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.

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

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

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

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

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 Lion[2] 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 slow growth in the labor supply, the labor market was tight in 2025 as well.

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

[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]

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

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

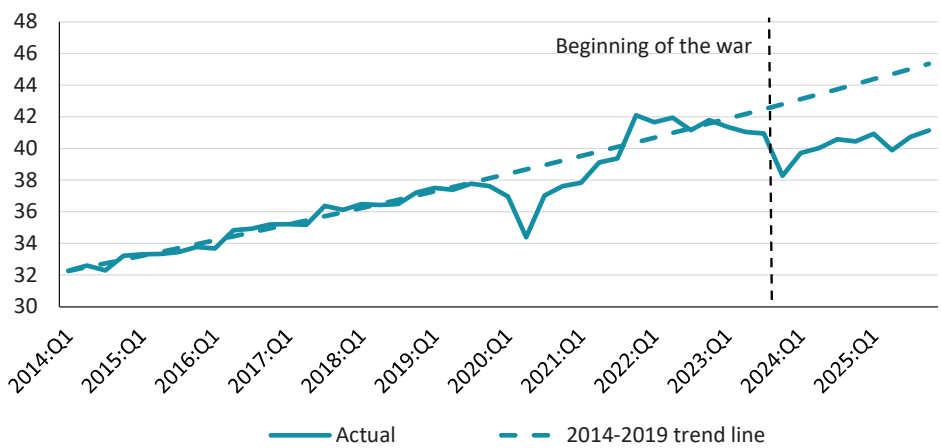
[3] See, for example, the discussion on the increase in mental health needs due to the war in Chapter 7 of this Report, and the discussion on reconstruction expenditures in Chapter 6.

[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]

Figure 1.1 | National Per-Capita Income from Civilian Activity, 2014–2025
(actual and pre-COVID trend, NIS thousand, in 2025 prices)



National per-capita income from civilian activity is defined as gross national income minus public defense consumption, divided by the total population and by the private consumption price index from the National Accounts. The trend is calculated based on 2014–2019 data.

SOURCE: Based on Central Bureau of Statistics.

[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.

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

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.

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.)

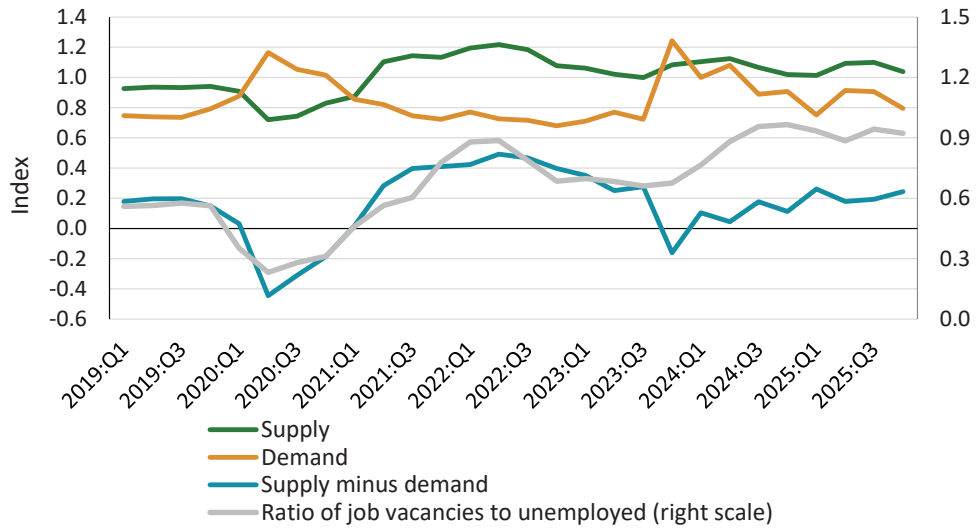
The twelve days of Operation Rising Lion led to a broad shutdown of economic activity, but the economy recovered swiftly.

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,	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,	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 gdovernment 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

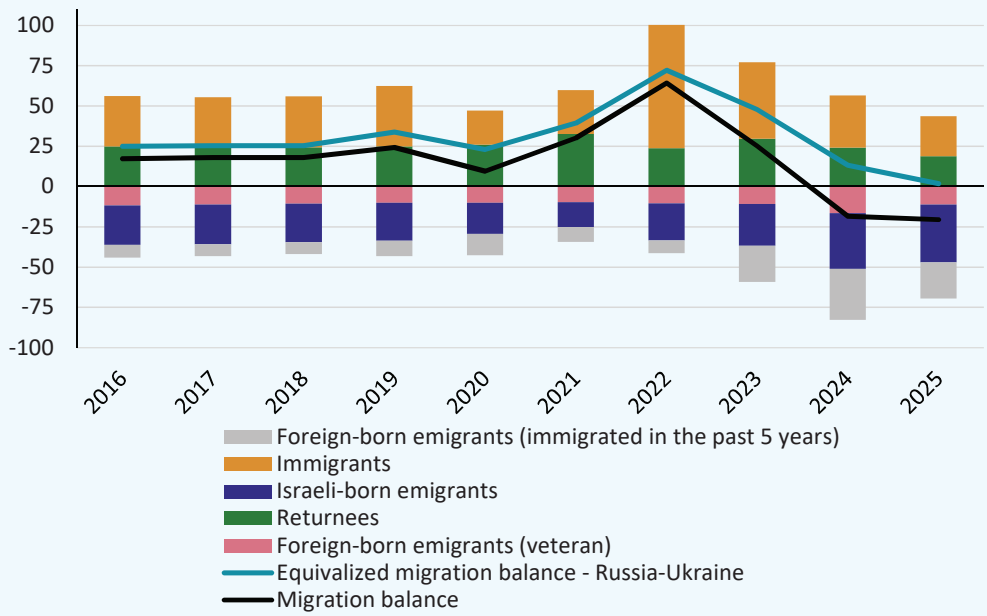
[f] Nominal rate of change - last day of December compared with the last day of the previous December

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 country[1] 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).

Figure 1 | Israel's Migration Balance, 2016–2025
(thousand)



SOURCE: Based on Central Bureau of Statistics.

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 war[8]—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

percent

	2019	2020	2021	2022	2023 (prewar average)	2023 (4th quarter)	2024	2025	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 unemployme	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 unemployme	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.

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

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.

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

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.

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

percent

	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
of which: Israeli	3.1	2.0	-1.2
Total employed in the business sector	-1.4	1.9	-5.0
of which: 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.

Due to the continuation of the war and elevated defense expenditures[10], 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 budget deficit was similar to the original forecast, despite expenditure overruns.

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 GDP[11]), 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

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

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.

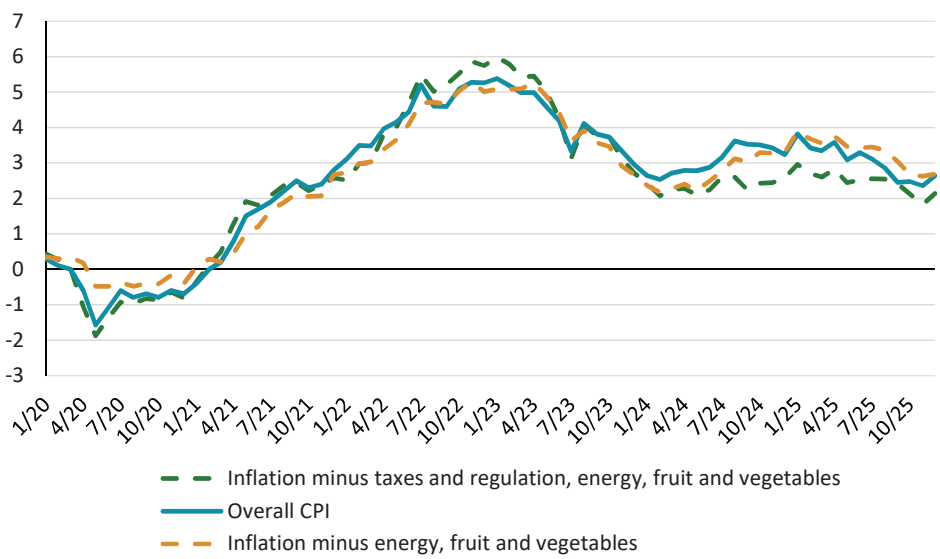
During the year, the inflation rate gradually declined, with volatility, converging into the target range with the August CPI reading that was published in mid-September. This development occurred against the backdrop of reduced combat intensity, a significant appreciation of the shekel, and a restrictive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

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

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.)

Figure 1.3 | Annual Inflation and Adjusted Indices, 2020–2025
(monthly data in annual terms, percent)



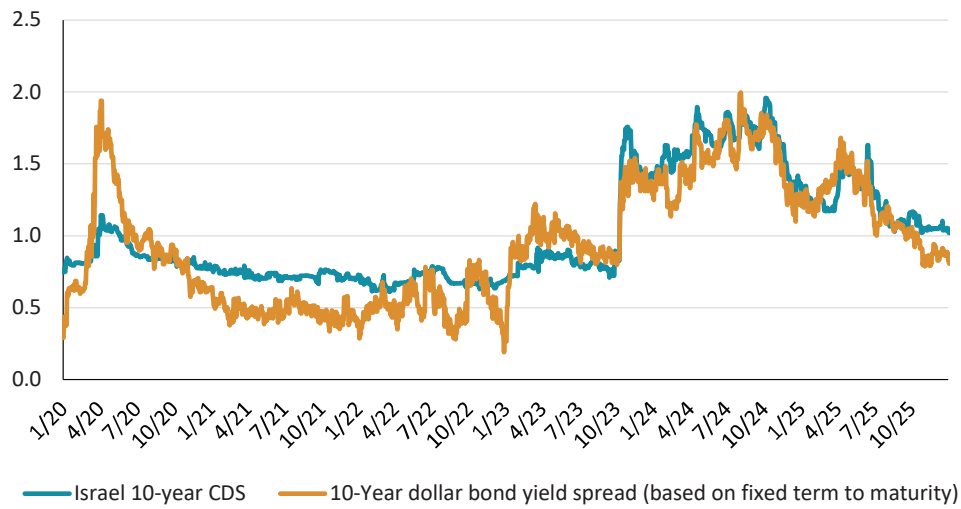
SOURCE: Based on Central Bureau of Statistics.

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).

Figure 1.4 | Yield Spreads on 10-Year Dollar Bonds between Israel and the US, and Risk Premium Based on the 10-Year CDS, 2020–2025
(percentage points)



SOURCE: Based on Bloomberg, and Bank of Israel.

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

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

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.

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.

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.

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

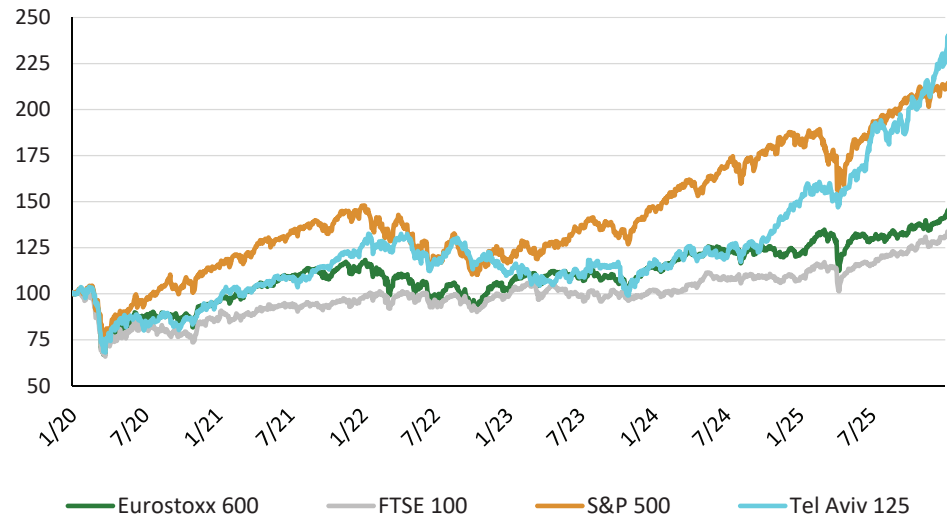
Due to the improvement in the geopolitical environment, the recovery in the domestic financial markets intensified.

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.

Figure 1.5 | Selected Equity Indices in Israel and Abroad, 2020–2025
(in dollar terms, index: January 2020 = 100)



SOURCE: Based on Bloomberg.

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

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

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,

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.

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

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).

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

a. Introduction

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

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

[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.

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

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]

[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).

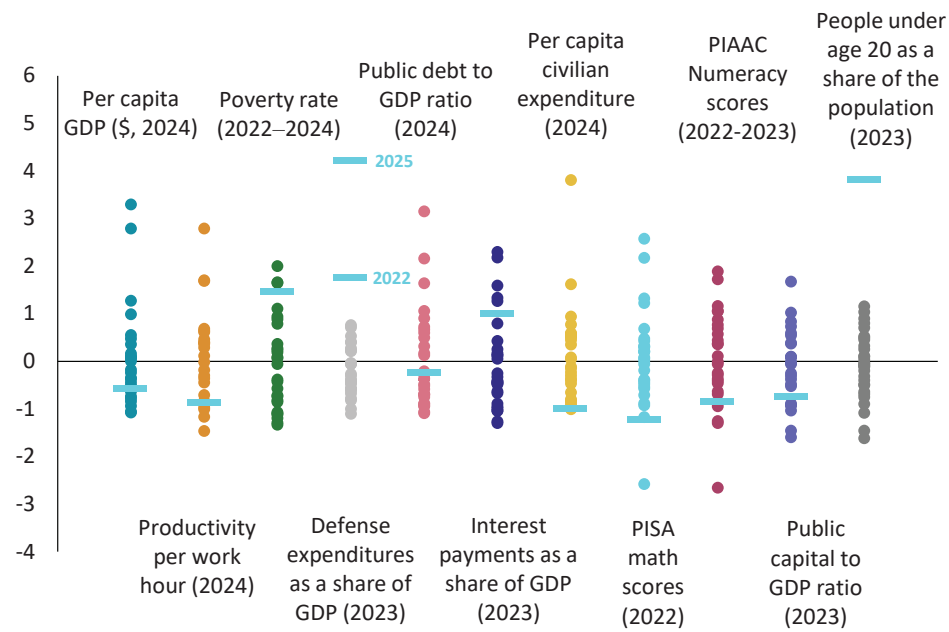
b. Components of the multidimensional challenge facing the government

(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.

Figure 1.6 | Productivity, Human Capital, Public Capital, and Fiscal and Poverty Indices, Israel and Advanced OECD Countries
(Israel in blue bar, in standard deviation terms)



SOURCE: Based on OECD, IES, and IMF data.

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:

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

1. A higher debt level leads to higher long-term interest rates (with an estimated elasticity of 0.1[18]), 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.

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

[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.

(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 countries[22]—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 stock of public capital and the quality of public infrastructure are lower than the acceptable levels.

The level of Israel's physical capital—particularly its stock of public capital[24] 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 rapid growth of Israel's population creates greater demand for expanded public infrastructure.

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 countries[25], 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.

[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 Committee[8]—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" initiative[12] 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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[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.

Filippuci, 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 productivity[28], 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.

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

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 of Israeli adults are evident in the labor market.

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 workers[31] 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]

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

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

[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 thee 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 construction[36], 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

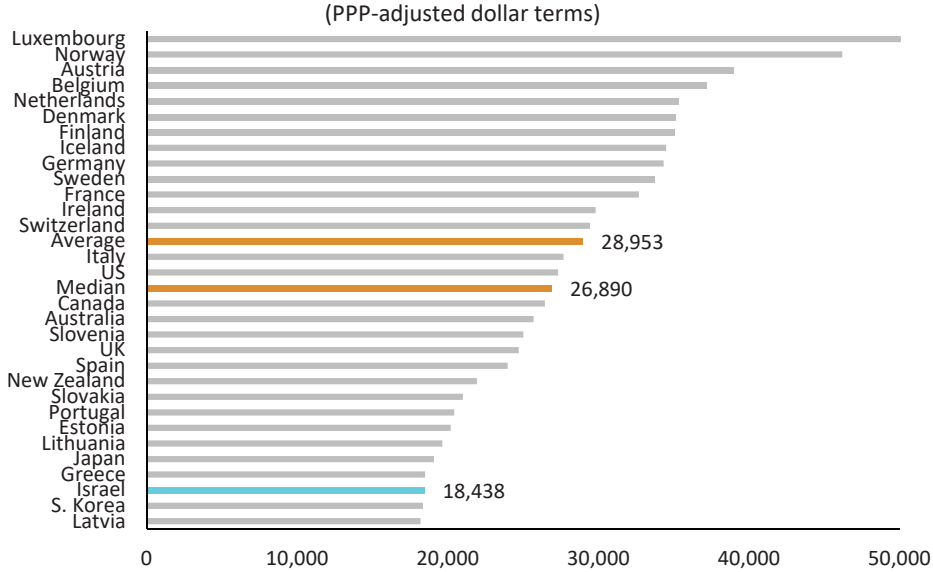
Per capita primary civilian expenditure amounted to only two-thirds of the average among advanced OECD economies.

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.

Figure 1.7 | Per Capita Primary Civilian Expenditure, Israel and OECD, 2024

(PPP-adjusted dollar terms)



SOURCE: Based on OECD.

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 sector[37], 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

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

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 Fund[40] and in the OECD's review on Israel.[41]

[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

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

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 implement, 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

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

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

[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."