

sector were limited, and many of those requiring treatment refrained from seeking it due to the stigma associated with mental health patients (Samuel and Hess, 2020).

In 2015, the insurance reform in the field of mental healthcare came into effect. The core of the reform was the transfer of insurance and therapeutic responsibility for mental health from the state to the health funds.

Several objectives were defined for this reform. First, improving accessibility and availability of mental healthcare services, which were perceived as insufficient prior to the reform. Second, reducing the stigma associated with individuals seeking mental health treatment. It was contended that a significant portion of those requiring mental healthcare services do not seek them due to this stigma, and those who do seek such services are primarily individuals suffering from severe symptoms that compel them to seek treatment despite the negative label. The transfer of mental health treatments to health maintenance organizations (HMOs) normalized these treatments, as following the reform, mental healthcare was provided within regular community clinics rather than in isolated government centers. This change conveys a message that mental health is an integral part of general health, thereby encouraging individuals who do not suffer from severe symptoms to seek assistance. Third, integrating the entity responsible for physical healthcare with that responsible for mental healthcare. Centralizing treatment under a single 'umbrella' enables a holistic view of the patient and improves the capacity for early diagnosis. As part of achieving this objective, training in mental healthcare was provided to primary care physicians, specifically family doctors and pediatricians (Samuel and Hess, 2020). Given that family doctors and pediatricians typically serve as the initial point of contact within the healthcare system, their specialized training in this field enables the identification of mental distress, even when manifested as physical complaints.

Since the implementation of the reform, there has been an increase in the number of individuals seeking treatment.

To meet the reform's objectives, health funds were required to establish infrastructure for mental health services and to expand awareness and accessibility to treatments in order to increase the number of individuals seeking care among those in need of treatment. Quantitatively, the reform's objectives were defined as increasing the number of treatment recipients annually to 4 percent of all adults and 2 percent of all children. (There are no available data on the rate of treatment recipients prior to the reform.) Indeed, since the implementation of the reform in July 2015, and in accordance with its objectives, there has been an upward trend in the number of individuals seeking treatment (Samuel and Alroy, 2019), and the rates of referrals and numbers of treatments for citizens in the mental health field have increased and approached the reform's objectives (State Comptroller, 2020).

Since 2019, following the implementation of the reform, the budget of psychiatric hospitals has been based on payments for hospitalization days and ambulatory services directly from the health funds, rather than from the state budget. This measure completed the transfer of responsibility for mental health treatments to the health funds, encompassing both hospitalizations and community care. The initiative also increased the budgetary and managerial independence of psychiatric hospitals.

The impact of the COVID-19 pandemic (2020-2021) – Following the COVID-19 pandemic in 2020, the number of individuals seeking mental health assistance and treatment increased. The pandemic created a widespread mental health crisis due to social isolation, economic uncertainty, and health anxiety. All these factors led to a significant increase in reports of symptoms of depression, anxiety, and emotional distress. This increase was documented in a study that focused on the adolescent population in Israel and found that during the COVID-19 period, the proportion of adolescents suffering from depression, anxiety, stress, and eating disorders increased by dozens of percentage points (Bilu et al., 2023).

A review conducted by the State Comptroller in 2020 (based on 2018 data) revealed that waiting times in the public sector were already extensive at that time, prior to the COVID-19 pandemic. The waiting period for psychotherapeutic treatment, following an insured individual's diagnosis by a health fund as requiring such treatment, averaged approximately 150 days (State Comptroller, 2020). Considering the increase in referrals for treatment during the COVID-19 pandemic and the rigidity of the number of therapists in the short term due to the lengthy training period, it is reasonable to assume that Israel's mental healthcare system was contending with significant burdens even before the outbreak of the war. Several documents addressing this issue also indicated a substantial shortage relative to the needs in this field prior to the war (Davidovitch, 2023; Blank, 2023).

The COVID-19 pandemic led to an increase in the rate of people suffering from emotional difficulties.

Israel's mental healthcare system was contending with significant burdens and manpower shortages even before the outbreak of the war.

3. THE WAR'S IMPACT ON MENTAL HEALTH

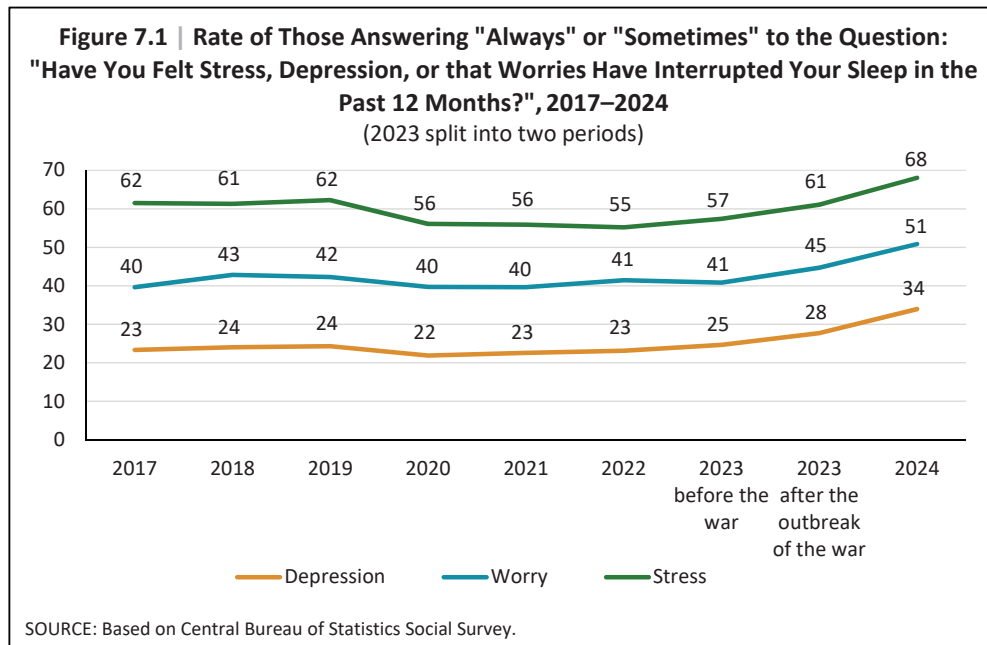
The war that began in October 2023 posed a challenge to the mental healthcare system. The manner in which it broke out, with an unprecedented terrorist attack, and its extended duration, led to a significant increase in the prevalence of mental distress among the public. Since the number of therapists is rigid in the short and medium term, there was a limited supply of therapists to meet the increased demand for mental healthcare treatments during this period, particularly in public healthcare. Therefore, there are indications that a significant portion of those who needed treatment either did without it or turned to the private system (State Comptroller, 2025).

Consequently, data on the number of patients and therapeutic contacts within the public system are likely not a reliable reflection of the actual increase in the scope of needs, but rather of the system's capacity constraint. Against this background, the data presented in this section focus on self-reporting of symptoms, which serve as an indication of the increase in needs resulting from the war, although these data are also subject to various problems. Furthermore, unlike physical medicine, where in the vast majority of cases medical treatment is sought by the affected individual in close proximity to the event, a significant percentage of referrals for mental health treatment arrive long after the traumatic event itself, and occasionally even many years later. Therefore, at this stage, it is not yet possible to assess the full impact of

The war created an increase in demand for mental healthcare treatments, which came against a rigid supply of therapists.

the war. Nevertheless, the data presented later in this section, updated to the time of writing, indicate that the war has had a profound impact.

The Central Bureau of Statistics (CBS) Social Survey includes several questions describing the mental well-being of respondents. Among other things, respondents are asked whether they felt stressed, depressed, or if worries interfered with their sleep during the past year. An analysis of the survey findings for the years 2017–2024 indicates a significant increase in the number of those reporting these feelings during the war period. For example, the percentage of those reporting depression, which stood at 23 to 25 percent in the years preceding the war, rose to 34 percent in 2024, reflecting a significant increase of over 40 percent in the number of those reporting (Figure 7.1).² The Social Survey data contain no evidence of the COVID-19 pandemic’s impact on the mental well-being of the Israeli population.



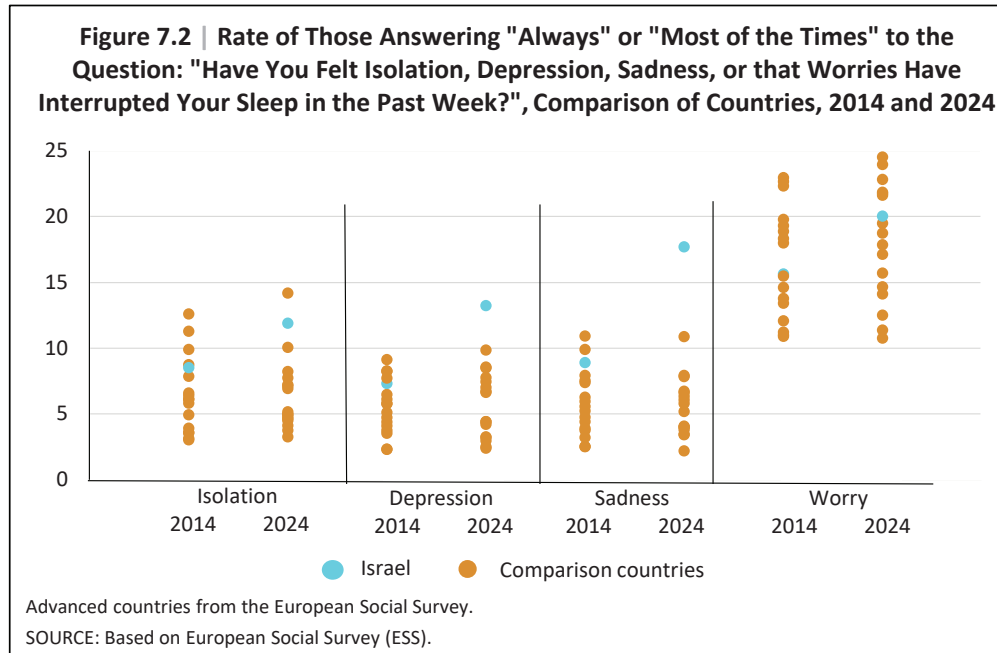
The European Social Survey (ESS)³, in which Israel participates, also included questions in 2014 and 2024 regarding the frequency of feelings of loneliness, depression, sadness, or worries that interfered with sleep during the week preceding

² Social Survey data indicate a moderate increase in the rates of individuals reporting stress, depression, and concerns in the final months of 2023, with a sharper increase observed during 2024. The relatively moderate increase in the final months of 2023, which reflected the shock of the outbreak of the war, may be the result of the small number of observations or of the respondents’ processing of events, as they may not yet have been able to express their feelings at that stage.

³ See: European Social Survey, European Research Infrastructure (ESS ERIC), (2024). ESS11 and ESS07 Data Documentation. Sikt - Norwegian Agency for Shared Services in Education and Research. <https://doi.org/10.21338/ess11-2023>

the survey. The data pertaining to Israel published in the 2024 survey were collected from December 2023, approximately two months after the outbreak of the war, until October 2024. The findings indicate that while Israel was positioned around the median for most indicators relative to the other countries in 2014, all of Israel's indicators rose significantly in 2024, and the rates of those reporting feelings of depression or sadness reached considerably high levels compared to all other countries that participated in the survey (Figure 7.2).

During the war, the rates of depression and sadness increased sharply relative to other countries.



A research group led by Professor Yossi Levi-Belz from the University of Haifa conducted several waves of surveys using clinically validated questionnaires⁴, and published several academic articles on the impact of the war on the mental state of Israeli residents. The research findings indicate a sharp increase in the rates of PTSD, anxiety, and depression cases in the initial months of the war, followed by a significant moderation (Levi-Belz et al., 2025). A study by the Brookdale Institute, based on an ongoing survey conducted at three time points during the war (also utilizing a clinically validated questionnaire), similarly identified a sharp increase in symptoms in the initial months of the war, followed by a significant moderation. In addition, this study observed that concurrently with the decline in the rate of

During the war, there was a sharp increase in symptoms of post-trauma and other emotional distress.

⁴ The studies were based on a recognized questionnaire in the field of psychology for the identification of a specific threshold level of mental states, such as anxiety, depression, and post-traumatic stress disorder. This threshold serves as an indication of a certain level of mental state, but it does not necessarily mean that individuals surpassing it will require psychological treatment. The first wave of the study was conducted in August 2023, and therefore provides an indication of the mental state of Israel's residents prior to the war.

symptoms, there was an increase in the proportion of individuals reporting receipt of treatment, rising from 14 percent of the total sample in January 2024 to 18 percent in October 2024 (Samuel et al., 2025). The increase in the number of individuals receiving mental health treatment was also prominently reflected in data from the Rehabilitation Department of the Ministry of Defense, which indicated that the number of soldiers receiving mental health treatment in the department, which stood at approximately 18,200 prior to the war, increased by approximately 12,800 additional soldiers (reflecting an increase of approximately 70 percent relative to the prewar level).⁵

A high percentage of individuals requiring treatment during the war did not seek that treatment.

Further findings from the Brookdale Institute’s study indicate that 44 percent of those who felt a need for treatment in October 2024 but did not seek it (13 percent of respondents) cited the primary reason for not seeking treatment as being related to access barriers such as waiting times, distance, or cost (Samuel et al., 2025). The State Comptroller’s Report from 2025, which was based on a survey from April 2024, also found that a high percentage of individuals requiring treatment did not seek it due to reasons related to public service access barriers. These included long waits at health funds (38 percent), and a lack of awareness regarding the possibility of receiving treatment at health funds (23 percent). Another reason individuals did not seek treatment was their lack of confidence in the professionals at the health funds (19 percent).⁶ Of those who sought treatment, 42 percent consulted a private practitioner, and only 38 percent were treated by health funds⁷ (State Comptroller, 2025).

The public mental healthcare system suffers from long waiting times, which encourages people to forego treatment or seek it in the private system.

The findings indicate that a significant portion of the increase in mental health needs resulting from the war was addressed by private sector practitioners. In addition, the Comptroller’s report points to long waiting times in the public system—6.5 months for mental health treatment during the war period, comprising 1.5 months until diagnosis and an additional 5 months from diagnosis until the commencement of treatment (measured in March-April 2024). These long waiting times likely prompted some applicants to seek treatment in the private sector, and it is therefore highly likely that without these shifts to the private sector, waiting times in the public sector would have been even longer.

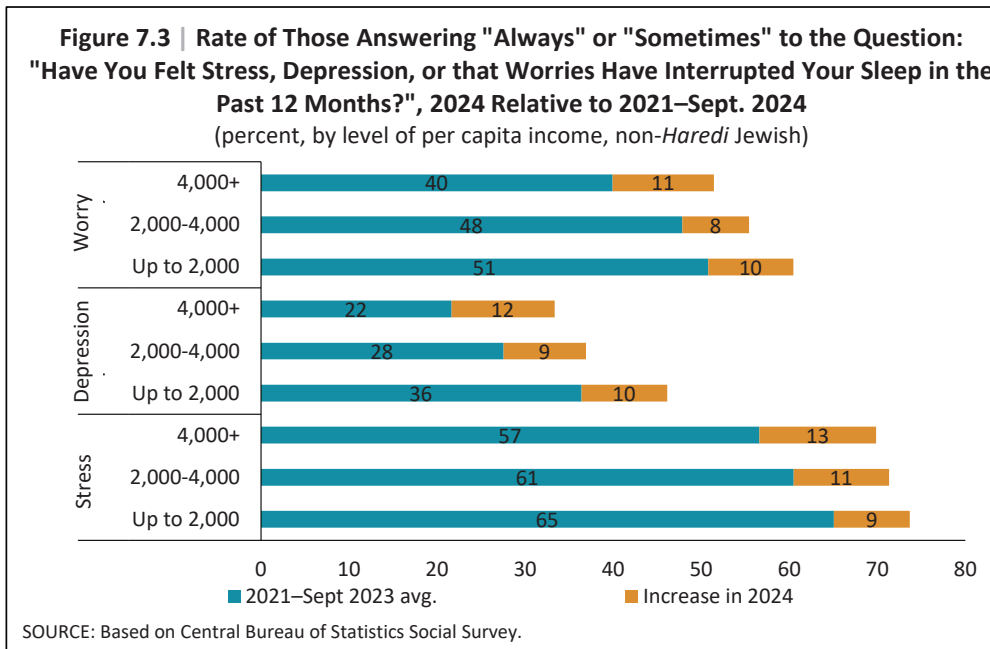
The war’s impacts on specific population groups: The psychological impact resulting from the war was not uniform across all population groups. A study by the Taub Center, based on a survey of parents of young children and conducted in several waves throughout the war, found that parents who were evacuated from their homes, parents from families in which one spouse was mobilized for reserve duty, and parents from the Arab community tended to suffer more from depression, anxiety, and stress during the war period than other parents. It was also found that

⁵ The data were published on December 7, 2025, on the website of the Ministry of Defense, Rehabilitation Department.

⁶ The respondents cited them as the primary reasons for not seeking treatment.

⁷ The remainder were treated through the call centers, resilience centers, and the ‘Three Calls’ service.

parents residing in close proximity to missile firing zones (based on the time to reach a protected space) were more affected than parents residing in more distant areas (Taub Center, 2025). Figure 7.3, based on Social Survey data, describes the change in the proportion of individuals reporting stress, depression, and worries interfering with sleep in 2024 compared to the prewar period (2021 to September 2023), divided by per capita household income levels. The figure indicates that the war affected the mental well-being of households across all income levels, but the increase was somewhat greater among households with high income.⁸



The National Mental Health Program (2024) – In January 2024, a new national mental healthcare program was established. Although the program was approved in the initial months of the war, it does not exclusively address the needs that emerged during that period. Rather, it provides a response to broader issues and needs in the field of mental health that had accumulated even before the war, following the reform implemented in 2015 and the COVID-19 pandemic.

The national mental healthcare program approved in 2024 is intended to provide a response to broader issues and needs in the field.

The primary objectives of the program are: expanding the workforce and increasing the number of patients and therapeutic contacts within the public system (health funds); optimal utilization of care providers with varying levels of training to match therapeutic resources to the severity of distress (“stratification” of the care system); establishing alternatives to hospitalization, such as home hospitalization and balancing

⁸ To avoid potential biases associated with the correlation between belonging to the Arab and Haredi sectors and income level, Figure 3 focuses on non-Haredi Jews.

homes; measures to strengthen continuity of care and improve service; and funding local mental health frameworks such as resilience centers, community centers, the education system, welfare services, early detection, and more. The program also includes updates to payment arrangements between health funds and psychiatric hospitals, designed to streamline the psychiatric hospitalization mechanism while creating incentives for the reduction and shortening of hospitalizations where feasible, as well as improving the quality of care in departments (Kaplinsky and Davidovich, 2025).

4. DEVELOPMENT OF THE STATE BUDGET FOR MENTAL HEALTH, 2015–2025

The governmental budgeting mechanism in the healthcare field is primarily based on the allocation of the large majority of the budget designated for medical care (“the Health Basket”) among the health funds according to the capitation formula. In addition, supplementary budgets are allocated in more limited amounts through dedicated support mechanisms for specific issues, and in many cases these budgets are absorbed after several years into the general Health Basket budget after several years. This budgeting method, combined with the managerial flexibility granted to the health funds, creates an inherent difficulty in identifying resources actually directed to specific areas, such as the mental health field. Furthermore, there is also a lack of comprehensive and reliable data that enable quantitative and qualitative assessment of effective output indicators, such as waiting times, quality of care, and its outcomes (State Comptroller, 2020; Blank, 2023).

As part of the reform implemented in 2015, and as part of the transfer of responsibility for mental health to the health funds, approximately NIS 2 billion were added to the health funds’ annual budget in two installments in 2015 and 2016.⁹ The budgetary supplement was comprised of approximately NIS 1.6 billion transferred from the Ministry of Health’s budget, which had been responsible for service provision prior to the reform, with the remainder coming from a budgetary supplement provided as part of the reform. The NIS 2 billion budgeted in 2016 constituted approximately 4.5 percent of the health basket for that year. From then until 2024, no dedicated additions were provided for the field of mental health, with the exception of a one-time budget of approximately NIS 100 million transferred during the COVID-19 pandemic.

As part of the implementation of the National Mental Health Program, which came into effect in 2024, the annual budget allocated for mental health was increased by NIS 1.4 billion in two installments: NIS 900 million in 2024, and an additional roughly NIS 500 million in 2025. This addition was financed through an increase in the health tax in 2025, which was estimated at approximately NIS 1 billion per year,

⁹ Concluding reports on the operations of health funds for 2015 and 2016.

The national mental healthcare program of 2024 included a budgetary increment of NIS 1.4 billion.

alongside supplements from the state budget. A portion of this budgetary addition—NIS 347 million in 2024 and NIS 591 million in 2025 (in the original budget)—was transferred to the health funds under support criteria that conditioned the budget transfer on improving services and their accessibility, as well as on the development and operation of additional systems and services. The remainder of the budget was transferred to the Ministry of Health and other ministries (Welfare, Education, and Interior).

5. THE THERAPEUTIC PERSONNEL IN THE MENTAL HEALTH FIELD

The mental healthcare array is based on a multidisciplinary team that provides an integrated response to the biological, emotional, and social aspects of the patient. Psychiatrists are responsible for medical diagnosis and pharmacological treatment; psychologists and social workers holding master's degrees, who have been trained to provide clinical services, focus on psychotherapeutic interventions and in-depth diagnosis; and other therapeutic professionals focus on non-psychotherapeutic interventions and on improving patient well-being and their integration into community support systems. The synergistic work of these professionals is essential for ensuring an effective continuum of care, from the stage of identification and prevention through to rehabilitation or recovery.

Wages and Employment Trends of Psychologists and Social Workers – Despite the extensive training and numerous qualifications required to provide high-quality mental health treatments, the income of therapists in this field is low compared to those employed in other academic fields. For example, the monthly income of psychologists and social workers with master's degrees—the two main providers of psychotherapy services, which constitute one of the cornerstones of mental health treatments—is at the bottom of the wage distribution for those with master's degrees (Figure 7.4).¹⁰ This finding was also observed in a study by Krill et al. (2016), which included an econometric analysis of the wage premium on higher education as a function of the field of study.

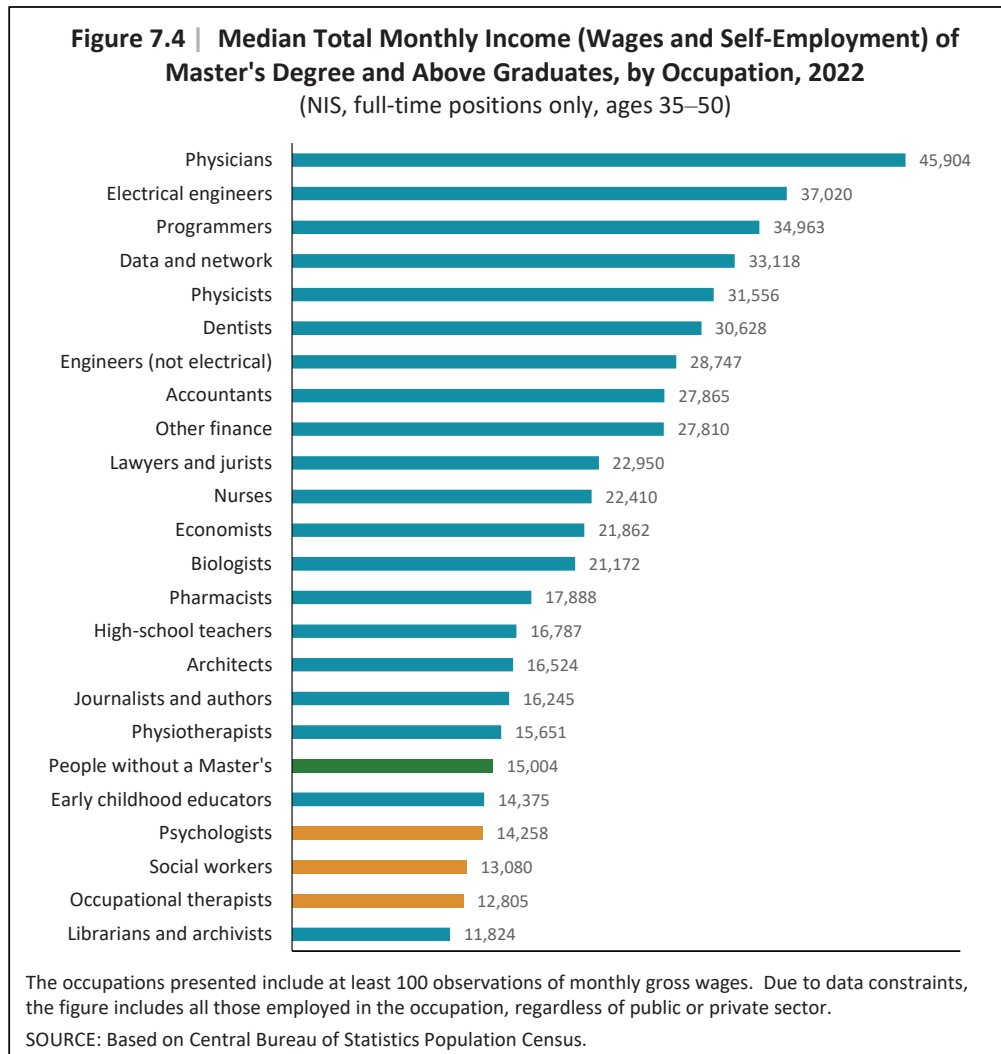
The income of psychologists and social workers is at the bottom of the wage distribution for those with Master's degrees.

In recent years, there has been a significant increase in the number of students studying psychology and a more moderate increase in the number of students studying social work (Figure 7.5). The number of psychology internship graduates has also increased in recent years, from 231 in 2006 to 342 in 2013 and 615 in 2023. This increase reflects a growth of 166 percent between 2006 and 2023 – significantly higher than the population growth during these years (approximately 38 percent). The largest increase was among interns specializing in educational psychology specializing in child therapy.¹¹

In recent years, there has been a significant increase in the number of students studying psychology.

¹⁰ To avoid the impact of outlier observations, the wage data in Figure 7.4 are presented based on median analysis.

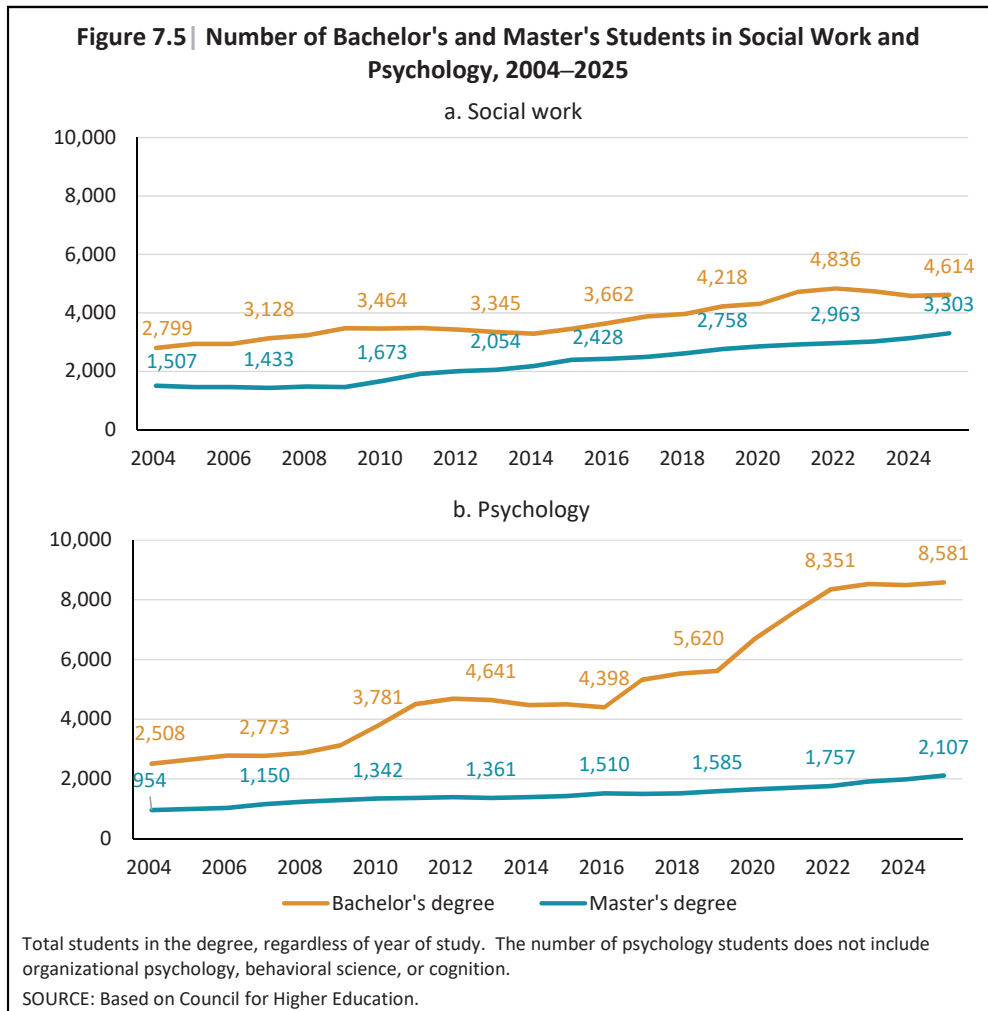
¹¹ Source: "Manpower in Health Professions 2023", Information Department, Ministry of Health. https://www.gov.il/BlobFolder/reports/health-professions-manpower/he/files_publications_units_info_manpower2023.pdf



In April 2025, a collective wage agreement was signed, providing significant increases in pay for psychologists in the public sector in Israel.

The Psychologists' Wage Agreement (2025)—To address the shortage of psychologists, particularly in the public sector, a collective wage agreement was signed in April 2025. This agreement stipulated significant increases in the remuneration of psychologists in the public sector in Israel. The agreement includes a transition to a dedicated wage scale, which separates psychologists from the general academic wage scale and increases their wages by rates that can reach approximately 40 percent for some psychologists (including a substantial increase in base salary, expansion of seniority increments, and other provisions). The wage increase stipulated in the agreement is to be implemented in three phases, commencing on January 1, 2025, and concluding on April 1, 2027. The agreement emphasizes the retention of human capital through the expansion of seniority increments, the creation of promotion tracks to management and professional responsibility roles, and the provision of financial incentives aimed

at strengthening public healthcare against the private market.¹² The annual cost of the agreement once fully phased in is NIS 350 million, with NIS 100 million of this sum being funded from the new mental health program (out of the NIS 1.4 billion approved for the program).



The wage agreement with social workers – The wages of social workers were updated in recent years under two agreements: the first in May 2022 and the second in June 2025. These agreements include staggered wage increases over several years, which collectively amount to average increases exceeding 30 percent. Furthermore, the agreements included a simplification of the wage structure, an improvement

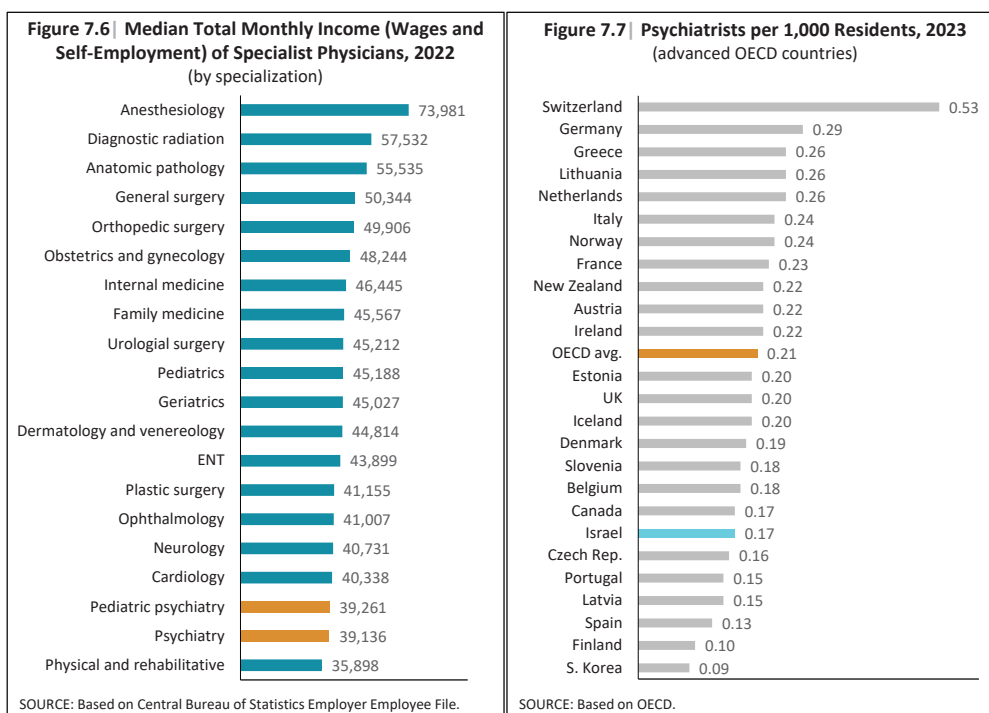
¹² Collective Wage Agreement of Psychologists in the Public Sector in Israel, April 1, 2025. <https://www.gov.il/BlobFolder/policy/psychologists-collectiveagreement-01042025/he/psychologists-collectiveagreement-01042025.pdf>

in the mechanism for wage increases for nonmanagerial employees, and other provisions. The agreements impacted the wages of social workers in the public sector as well as those employed by nonprofit organizations and in privatized services.

The incentives in the field of psychiatry in the 2011 wage agreement had little impact in attracting physicians to specialize in the field.

Wages and trends among psychiatrists and the wage agreements signed in 2011 and 2024 – The wages of specialists in psychiatry are relatively low compared to those of specialists in other fields (Figure 7.6) – a phenomenon not unique to Israel. The low wages in this field contributed to the designation of these areas as “distressed fields” in the physicians’ wage agreements of 2011 and 2024 – meaning fields experiencing a shortage of doctors. The 2011 agreement included generous incentives for physicians to specialize in these fields. However, several studies that examined their effectiveness found that they had little impact in attracting physicians to specialize in these fields (Ashkenazi et al., 2017; Markovitz et al., 2021; Zontag, 2025). This low effectiveness may be attributed in part to the fact that even after wage increases, wages in these specializations remained significantly lower than other specializations, as shown in Figure 7.6, which presents wage data for 2022. Furthermore, the general shortage of physicians may further complicate the incentivization of doctors to specialize in these less attractive fields.

The wage agreement signed with physicians in 2024 included additional wage incentives for psychiatrists, as the field of psychiatry was defined as one of the essential areas for treating war casualties. The shortage of psychiatrists and the low popularity of this field among physicians are not unique to Israel, and are typical of many countries. The ratio of psychiatrists to population size in Israel, while lower than the average among other developed OECD countries, is not exceptionally low (Figure 7.7).

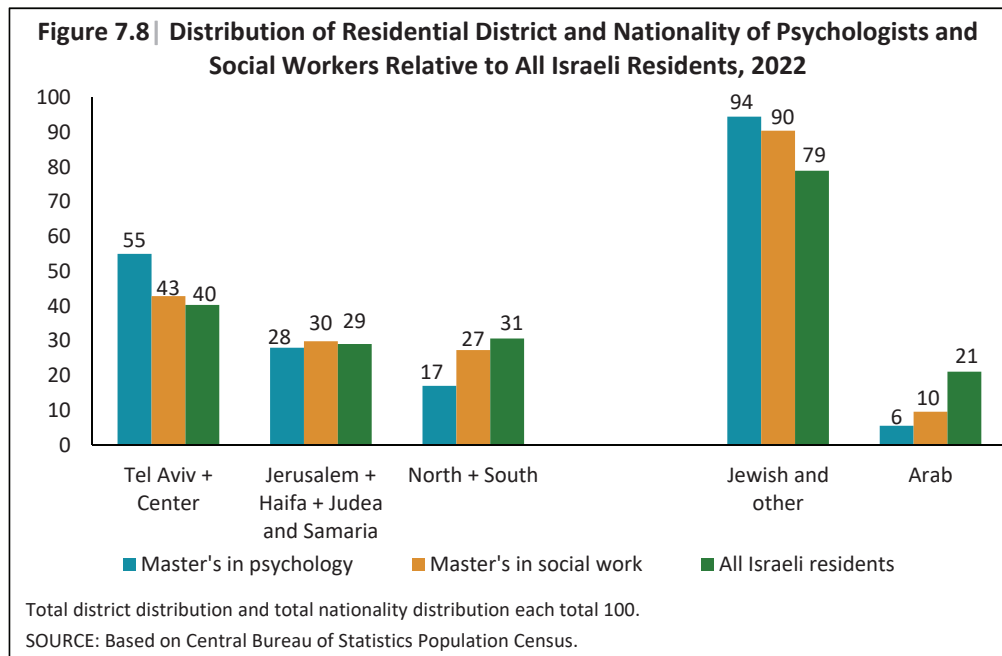


The mental health program, which came into effect in 2024, included several measures aimed at increasing the number of psychiatry residents and encouraging the training of residents also within the health funds. (Currently, all residents are trained in hospitals.) The program's objective is an immediate increase in the number of psychiatry residents by approximately 50 per year, reaching 110 within three years. These measures, to the extent that they prove effective, will only be reflected in several years, after the new residents complete their specialization.¹³

Disparities in the distribution of mental health professionals across geographical regions and sectors – Beyond the aggregate number of therapists, and in order to provide quality mental health services to all residents in Israel in proximity to their places of residence and in a manner consistent with their language and culture, the geographic distribution of therapists and their allocation among different sectors are also very important. Figure 7.8 presents the distribution of psychologists and social workers holding master's degrees engaged in therapeutic professions relative to the population distribution by districts and nationality. Significant disparities are evident from the figure, with a very low proportion of therapists in peripheral areas and within the Arab community relative to the population size. These disparities are more pronounced with respect to psychologists, but are also notable concerning social workers. The significance of the disparities between central and peripheral areas is underscored by the fact that most of the areas where the impact of the war was most pronounced, in terms of resident evacuation and proximity to combat zones and missile fire, are peripheral areas in the Northern and Southern Districts. The expanded use of technology for remote services may make it possible to reduce the impact of these geographical disparities.

There are significant disparities in the distribution of mental healthcare professionals, to the detriment of the geographic periphery and the Arab community.

¹³ Space for the Mind – Accessible and Tailored Public Mental Health (The National Mental Health Program), Ministry of Health. https://www.gov.il/BlobFolder/reports/national-mental-health-program-publication-2082024/he/units_mental-health_mental_health_prog_22082024.pdf



6. CONCLUSION

In recent years, demand for mental health treatment has increased following the insurance reform (2015), the COVID-19 pandemic, and the war that broke out on October 7, 2023. This growth was reflected in long waiting times and recourse to private clinics. It appears that the shortage of practitioners, particularly in the public sector, is partly due to the fact that their salaries were low relative to other academic professions, and the salaries of psychiatrists in Israel are low relative to physicians in other specialties. The impact of these relatively low salaries is brought into sharper relief in view of the high skill level and the long and demanding training path required in these fields.

Against this backdrop, several important measures have been implemented since the outbreak of the war, which are expected to support the expansion and improvement of services. In 2024, a new program was launched in the mental health field, aimed at increasing the number of therapists, patients, and therapeutic contacts within the public system, while also addressing additional aspects of the mental healthcare system. This program was budgeted at NIS 1.4 billion per year. Furthermore, the wage agreement signed with psychologists in 2025 is expected to significantly improve the employment conditions of psychologists in the public sector. The field of psychiatry, which was defined in the physicians' wage agreements as a specialty in distress, also received unique wage supplements in the physicians' wage agreement signed in 2024. Concurrently, steps were taken to increase the number of residents in both psychiatry and psychology. However, these measures are expected to increase the number of therapists only in several years' time.

In the coming years, it will be important to continuously monitor whether the expansion of services is keeping pace with the increased needs in this field, for example, by measuring the length of waiting times for treatment and indicators of treatment quality. It will also be important to track the development of the availability and relative compensation of care professionals in the field. To enable such monitoring, it is essential to develop standardized output indicators and to publish them consistently. In addition, it is important to address the disparities in service availability between central and peripheral areas and between the Jewish and Arab sectors. The importance of these steps is underscored by the fact that combat zones and missile attacks were in close proximity to peripheral areas, thereby intensifying the war's impact on the psychological well-being of residents in those areas, particularly in the northern border region and the Gaza Envelope localities.

In the coming years, it will be important to examine whether the expansion of mental healthcare services is keeping pace with increased needs.

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Chapter 8

The Housing Market

- » During 2025, the total number of home purchase transactions declined, and home prices decreased moderately. Against this, the volume of housing starts was high, as was the volume of land purchases by developers in Israel Land Authority (ILA) tenders.
- » The number of persons employed in the construction industry returned to its prewar level, due to a marked increase in the number of foreign workers and the entry of Israelis into the industry. However, a shortage of workers still persists, in view of the considerable increase this year in the volume of activity in the industry. This increase was reflected in about 80,000 housing starts and in reconstruction needs.
- » The decline in the number of transactions in both new and second-hand dwellings relative to the previous year occurred against the background of the interest rate environment, which remains high relative to the years preceding the outbreak of inflation globally and in Israel, and the attractiveness of the returns offered by the capital market relative to the housing market. The decline in new home transactions also reflected measures to limit contractor sales promotions, as well as the bringing forward of purchases to the end of 2024 in order to precede the VAT increase.
- » In view of the increase in construction activity and the decline in new home transactions, the stock of unsold new homes increased this year and reached a high level relative to the past.
- » In 2025, the planning institutions approved 223,000 housing units—an increase of about 10 percent relative to 2024. The number of housing units marketed by the ILA, through tenders with a winning bid and without tender, totaled about 60,000 units, similar to 2024.
- » In October 2025, about 7,400 housing units in the North, the Gaza periphery, and the Center remained outside the effective housing stock due to war-related damage. By contrast, negative net migration moderated demand for housing services. Rental prices increased by 3.2 percent during 2025.
- » Following the increase in home prices that began in November 2023 and continued through January 2025, home prices declined during most of the year (February–October 2025). In October–November, home prices resumed rising, alongside a slight decline in the stock of unsold new homes. On an annual basis, home prices declined by 0.9 percent.



Construction volume, especially **building starts** increased this year



There is still a **shortage of workers** in the construction industry



A decline in transactions led to **record-high stock** of new homes for sale



Home prices declined this year, led by new homes

1. BACKGROUND CONDITIONS AND MAIN DEVELOPMENTS

During 2025, the housing market was affected by the continuing consequences of the war that broke out on October 7, 2023, and by an interest rate environment that remained high relative to the years preceding the outbreak of inflation globally and in Israel. Despite these challenges, construction volume was high, but the volume of transactions—particularly new home purchases—contracted relative to 2024.

The supply constraint in the construction industry, which was due to limited worker availability, eased relative to 2024 but continued to weigh on the industry in view of the volume of activity and the need for reconstruction work. By the end of 2025, the increase in the number of foreign and Israeli workers had offset about 90 percent of the decline in the number of Palestinian workers relative to the eve of the war.¹

During 2025, there was a marked increase in housing starts, which totaled about 80,000 units. The increase in construction activity this year followed the high number of building permits issued in 2024, and was made possible by the large number of housing units marketed by the Israel Land Authority (ILA) in 2021–22. It is likely that some projects on which construction could have begun earlier were postponed to 2025 due to the severe labor shortage created by the war. The ability to sustain a high volume of residential construction under labor shortage conditions was made possible by shifting production factors from nonresidential construction to residential projects. Nevertheless, construction times lengthened as a result of the shortage.

While supply continued to expand, only about 34,000 new homes were purchased this year—a marked decline relative to 2024. As a result of this gap, the stock of unsold new homes continued to increase, reaching about 83,000 units at the end of December 2025 (Central Bureau of Statistics figure based on seasonally adjusted reporting).

¹ Most Palestinian workers in the industry were employed in “wet trades” (Occupation 71)—“Building and related trades (excluding electricians)” —as were foreign workers. The offset for the absence of Palestinians is calculated as the increase in the number of foreign workers in construction plus the increase in the number of Israelis working in Occupation 71.

CHAPTER 8 | The Housing Market

Table 8.1 | Selected Housing Market Data, 2006–2025

	2006–2018 average	2019	2020	2021	2022	2023	2024	2025
Factors of demand								
General population (rate of change) ^{a,b}	1.9	1.9	1.8	1.7	2.0	2.1	1.1	1.1
Population aged 25+ (rate of change) ^{a,b}	2.1	2.0	1.9	1.8	2.2	1.9	1.4	1.4
Average real wage per Israeli employee post (rate of change) ^{a,c}	1.1	2.1	3.1	4.9	-1.7	1.9	1.5	0.3
Unemployment rate ^c among those aged 25–64 (annual average)	5.9	3.4	14.6	9.6	3.3	3.0	3.0	2.7
Weighted real interest rate on new mortgages ^d (annual average)	2.1	1.5	1.1	0.8	1.7	3.4	3.1	3.0
Real per capita GDP (rate of change)	2.2	1.9	-3.2	7.6	4.4	0.1	-0.3	1.7
Rate of those planning to buy a home in the next 12 months ^e (annual average)		8.0	6.4	7.4	5.6	3.6	3.9	3.6
Factors of supply								
Building starts (thousands of housing units)	44.5	56.5	56.7	64.6	69.4	65.2	69.8	80.0
<i>of which</i> : Dwellings not for sale under construction (thousands of housing units)	18.0	20.6	16.4	19.2	24.4	22.1	21.0	23.8
<i>of which</i> : Rental dwellings (thousands of housing units)		2.9	2.5	2.5	3.1	2.3	2.6	3.8
Building completions (thousands of housing units)	39.3	53.3	50.2	47.1	53.3	61.0	54.4	59.7
Construction duration of completed buildings (months)	26.7	29.2	31.2	31.0	33.1	32.7	34.3	37.8
Stock of homes under active construction (end of year, thousands of housing units)	87.6	127.0	133.0	150.4	167.5	171.5	186.8	207.2
Building permits (thousands of housing units)	44.8	56.9	53.8	73.0	77.8	73.6	79.5	81.2
Real investment in residential construction (rate of change)	4.6	3.4	-7.8	16.8	16.1	-8.1	-17.4	16.0
Housing units approved in the district committees and in the VATMAL (thousands) ^f	66.4	140.6	95.3	108.1	158.4	168.4	204.0	223.0
Land marketed in ILA tenders (thousands of housing units)		39.0	26.0	63.0	81.0	55.0	58.4	60.0
Outcome data								
Housing transactions (thousands) ^g	90.4	101.1	101.5	150.1	107.4	71.5	102.9	90.7
<i>of which</i> : New homes sold (thousands)	23.1	40.4	40.6	57.0	41.1	27.4	45.7	34.0
<i>of which</i> : With government support (thousands)		16.7	4.0	12.0	7.8	6.9	9.6	10.2
Home prices - nominal (rate of change during the year)	6.3	4.2	4.0	13.1	14.7	-1.0	7.7	-0.9
Home prices - real (rate of change during the year) ^h	5.3	4.1	4.8	10.4	9.3	-3.7	4.5	-3.0
Rents - nominal (rate of change during the year) ⁱ	3.4	2.8	0.2	3.3	6.3	3.1	4.0	3.2
Rents - real (rate of change during the year) ^{h,i}	2.4	2.7	1.0	0.8	1.3	0.3	0.8	1.1
Homes purchased by investors as a share of total purchases (annual average)		12.8	14.2	18.0	14.3	13.8	12.8	12.2

^a Rates of change are shown as the average of the current year compared with the average of the previous year.

^b The 2006-2018 average does not include 2009 due to a break in the statistical series.

^c Correction in respect of the COVID-19 crisis in 2020 and 2021: The real wage is adjusted to the composition of employees and the broad unemployment rate.

^d Assuming an annual inflation rate of 2 percent.

^e The Central Bureau of Statistics Consumer Confidence Index. The rate of respondents who believe that it is quite likely or very likely that they will buy a home in the next 12 months.

^f The multiyear average is from 2007 to 2015.

^g Market transactions only. Excluding inheritances, transfers with no payment, among relatives, etc.

^h Adjusted for the Consumer Price Index excluding housing.

ⁱ Rents in new and renewing contracts (the owner-occupied housing services item in the Consumer Price Index).

SOURCE: Central Bureau of Statistics, Ministry of Construction and Housing, Israel Tax Authority, Israel Land Authority, and Bank of Israel.

Due to the slowdown in the number of new home transactions and the rapid increase in the stock of unsold homes, a turning point occurred in February 2025 and home prices began to decline. By September, the cumulative decline reached 2.8 percent, while in the new homes segment the decline was even more pronounced (5.4 percent). However, in October–November, against the background of the ceasefire and declining interest rates in the economy, home prices again rose, alongside a slight decline in the stock of new homes. On an annual basis, home prices declined by 0.9 percent.

The total number of transactions amounted to about 91,000, a decline of about 11 percent relative to 2024.² This decline occurred partly against the background of the attractiveness of the returns offered by the capital market relative to the housing market.

At the beginning of 2025, at least 15,000 dwellings—mainly in the North—were outside the effective stock of housing services. Between January and September 2025, most evacuees returned to their localities, and by October 2025 about 7,400 housing units in the North, the Gaza periphery, and central Israel remained outside the effective housing stock.

The background conditions described above increased excess supply, mainly in the market for home purchases, since most dwellings are sold before construction is completed but begin to provide housing services only after completion. The market for housing services was affected by the decline in the effective housing stock—a decline that narrowed during the year—and by the relatively low growth rate of the population aged 25 and over by historical standards. These factors contributed to moderating the increase in rents (the owner-occupied housing services component) to 3.2 percent.

It appears that the effort to increase housing supply—from the planning stage through the execution stage—which the government began about a decade ago supported the increase in construction activity and the moderation in prices, which have declined by 2.5 percent in real terms since January 2023. Thus, in recent years the number of housing starts has been consistent with annual demographic housing needs, and in the coming years this is expected to also be reflected in an increase in building completions and in the stock of homes available for occupancy.

2. SUPPLY

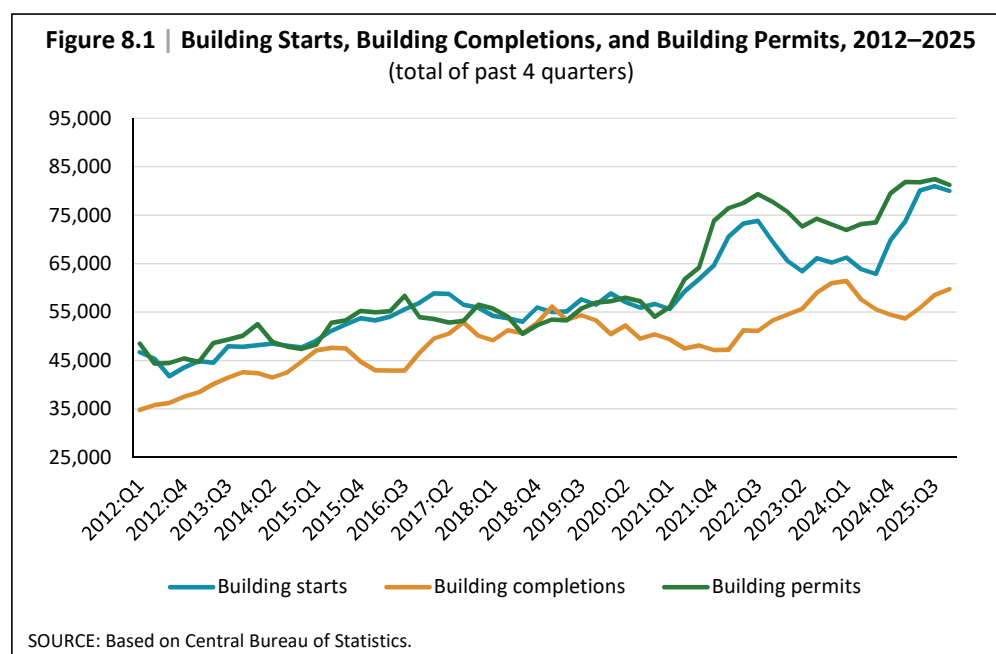
a. Activity in the residential construction industry

The number of building starts grew this year, to 80,000.

In 2025, the volume of residential construction starts increased. About 80,000 housing units were started this year—an increase of about 15 percent compared with 2024 and of about 20 percent compared with October 2022–September 2023 (Figure 8.1). The increase in housing starts occurred against the background of the high level of building permits issued in previous years. The increase in the number of dwellings for which permits were issued was made possible by the continued rise in the number of urban renewal projects and the high level of land marketing for residential construction by the ILA in 2021–22. The purchase of land in ILA tenders includes a condition requiring completion of construction within a defined period, and this—together with the high level of interest rates, which raises the cost of holding land inventories—creates an incentive to begin construction of projects despite the

² Net of the effect of bringing forward transactions from 2025 to December 2024 and postponing transactions from the end of 2023 to the beginning of 2024, this represents a decline of about 6 percent.

decline in demand for new dwellings.³ In addition, following the outbreak of the war and the resulting severe labor shortage, the start of construction of some projects that were close to receiving permits was apparently delayed. However, with the decline in the intensity of the fighting during 2025 and the increase in the number of persons employed in the industry, there was a marked increase in residential construction starts.



During 2025, the number of persons employed in the construction industry continued to increase. This year, the number of foreign workers employed in construction⁴ totaled 75,200—an increase of about 44,500 workers relative to the prewar period. According to National Accounts data, the pace of increase in the number of Israelis employed in construction accelerated during 2025, and their number⁵ totaled about 267,000—an increase of about 19 percent relative to the prewar period.⁶ The increase in the number of Israeli workers in occupations from which Palestinian workers had been absent offset about 25 percent of the decline in

The increase in the number of foreign and Israeli workers compensated for most of the decline in the number of Palestinian workers in “wet trades”.

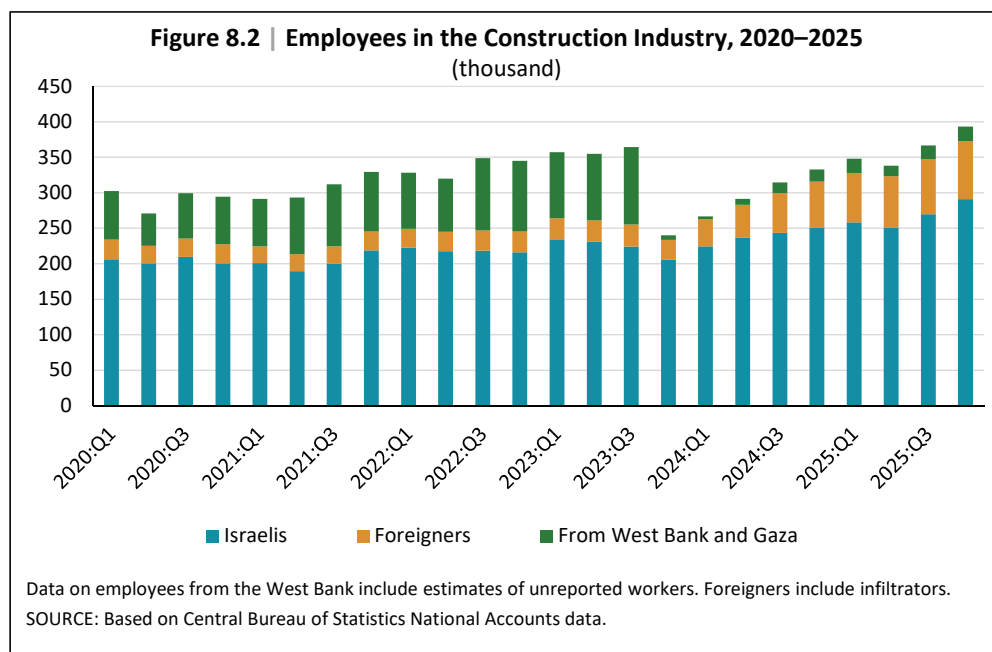
³ For further discussion, see Chapter 8 of the Bank of Israel *Annual Report* for 2023.

⁴ 2025 average.

⁵ 2025 average.

⁶ There are significant gaps between the quantitative estimates of the increase in the number of Israelis employed in construction since the outbreak of the war. Administrative employee-post data indicate a more modest increase in the number of Israelis in the construction industry than do the National Accounts data cited here, which are based on the Labor Force Survey. (For further discussion, see Chapter 5 of this Report.)

the number of Palestinians (Figure 8.3)⁷, while the increase in the number of foreign workers offset an additional approximately 65 percent. (These percentages relate to the wet trades. See Footnotes 1 and 7.)



In 2025, there were about 361,000 people employed in the construction industry as a whole⁸—similar to the number prior to the war. Nevertheless, in view of the marked increase in the volume of activity in the industry and the need for reconstruction work following war damage, a shortage of workers still exists. In the last quarter of 2025, the number of job vacancies totaled about 20,000. The vacancy rate—8.8 percent—was high relative to its prewar level (6.8 percent). (For further discussion, see Chapter 5.) According to the Central Bureau of Statistics Business Tendency Survey, the share of firms reporting a constraint (severe or moderate) in recruiting workers increased in 2024 and moderated in 2025, but remained high relative to its prewar level (Figure 8.4).

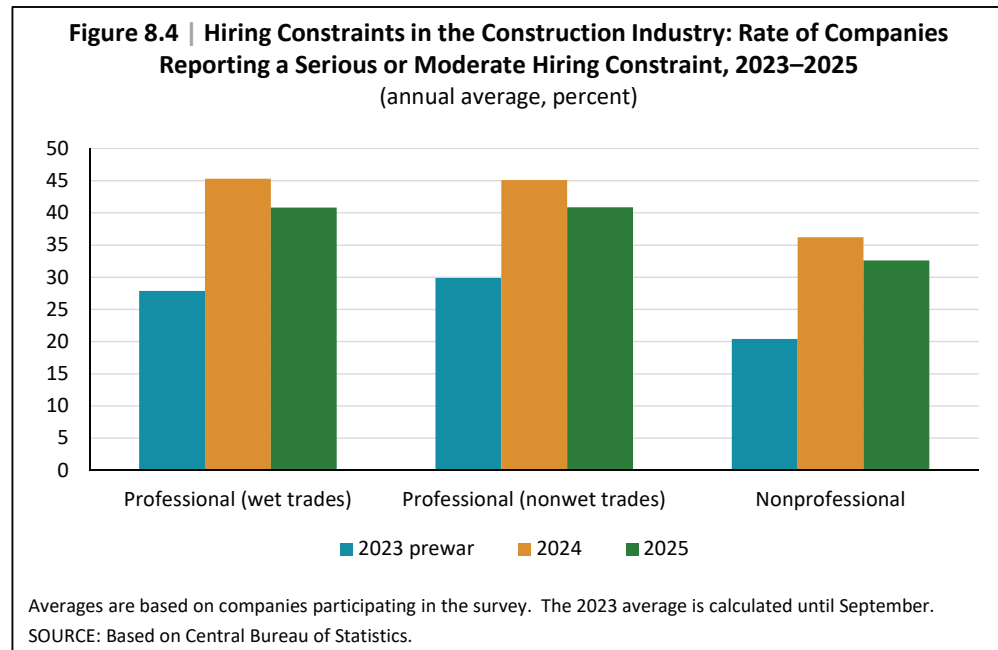
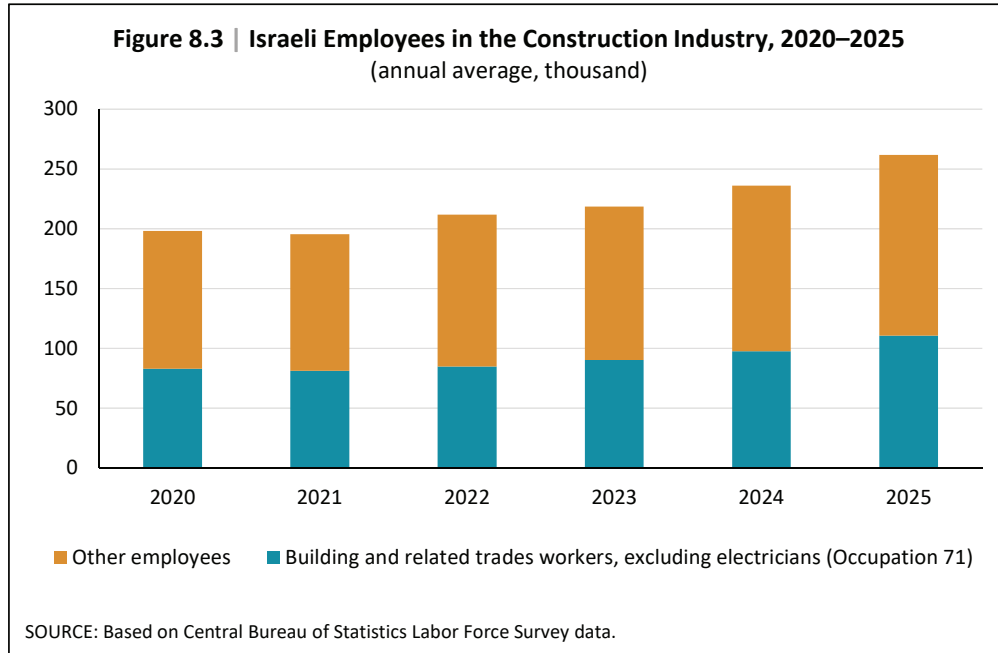
The vacancy data and the findings of the CBS Business Tendency Survey support the assessment that, despite the closure of the gap in the number of persons employed relative to the prewar period, a labor shortage persists due to the increase in the volume of activity in the industry. The gap between the ratio of the volume of active construction to the number of persons employed in construction this year and that ratio prior to the war reflects a shortage of about 30,000 workers as of the

Despite the increase in the number of workers this year, there is still a shortage of workers in the industry.

⁷ Most Palestinian workers in the industry were employed in “wet trades” (occupation 71)—“Building and related trades (excluding electricians)”.

⁸ According to National Accounts data, annual average.

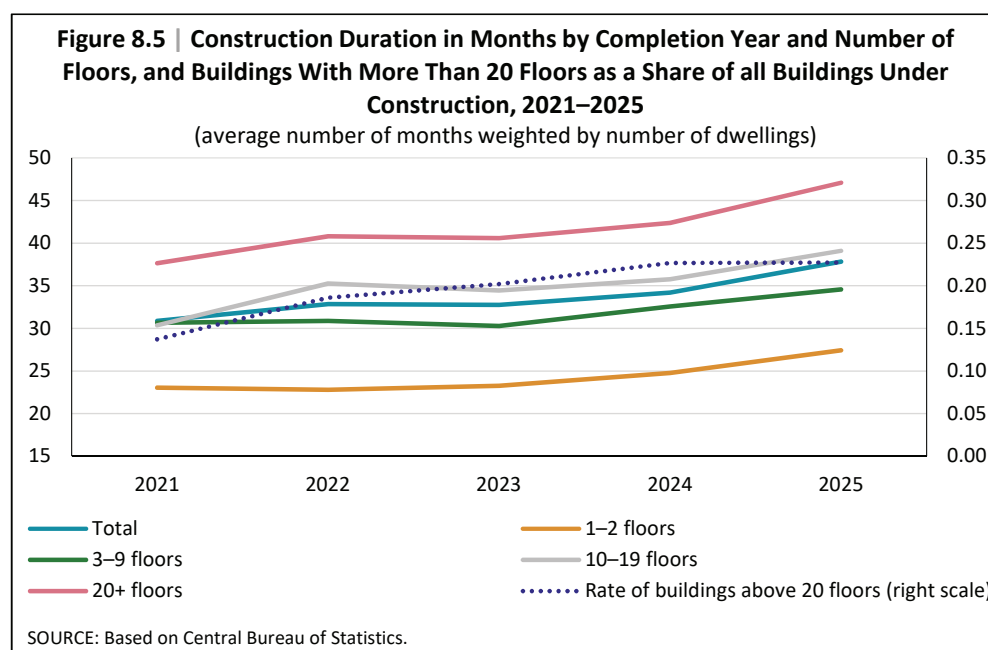
last quarter of 2025. Since the outbreak of the war in October 2023, the residential construction input price index has increased by 9 percent. The wage component led this increase, rising by about 13.8 percent. The increase in wages in the construction industry also reflected the change in the composition of workers: the replacement of Palestinians by foreign and Israeli workers, whose employment cost is higher than that of Palestinian workers.



Despite the labor shortage relative to the prewar period, real wages per employee post of Israeli workers in construction increased by less than wages in the business sector⁹, although in the second half of 2025 the relative wage in construction increased.

Diverting production factors from nonresidential to residential construction supported the increase in residential construction.

The gap between the high volume of residential construction and the labor shortage was apparently made possible by the contraction in nonresidential construction and the shifting of production factors from the initiation of new nonresidential projects to residential projects. Alongside the acceleration in residential construction starts, the recovery in nonresidential construction has been slow. In 2025, nonresidential construction starts and completions were lower by about 16 percent and 28 percent, respectively, than in 2023.¹⁰ Another factor that may enable an increase in construction activity without an increase in the number of workers is greater use of equipment, technologies, and advanced production methods, which constitute a partial substitute for labor. (For further discussion, see Box 8.2 in the Bank of Israel Annual Report for 2023.) However, at present, data on investment in machinery and equipment in the construction industry in 2024–25 do not indicate an increase. (For further discussion, see Chapter 2 of this Report.) Beyond this, there is no firm information regarding technological developments in the construction industry.



⁹ Real wages per employee post of Israeli workers in the business sector increased by about 5 percent from October 2023, compared with about 3.8 percent in the construction industry.

¹⁰ There is no breakdown of employment in the industry between residential and nonresidential construction, but the assessment is that about two-thirds of workers in the industry are employed in residential construction and about one-third in nonresidential construction. Accordingly, a decline of between 16 and 28 percent in the number of workers in nonresidential construction implies a transfer of between 19,000 and 33,000 workers to residential construction projects.

The number of building completions in 2025 totaled 59,700 housing units—an increase of about 10 percent relative to 2024. Construction duration (weighted by the number of dwellings) stood this year at about 38 months per dwelling—an increase of about 3.5 months relative to 2024. The lengthening of construction duration almost certainly reflects the labor shortage, and is manifested in the gap between building starts and completions. In addition, it appears that an ongoing change in the composition of construction has also contributed to the lengthening of construction times: an increase in the share of buildings with more than 20 stories, for which construction duration is the longest among all buildings under active construction (Figure 8.5).

The number of building completions increased this year, even as construction duration lengthened.

b. Supply of subsidized housing

About 11,400 dwellings were allocated by lottery in 2025 under the “Discounted Apartment” program, down from about 16,400 dwellings in 2024. In September 2025, it was decided that beginning in November 2025, land tenders under the “Discounted Apartment” framework would be limited to localities in which the price per square meter is up to NIS 20,000 including VAT—an arrangement that is expected to confine the program to periphery areas only. This change did not affect the market in 2025, since the tenders closed in 2025 had been published before November. However, beginning in 2026, the quantity of subsidized dwellings offered in high-demand areas is expected to decline gradually. During the year, changes were made in the allocation of dwellings, and preference was given to active reserve-duty soldiers. However, it is likely that the dwellings to be allocated under the benefit will not be located in high-demand areas.

c. Early stages of housing production

(1) Approval of plans by the district committees and the National Building Committee for Priority Housing Areas

The volume of dwellings approved by the planning institutions continued to expand, and even exceeded the government targets. In 2025, approvals totaled about 223,000 units (Figure 8.6)—80 percent above the target. The increase in the stock of approved plans in recent years followed a prolonged period of planning shortage. A high volume of approved plans contributes to greater planning certainty and to the creation of a substantial planning inventory, which can support flexibility and an increase in the future supply of housing units. However, the effective constraint on increasing the volume of construction lies at more advanced stages. A significant share of plans is approved subject to various conditions, and if these conditions are not met, construction cannot proceed under the plan. Accordingly, these plans have not yet been implemented due to the absence of housing-supportive infrastructure (wastewater treatment, transportation, electricity infrastructure, and water conveyance). In recent years, the lack of wastewater treatment infrastructure

The number of dwellings approved by the planning institutions continued to increase beyond government targets, but most of them were approved with significant conditions.

has become one of the main factors delaying the implementation of housing plans (Economic Arrangements Law 2025, p. 143). The government decision adopted at the end of 2025¹¹ advances the removal of barriers to the establishment of wastewater treatment plants. The decision authorizes Mekorot (through its subsidiary Mekorot Initiatives) to build and maintain wastewater treatment plants, mainly in localities that face difficulties in doing so.

In addition, in order to increase the pace of implementation of plans, in January 2026 the National Planning and Building Council decided to advance a new National Outline Plan for infrastructure hubs—NOP 55—the purpose of which is to integrate national infrastructure systems in designated complexes throughout the country. The plan seeks to address the widening gap between the pace of housing planning and the pace of infrastructure development.

These are important steps, which, once implemented, are expected to increase the pace at which approved housing plans are realized. This will also reduce the risk of irrelevance: the longer the period between planning and implementation, the greater the likelihood that some plans will no longer suit market needs or infrastructure policy by the time they are actually implemented. Such a situation may lead to a waste of planning resources and to a gap between the volume of approved plans and the actual supply of land available for construction.

(2) Land marketing

Stability in ILA land sales reflects positive sentiment among developers.

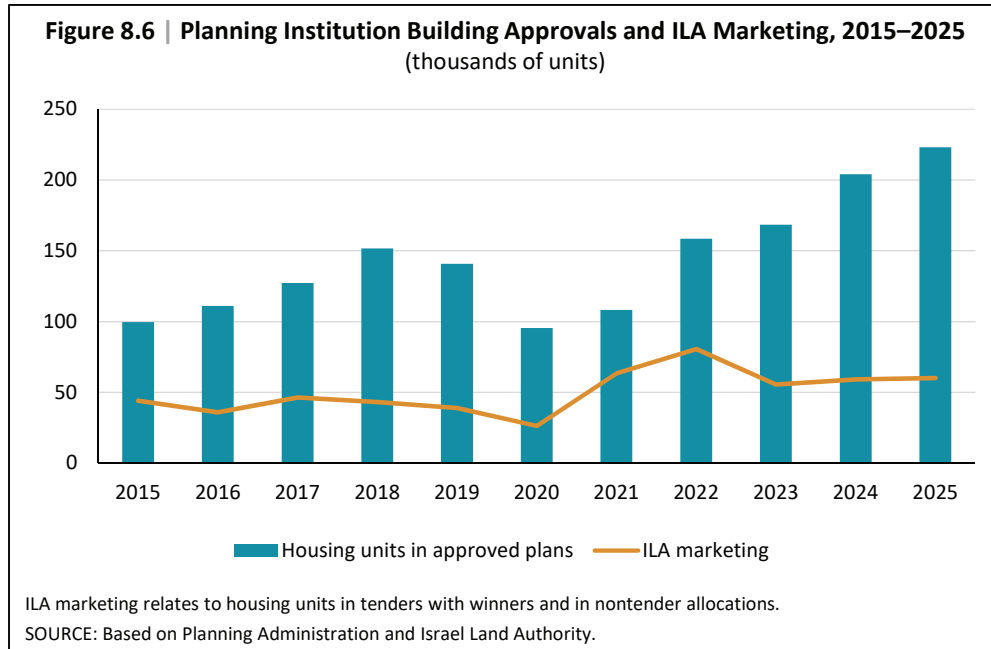
The growing volume of plans approved in recent years, together with efforts to advance the establishment of supporting infrastructure, made it possible to increase the number of housing units offered in ILA tenders. In 2025, land was sold for about 60,000 housing units—a slight increase compared with 2023–24—of which about 43,000 were sold through tenders and the remainder without tender. The stability in ILA land sales reflects positive sentiment among developers, and is the result of measures taken by the ILA to encourage land marketing, including reductions in minimum prices and subsidies for development costs in some tenders. These measures allow land prices to respond to changes in the macroeconomic environment, and in particular to changes in the housing market. Thus, for example, given the increase of about 1.5 percent in residential construction input prices in 2025 and the slight decline in home prices, it is possible that without downward adjustments in minimum prices and without subsidies for development costs in certain tenders, those tenders would have closed without a winning bid and land marketing would have declined. This would have slowed the market's response in the event of a renewed rise in demand.

Profitability in projects being built on land acquired in 2021–22 declined due to the erosion in home prices in real terms¹², which totaled about 2.5 percent in 2023–

¹¹ Government Decision No. 3587 of December 4, 2025.

¹² The index of home prices net of the CPI excluding housing.

25, and due to the increase in input costs in the construction industry. However, from the developers' perspective the cost is sunk, since the land has already been purchased, and delaying the issuance of a building permit may lead to additional costs. Therefore, even when expected profitability is low, many developers choose to continue advancing construction, partly in order to preserve cash flow and reduce potential losses.



(3) Urban renewal

Alongside the marketing of land for residential construction, construction within the framework of urban renewal constitutes an additional source for increasing the future housing supply—through the addition of housing units on existing land by means of demolition and reconstruction or the addition of floors to existing buildings. In 2025, construction began on 22,600 housing units as part of urban renewal—about 28 percent of all housing starts¹³—about half of them in the Tel Aviv District. This took place alongside the demolition of about 5,700 existing housing units. In 2025, the volume of construction in this channel remained stable relative to previous years. However, against the background of the decline in new home purchases, interest rates that were higher than expected at the time projects were contracted, rising construction costs, and the benefits promised by developers to residents¹⁴, there

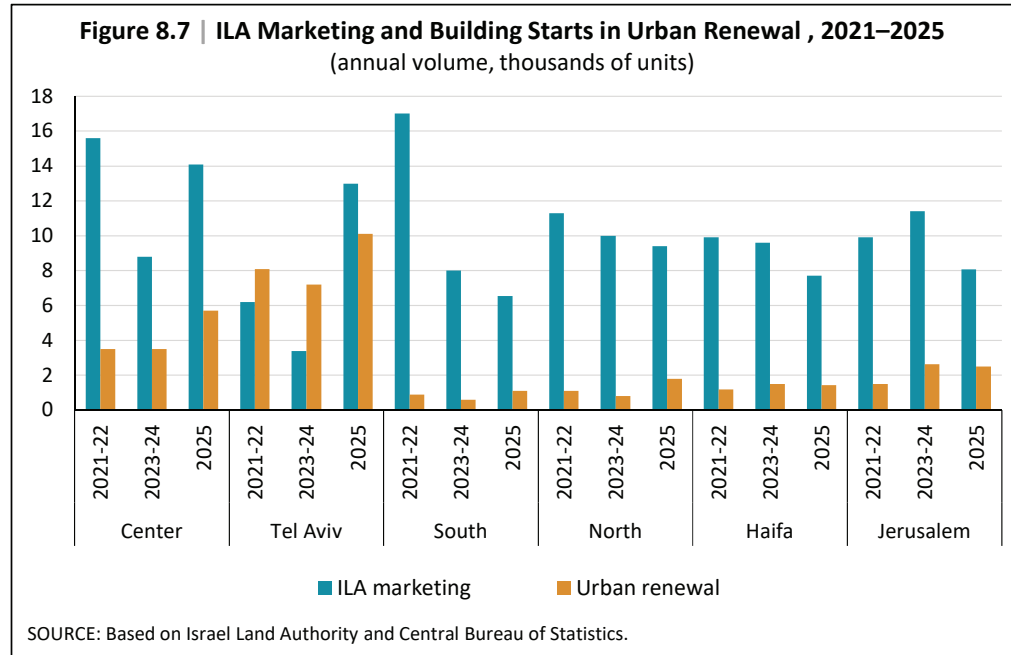
The volume of urban renewal construction remained stable at a high level.

¹³ Of these, about 16,800 housing units were within the framework of National Outline Plan 38 (TAMA 38) and vacate-and-build projects.

¹⁴ The benefits and rights granted to apartment owners in an urban renewal project—such as an increase in apartment size, the addition of parking or a balcony, and compensation for relocation costs—provided in exchange for their consent to demolish the existing building and construct a new one in its place.

There is concern that some urban renewal developments in advanced planning stages will become unfeasible due to changes in market conditions.

is concern that some projects currently in advanced planning stages may become economically unfeasible. The 2025 year-end data published by the Urban Renewal Authority indicate a decline in the number of urban renewal permits issued in 2025 relative to 2024.



3. THE HOUSING SERVICES MARKET

The negative migration balance to Israel supported a moderation of demand for housing services.

Demand for housing services in the long term is derived mainly from demographic needs. In our assessment, annual demand for dwellings increased gradually from about 45,000 on average in 2003–09 to about 60,000 in 2016–23—mainly due to demographic processes (high fertility in the past¹⁵, and rising life expectancy), which increase the number of households. According to the estimate in the “Strategic Housing Plan”¹⁶, the demographic need for additional housing units in 2026–35 amounts to about 65,500 units per year. However, in 2024–25 the growth rate of the population aged 25 and over moderated, partly due to a change in Israel’s migration balance. Israel had a negative migration balance of 38,800 persons this year relative to 2016–19.¹⁷ Based on the average household size—3.25 persons—this implies an

¹⁵ Demand for housing services, measured by the number of housing units, is determined mainly by the population aged 25 and over.

¹⁶ D. Badel, R. Hilo, and E. Buzaglo (2025), The Strategic Housing Plan 2050, National Economic Council. (in Hebrew)

¹⁷ A significant part of the increase in the number of Israelis leaving the country (about 19,000) was due to the departure, within a short period, of immigrants who had come to Israel following the Russia–Ukraine war as a temporary refuge, and therefore may not indicate a continued decline in the coming years.

annual gap of 11,900 households in 2024–25 compared with 2016–19. Moreover, among emigrants from Israel there was a high share of persons aged 30–44 (about 29 percent, while their share in the population is about 18 percent), the age group with the highest incidence of home purchase.¹⁸ If these trends continue, they will reduce the demographic need for dwellings. By contrast, the rapid increase in the number of foreign workers¹⁹ creates additional demand for housing services. In our assessment, and based on research on the subject²⁰, this amounts to an annual addition of about 2,000 housing units to demand for housing services in 2024–25.

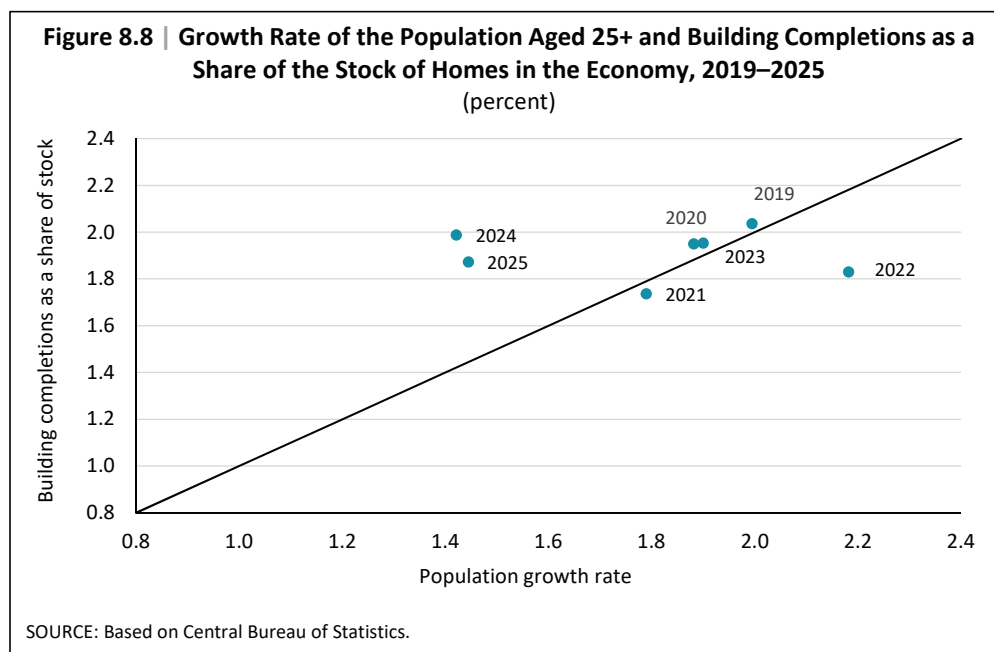


Figure 8.8 presents the rate of change in the economy’s housing stock (equal to construction completions divided by the housing stock) relative to the growth rate of the population aged 25 and over. According to the data, current construction volumes provide a response to demographic needs. However, beginning in October 2023, the evacuation of residents and missile fire left thousands of dwellings outside

The decline in the effective stock of homes due to the evacuation of homes in various parts of the country slowed in 2025.

¹⁸ According to the CBS publication *Home Ownership, 2013–2023*, 42 percent of those under age 34 and 62 percent of those aged 35–44 live in owner-occupied dwellings. At older ages, the increase in the ownership rate moderates considerably.

¹⁹ These are workers employed in construction, manufacturing, accommodation, and food services. Foreign workers employed in caregiving and residing in the patient’s home are not included. Foreign workers employed in agriculture generally reside in portable structures, which are not included in the supply of dwellings.

²⁰ See: R. Rajjman and N. Kushnirovich (2019), *The Effectiveness of the Bilateral Agreements: Recruitment, Realization of Social Rights, and Living & Employment Conditions of Migrant Workers in the Agriculture, Construction and Caregiving Sectors in Israel, 2011–2018*. Emek Hefer: Ruppin Academic Center and Center for International Migration and Integration.

the effective housing stock, which moderated its increase. Following the anomalous shock generated by the war in 2024, at the beginning of 2025 at least 15,000 dwellings still remained outside the effective stock of housing services.²¹ Between January and September 2025, most evacuees from the North returned to their localities, while the number of evacuees from the South declined from about 7,000 at the beginning of 2025 to fewer than 5,000.²² Based on estimates derived from average household size, from October 2025 about 7,400 housing units remained outside the effective housing stock: about 4,000 in the North, about 1,000 in the Gaza periphery, and about 2,400 additional dwellings as a result of Operation Rising Lion²³—most of them in central Israel.

Over the past 12 months, rental prices (the owner-occupied housing services component of the CPI) increased by 3.2 percent—somewhat slower than in 2024, when they increased by 4 percent.

4. TRANSACTIONS

a. Demand for home purchases

During 2025, mortgage interest rates in all tracks showed a moderate downward trend, mainly in the second half of the year. Nevertheless, the interest rate environment remained high relative to the 2014–21 average, before the interest rate increases that began in 2022. In the mortgage market, the volume of new mortgage borrowing remained relatively stable despite the decline in the number of home purchases. This stability reflected an increase in the average mortgage size, accompanied by an increase in the share of new borrowing related to transactions carried out in the past. (For details, see Chapter 4.)

At the end of March 2025, the Bank of Israel imposed a limit on the share of new borrowing through “bullet” or “balloon” loans subsidized by contractors, such that they would not exceed 10 percent of total monthly borrowing for housing loans.

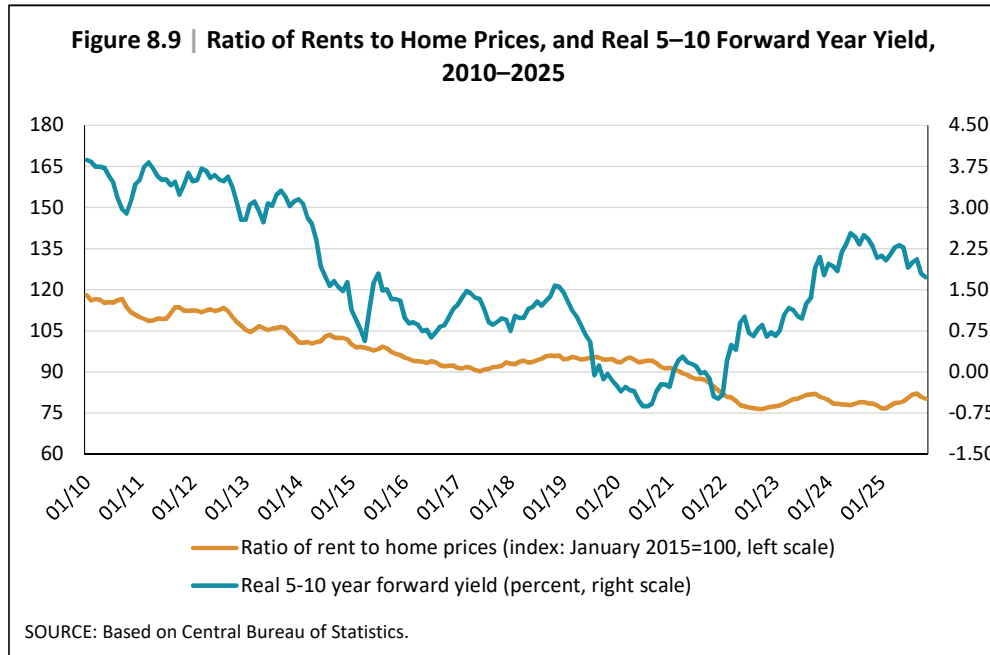
²¹ This may be an underestimate, since it is based only on data for evacuees under government decisions at the beginning of 2025: about 68,500 evacuees from the North and about 7,000 from the South—about 20,000 households, of whom about 17,500 were staying in the evacuated locality. It is therefore assumed that their dwellings had returned to the effective housing stock. There are no data on the return of self-evacuees to their localities, but it may be estimated that, due to the absence of government support for financing alternative housing arrangements, and because the localities that were not evacuated are safer than those that were evacuated, their return rates were higher than those of evacuees under government decisions. However, it is also likely that some of them had still not returned to their homes at the beginning of 2025.

²² According to the September 11, 2025 publication of the Information and Knowledge Center, at least 55,500 of the evacuees from the North had returned to their localities. As of the end of May 2025, about 5,000 evacuees from southern localities remained displaced, and some of them returned to their localities by the end of 2025.

²³ Operation “Rising Lion” led to the immediate removal of about 6,400 housing units during June, and the return of about 4,000 housing units to residential use by September.

Deferral of payments until occupancy constitutes an effective discount relative to the stated home price and encourages bringing home purchases forward. Therefore, these restrictions likely had a moderating effect on the quantitative demand for new homes beginning in April 2025, since contractors preferred to minimize direct reductions in home prices themselves. In November–December 2025, a number of developers began offering substantial financing promotions, but their effect on demand for home purchases has not yet been reflected in the data.

The restrictions imposed by the Bank of Israel on financing promotions moderated demand for new homes.



A comparison between the 5–10 year real forward yield and the ratio of rent to home prices (Figure 8.9) indicates that capital market yields have returned to their level of about a decade ago, while the rent-to-price ratio is now markedly lower than it was then. Government bonds therefore currently offer a more attractive return than the housing market relative to the years preceding the COVID-19 pandemic, and this likely moderates demand for home purchases. (For further discussion, see Box 1 in the Bank of Israel’s Financial Stability Report for 2025.) This is compounded by the strong performance of the equity market in Israel, and in recent years globally as well.

The excess yields in the financial markets relative to the housing market worked to moderate demand for dwellings.

Economic and security uncertainty during 2025 also likely had a moderating effect on demand. By contrast, the labor market remained tight and real wages increased during 2025 (see Chapter 5), which supported demand.

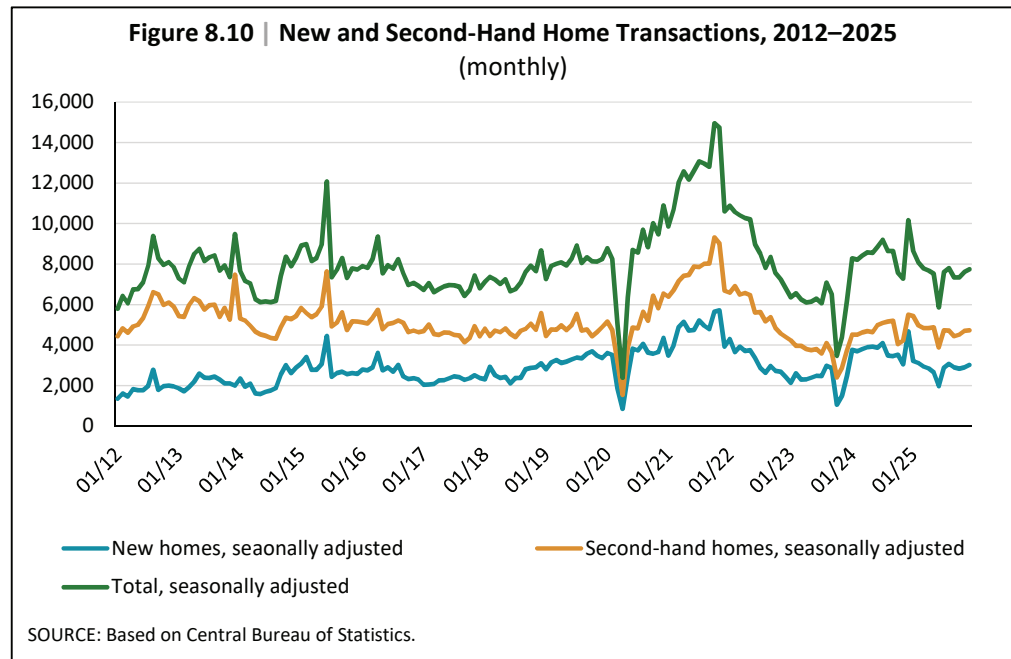
b. Total transactions

The number of new home transactions declined this year, while the number of second-hand home transactions remained stable.

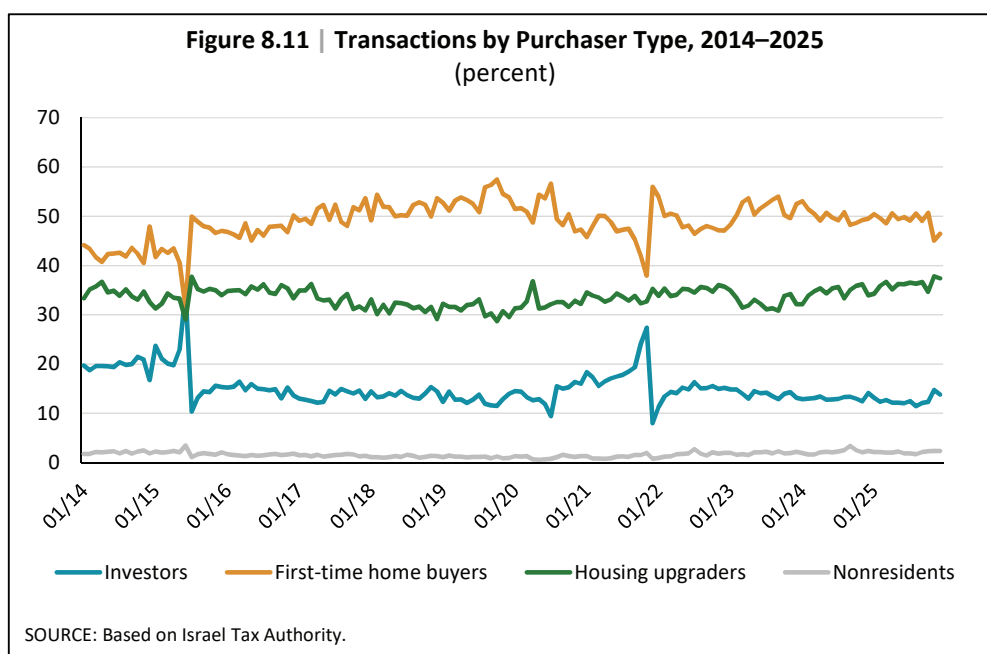
There were a total of about 91,000 transactions this year, a decline of about 11 percent relative to 2024. The decline occurred in new home purchases, while the number of transactions in second-hand dwellings remained stable (Figure 8.10). The decline specifically in new homes reflected the bringing forward of purchases from 2025 to December 2024 due to the VAT increase, and the postponement of transactions from the end of 2023 to the beginning of 2024 against the background of the outbreak of the war²⁴; the restrictions imposed by the Bank of Israel at the end of March 2025 on the share of new borrowing in contractor-subsidized loans; and uncertainty regarding the final occupancy date of new dwellings in view of the lengthening of construction times.

The decline in the number of transactions was concentrated among first-time home buyers and investors.

The decline in the number of transactions relative to 2024 was concentrated among first-time home buyers and investors, compared with home upgraders, although the latest data point to a certain increase among investors and a decline among first-time home buyers (Figure 8.11).



²⁴ Net of bringing forward purchases from 2025 to December 2024 and postponing transactions from the end of 2023 to the beginning of 2024, this represents a decline of about 15 percent in new homes and a decline of about 6 percent in the total number of transactions.



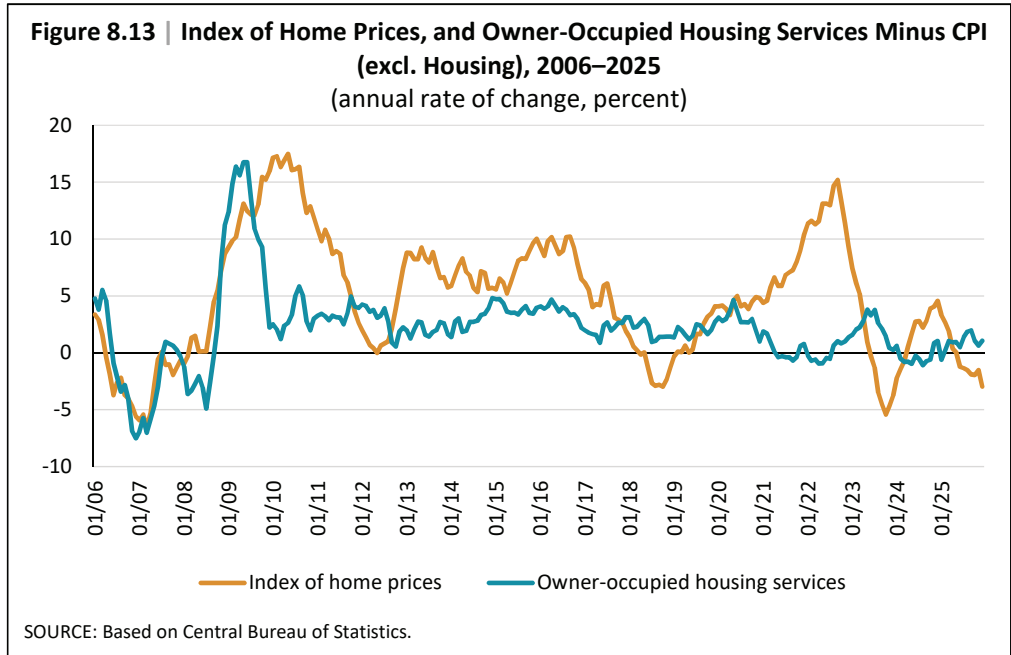
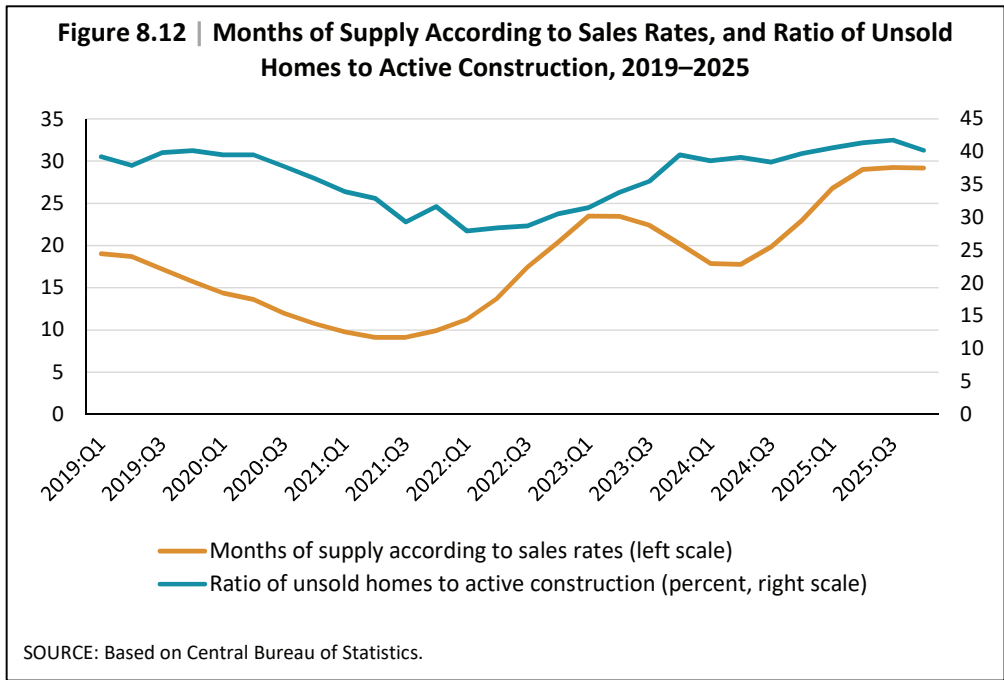
c. New dwellings remaining for sale (stock of unsold homes)

The stock of unsold homes²⁵ continued to increase this year, reaching a high level of about 83,000 dwellings at the end of December 2025—an increase of about 13 percent relative to the end of December 2024.²⁶ The increase in the stock of new homes for sale occurred in most districts. The “months of supply” indicator presents the estimated time required to sell the stock of unsold homes if the pace of sales over the previous 12 months continues. This increased from about 24 months at the end of 2024 to about 30 months in August 2025 and remained stable thereafter (Figure 8.12). The stock of unsold homes increased beyond the increase in construction activity this year as well. The ratio of the stock of unsold homes to the total number of homes under active construction increased from mid-2024, and stabilized in the second half of 2025 (Figure 8.12). The existence of excess inventory supports a decline in new home prices in the short term.

The stock of unsold homes continued to increase this year, reaching a high level of about 83,000 dwellings.

²⁵ According to the CBS definition, the stock of unsold homes at the end of the period equals the stock of unsold homes at the beginning of the period plus the number of permits issued during the period for the construction of homes for sale, minus the number of new homes sold during the period.

²⁶ A high level relative to 2019–24. Data on new homes for sale in their current definition are available only from 2019 onward.



5. HOME PRICES

a. Current developments

After 2024, in which homes prices increased by 7.3 percent, there was a continuous decline in home prices between February and September 2025, totaling 2.8 percent, while prices of new homes declined by about 5.4 percent during that period.²⁷

However, in October–November 2025, against the background of the ceasefire in Gaza and declining interest rates in the economy, there were cumulative increases of about 1.4 percent in home prices and 1.7 percent in new home prices. The increase in homes prices in the latest data occurred alongside a slight decline in the stock of unsold new dwellings in November–December 2025. In December, home prices declined by 0.1 percent, and on an annual basis they declined by 0.9 percent. Net of the CPI excluding housing, home prices declined by 3 percent this year (Figure 8.3).

Home prices declined by 0.9 percent this year.

b. Historical perspective on home prices

Between 2008 and 2022, home prices increased almost continuously²⁸, but this increase began after a prolonged period of erosion in real home prices. The period between 1996 and 2007 was characterized by a sharp transition from peak activity—driven by the absorption of the large immigration wave of the early 1990s—to a prolonged process of adjustment in the economy’s housing stock, a slowdown in activity, and price erosion. After the immigration wave subsided, the volume of residential construction declined persistently as part of the process of adjusting the housing stock to changing demographic needs. Home prices underwent a process of continuous real decline (net of the CPI) throughout that period. With the recovery in demand in 2004–05, prices began to rise—initially only in high-demand areas and subsequently also in periphery areas. However, the ability to adjust construction volumes to the level of demand was limited due to supply rigidities, partly due to a shortage of planning inventory and a limited supply of land for construction in high-demand areas. Against the background of excess demand, home prices began to rise rapidly.

In January 2023, the increase in home prices came to a halt, and between March 2023 and October 2023, against the background of a contraction in the volume of transactions, home prices declined continuously, by a total of 2.5 percent. Net of the 2.4 percent increase in the CPI excluding housing during the period, this amounted to a real decline of 4.9 percent. With the outbreak of the war in October 2023, against the background of uncertainty and concerns regarding a decline in supply due to the

²⁷ This index was calculated separately and independently from the general index of home prices. Due to the financing benefits granted to purchasers, the reported prices of new dwellings may be biased upward.

²⁸ Between October 2017 and January 2019, against the background of an increase in the volume of subsidized transactions (“Buyer’s Price”), home prices declined. The cumulative decline during that period was about 2.9 percent.

labor shortage, home prices began to rise, while the volume of transactions increased in general and particularly in new dwellings. The increase in prices continued through January 2025. Over the period from January 2023 to December 2025, home prices increased by 5.6 percent, while the CPI excluding housing increased by about 8.1 percent (Figure 8.13).

In recent years, the number of building starts has been in line with the increase in annual demographic needs for dwellings.

It appears that the effort to increase housing supply, which the government began about a decade ago, supported the increase in construction activity, such that in recent years the number of housing starts has been consistent with annual demographic housing needs. This is expected to also be reflected in the coming years in an increase in building completions (an addition to the stock of homes that actually provide housing services). Moreover, the mechanism for adjusting minimum prices in ILA tenders allows residential land prices to decline when home prices decline. In the past, the adjustment occurred only through a decline in land marketing, which would have led to a reduction in construction activity several years later.

BOX 8.1: THE PREMIUM ON A RESIDENTIAL SECURE ROOM FOLLOWING OPERATION RISING LION

- **Dwellings that include a secure room (Mamad) are priced higher than similar dwellings without one. Accordingly, their rental prices are also higher.**
- **Operation Rising Lion (Israel's military campaign against Iran in June 2025) did not lead to any change in the Mamad premium in the asking rents listed in rental advertisements.**
- **With regard to the premium in home prices, the results were mixed. While the estimated premium based on sale listings increased slightly, actual transaction prices indicate a slight decline in the premium. This difference suggests that sellers tended to value the Mamad in their dwellings above its actual market value.**

1. Introduction

The war that began on October 7, 2023, and the accompanying rocket threat, increased the demand for dwellings with a Mamad. Yachin and Talmon (2025) estimated the Mamad premium in home prices and rents—that is, the price and rent gap between otherwise similar dwellings differing only in the presence of a Mamad.¹ They found that the war led to an increase in the rent premium, whereas in home prices, the premium rose at the outbreak of the war but declined shortly thereafter to its prewar level. The authors argued that since a dwelling's price reflects the value of the housing services it is expected to provide over its entire lifetime, a temporary security threat has only a limited effect on the Mamad

¹ Yossi Yachin and Aya Talmon (2025). "The Premium on a Residential Secure Room in Home Prices and Rents", Research and Policy Analysis Notes Series 2025.03.

premium embedded in its price. In contrast, rent reflects the value of housing services during the rental period only, and since the security threat intensified during that period, the rent premium increased more sharply.

This box estimates the impact of Operation Rising Lion (June 13–24, 2025) on the Mamad premium in home prices and rents. The analysis covers data through the end of 2025. In view of renewed confrontation with Iran in Operation Roaring Lion (beginning February 28, 2026), it will be interesting to examine, over time, whether the market's response after the latest operation differs from that following Rising Lion.

2. Methodology

The Mamad premium is estimated using a hedonic regression that models the dwelling's price or rent as a function of its various characteristics (size, location, floor, etc.), and in particular, estimates the contribution of having a Mamad to the price or rent. This contribution is the premium attributed to the Mamad.

For the analysis, we use both transaction prices² and asking prices from online sale and rental listings. In the listing data, we use two versions of the price: the asking price in the first publication of the listing and the asking price in its latest observed update.

The indication of whether a dwelling includes a Mamad is based on its year of construction in the transaction data and on the listing's report in the advertisement data. For further details on the estimation methodology, see Yachin and Talmon (2025).

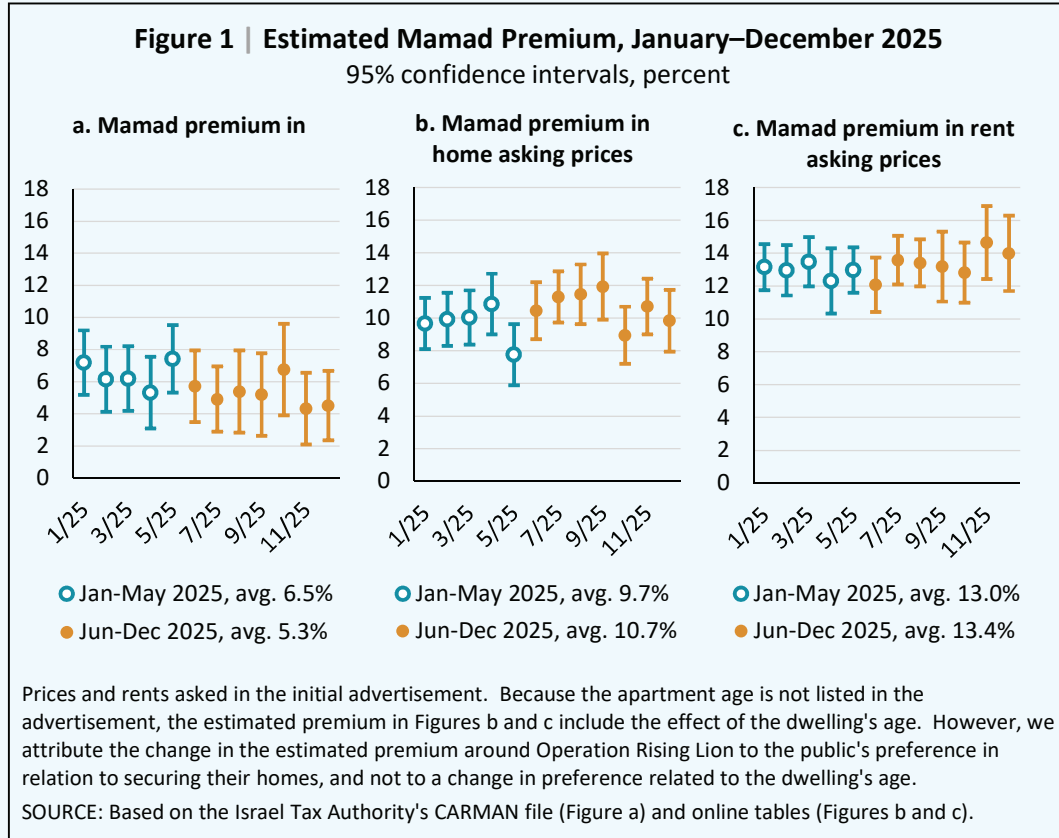
3. Results

Figure 1 presents the evolution of the estimated Mamad premium over time, and Table 1 examines whether the change in the premium after Operation Rising Lion is statistically significant across the different estimations.

Premium in home prices: The results for the price premium are mixed. The premium in actual transaction prices declined slightly after the operation (Figure 1a and first row of Panel A in Table 1). In contrast, the listing data indicate a slight increase of up to 1.3 percentage points (Figure 1b and Panel B in Table 1), although this result may be driven by an outlier observation in May (Figure 1b). The difference between the results suggests that sellers valued the Mamad in their dwellings above its market value.

The hedonic regression assumes that controlling for the observed characteristics of dwellings is sufficient, so that the estimated premium compares dwellings with similar attributes except for the presence of a Mamad. Naturally, the regression cannot control for all characteristics, as some are unobserved, and even for observed ones, control is imperfect. To partially address this issue, we re-examined the results for more homogeneous subsamples—specifically, second-hand dwellings only, and an even narrower sample of dwellings built around the time the Mamad construction regulation was introduced (between 1985 and 2000). The results are shown in the second and third rows of Panel A.

² CARMAN file (Real Estate Price Registry) of the Israel Tax Authority.



For second-hand dwellings, the result remained unchanged—a slight decline in the premium. For dwellings built between 1985 and 2000, the decline was smaller and not statistically significant.

In summary, the range of estimated changes in the premium is relatively narrow, and after more than a year and a half of ongoing rocket threats, Operation Rising Lion appears to have had only a limited impact on the Mamad premium in apartment prices.

Premium in rents: The asking rent premium in listings did not change significantly during the year (Figure 1c and Panel C in Table 1). There appears to have been a slight increase toward the end of the year (Figure 1c), possibly influenced by the renewed threat from Iran. However, overall, the change in the half-year following Operation Rising Lion is not statistically significant (Panel C in Table 1). Finally, it should be noted that the level of the estimated premium is similar to that found by Yachin and Talmon (2025) for 2024.

Table 1 | Estimated Mamad Premium and its Change Following Rising Lion, January–December 2025

	95% confidence intervals ^a				
	Premium before Rising Lion	Change in premium	Premium after Rising Lion	Number of observations	R ²
Panel A: Home transactions					
All observations	0.0656***	-0.0142***	0.0514***	51,613	0.8018
Second-hand homes	0.0740***	-0.0151**	0.0589***	33,045	0.7799
Homes built between 1985 and 2000	0.0339*	-0.0040	0.0299	5,651	0.7780
Panel B: Home sale advertisements					
First publication	0.0984***	0.0076	0.1060***	35,757	0.8085
Most recent update	0.0944***	0.0131**	0.1075***	49,291	0.7425
Panel C: Home rental advertisements					
First publication	0.1278***	0.0080	0.1358***	85,463	0.6067
Most recent update	0.1323***	-0.0044	0.1280***	85,286	0.5780

^a* - 10% significance; ** - 5% significance, *** - 1% significance.