Chapter 1

The Economy and Economic Policy During the War

- The war had a significant impact on economic activity this year, primarily due to supply constraints, most notably a shortage of workers. GDP increased by only 0.9 percent compared to 2023, and business output contracted by 0.8 percent.
- Despite a partial recovery due to a decrease in the war's intensity during the year, GDP and most of its components remained lower throughout the year than they were before the war.
- The global environment was relatively favorable in terms of demand, as reflected in global GDP growth and increased world trade. Inflation in the advanced economies moderated, and central banks reduced interest rates.
- The easing of supply constraints was only gradual during the year, mainly due to the continued prohibition on the entry of Palestinian workers and the absence of many reservists and residents of conflict areas from their regular workplaces.
- The government's main fiscal policy dilemma was balancing the immediate needs of the war with maintaining the credibility of its commitment to a sustainable fiscal path. Therefore, the government financed the ongoing war expenses by increasing public debt, which soared to about 68 percent of GDP, and implemented restrictive fiscal measures, mostly in the 2025 budget, to offset the expected permanent increase in expenditures due to the war.
- Annual inflation totaled 3.2 percent, slightly higher than in 2023, in view of a gradual recovery in demand alongside persistent supply constraints. This was contrary to the global trend of moderating inflation.
- The Bank of Israel lowered the interest rate by 0.25 percentage points at the beginning of the year, following the stabilization of the financial markets, moderation of the inflation environment, and reduced war intensity compared to the beginning of the war.
- The Bank of Israel's interest rate remained at 4.5 percent throughout 2024, in order to continue supporting market stability in view of the ongoing war and to bring inflation, which had risen, back to the target range amid dominant supply constraints.
- The labor market was tight due to the supply constraint on workers, alongside increased demand supported by the sharp rise in government expenditures. As a result, nominal wages rose rapidly, as did the unit labor cost.

- The construction industry faced a particularly severe shortage of workers, leading to extended construction times, a slowdown in building completions, and increased financing costs for contractors. These issues gradually and partially eased. Housing demand declined at the beginning of the war but recovered later, with the number of transactions and mortgage volumes increasing, accompanied by rising home prices.
- The economy's risk premium rose significantly at the beginning of the war and was characterized by volatility and a moderate upward trend for most of the year, mainly due to increased geopolitical risk, accompanied by a significant rise in the debt-to-GDP ratio.
- Toward the end of the year, in view of the ceasefire in the north and assessments that security risks had decreased, there was a turnaround in the markets. The shekel appreciated, local stock prices soared, the economy's risk premium decreased significantly—though it remained higher than before the war—and the yield on government bonds, which had surged at the beginning of the war, returned to its prewar level. These positive developments were also supported by significant fiscal measures to reduce the deficit, which the government approved at the end of 2024.
- Due to the war and its expected long-term effects on the growth of public expenditure, the challenge of addressing the economy's fundamental problems—such as low labor productivity and high poverty rates—through increased public investment in human capital and infrastructure has intensified. Additionally, the economic necessity of quickly integrating additional population groups into the labor market and sharing the burden of military service has become more pronounced.

1. ECONOMIC BACKGROUND CONDITIONS

a. Local developments in the shadow of war

The Swords of Iron War continued throughout 2024 with varying intensity. Economic developments, accompanied by high uncertainty, were significantly influenced by the nature and intensity of the war, government decisions, and the budgetary response to security and civilian needs, as well as the policies and actions of the Bank of Israel.

Economic developments during the year were influenced by the nature and varying intensity of the war, and the economic policy adopted as a result.

The war was at its peak in the fourth quarter of 2023. Its intensity decreased on the southern front during the first quarter of 2024 and remained low until October, and it then escalated on the northern front. In 2024, there were two direct confrontations between Israel and Iran, and attacks from the Houthis in Yemen continued. Toward the end of the year, after a ceasefire agreement in the north, the intensity decreased. On January 16, 2025, a ceasefire agreement in Gaza was signed.

Growth was affected this year. The debt-to-GDP ratio, the state budget, and the deficit all increased significantly.

Despite the prolonged war on multiple fronts, the Israeli economy showed resilience. Although GDP levels, especially business output, were lower than prewar levels, the main impact on activity was concentrated in industries and regions directly affected by the war. Inflation slightly exceeded its target. The debt-to-GDP ratio, the state budget, and the deficit increased, but the markets continued to function, and during the year, foreign direct investments in Israel recovered. The underperformance in local stock indices, which had widened over the past two years, narrowed toward the end of 2024. The economy's risk premium, as measured by the capital market, rose sharply at the beginning of the war but stabilized during the year. It moved in a slight upward trend until October, but fell sharply after the ceasefire agreement in the north, although it remained higher than prewar levels.

Toward the end of the year, the risk premium declined, the domestic equity indices soared, and the shekel appreciated.

Several key factors contributed significantly to maintaining the economy's financial stability. These include the surplus in the current account of the balance of payments[1], which has persisted for about two decades, the reduction of the public debt-to-GDP ratio to below 60 percent before the war, the high rate of private savings, and the robust financial system. These factors also allowed the government to finance war expenses almost exclusively by increasing debt, without losing market confidence. The economy's stability was also supported by the high level of foreign exchange reserves and the Bank of Israel's announcement at the beginning of the war that it would sell foreign currency—if market conditions required it—up to $30 billion. In practice, the bank sold $8.5 billion in October and November 2023 and did not intervene in the market in 2024.

Significant steps are necessary to solve the economy's fundamental problems that could lower its growth potential.

The war is expected to have significant medium-term implications ("scars") on the Israeli economy. Defense expenditures are expected to increase relative to their prewar levels; the military will expand; it will be necessary to reduce the debt-to-GDP ratio, which has risen, to once again create fiscal space; the risk premium may remain high; and the economy will be accompanied by a lower international credit rating

[1] Which means an accumulation over years of assets abroad.

than before the war, and extensive expenditures on rehabilitating conflict areas and ongoing care for the many war casualties. All these are expected to have a negative impact on the economy's growth potential. Against this backdrop, the government's economic challenge in the coming years will be particularly significant, as addressing the economy's fundamental problems, including low labor productivity and social disparities (detailed in the last part of this chapter), will require substantial resources.

b. Major global developments in 2024

Globally, the "soft landing" continued, and in the second half of the year, central banks began lowering their interest rates.

In the advanced economies, the year began with expectations for a continued "soft landing" process, meaning a moderation of the high inflation rate toward the target with a gradual slowing of the growth rate toward its trend and a measured release of the tight labor market. World trade, which is an important indicator of global demand for Israeli exports in normal times, increased by 2.7 percent in 2024. (See Table 1.1, which also details other indicators.) In the US, robust growth continued in 2024, while in the eurozone, gradual recovery in growth continued after its sharp decline with the Russian invasion of Ukraine. China, supported by government activity, met its growth target of about 5 percent, a slight moderation compared to 2023, and a sharp decline in inflation in the country indicated weakness in nongovernmental domestic demand.

With the continued moderation of the inflation rate in both the US and Europe to levels still slightly above the central banks' targets, the Federal Reserve and the European Central Bank adopted slightly different approaches. The Fed began to lower interest rates, but relatively moderately—by 1 percentage point during 2024 and more slowly from early 2025. The ECB lowered interest rates by 1.35 percentage points in 2024 and continued to lower them by another 0.5 percentage points in early 2025.

Table 1.1 | Economic Indicators by International Comparison, 2019–2024

percent

	2019	2020	2021	2022	2023	2024
Global GDP (rate of annual change)	2.9	-2.7	6.6	3.6	3.3	3.2
World trade (rate of annual change)	0.5	1.2	7.1	-2.7	0.7	2.7
a. US						
Per capita GDP (annual rate of change)	2.1	-3.0	5.7	2.2	2.4	2.3
Average annual unemployment rate	3.7	8.1	5.4	3.6	3.6	4.1
Inflation in December	2.3	1.4	7.0	6.5	3.4	2.9
Central bank interest rate in December	0.25	0.25	0.25	4.50	5.50	4.50
b. Eurozone						
Per capita GDP (annual rate of change)	1.8	-5.8	6.7	3.5	0.2	0.8
Average annual unemployment rate	7.6	8.0	7.8	6.8	6.6	6.5
Inflation in December	1.3	-0.3	5.0	9.2	2.9	2.4
Central bank interest rate in December	-0.50	-0.50	-0.50	2.00	4.00	3.00
c. Israel						
Per capita GDP (annual rate of change)	1.9	-3.6	7.6	4.3	-0.1	-0.4
Average annual unemployment rate	3.8	4.4	5.0	3.8	3.4	3.0
Inflation in December	0.6	-0.7	2.8	5.3	3.0	3.2
Central bank interest rate in December	0.25	0.10	0.10	3.25	4.75	4.50

SOURCE: Bank of Israel and Bloomberg.

Israel's terms of trade improved by 4.6 percent this year. This means that the price of an export unit rose more than that of an import unit, contributing to an increase in the economy's current income. The improvement was mainly due to rising export prices. Given the weights of exports and imports in GDP, the improvement in terms of trade contributed about 1.5 percentage points to the rise in GDP prices.

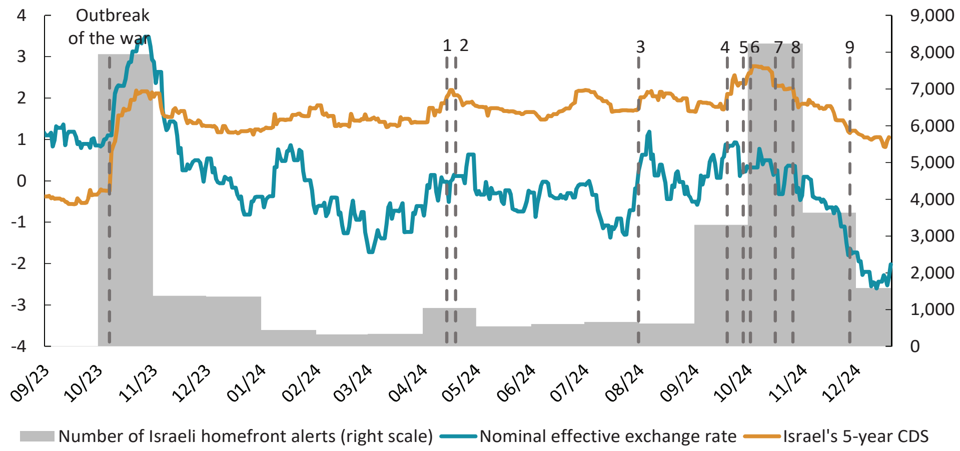
2. THE MACROECONOMIC ENVIRONMENT

a. Main developments during the year

The Israeli economy was significantly affected by the war and its intensity.

The Israeli economy was significantly affected by the development and intensity of the war. Since the outbreak of the war, there has been a very high correlation between the war's intensity, reflected in the number of alerts in the Israeli home front and security events, and the development of the exchange rate and Israel's risk premium (Figure 1.1). Thus, after a sharp depreciation at the beginning of the war, the shekel appreciated until March, in parallel with the reduction in the war's intensity.[2] From March to October, the shekel depreciated slightly, with high volatility around specific geopolitical events. From October, after Iran's second missile attack and the Israeli response, and in parallel with achievements in the war along the northern front, the trend reversed, with the shekel appreciating significantly.

Figure 1.1 | Exchange Rate and Risk Premium in View of Intensity of the War and Significant Security Events, September 2023–December 2024 (standard score)



Key: 1 - Iranian attack on Israel (April 13); 2 - Israeli attack on Iran (April 19); 3 - Elimination of Ismail Haniyeh (July 31); 4 - Beeper operation in Lebanon (September 18); 5 - Elimination of Nasrallah (September 27); 6 - Iranian attack on Israel (October 1); 7 - Elimination of Yihyeh Sinwar (October 16); 8 - Israeli attack on Iran (October 26); 9 - Ceasefire in Israel's north (November 26).
SOURCE: Bank of Israel, Institute for National Security Studies (INSS), and Bloomberg.

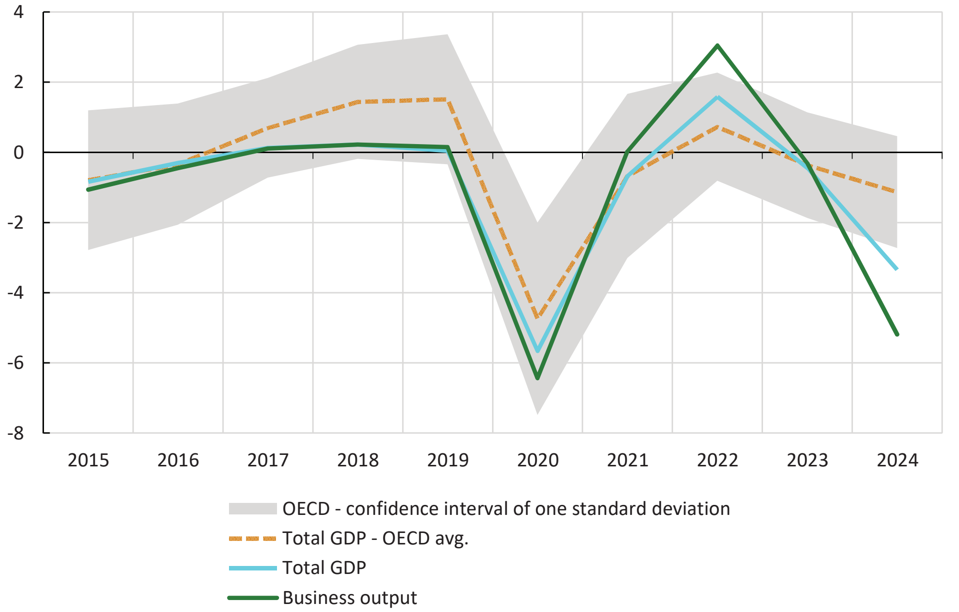
2 The shekel's depreciation was also moderated by the Bank of Israel's immediate intervention in the foreign exchange market on the first trading day after the outbreak of the war, and the provision of shekel liquidity, aimed at mitigating market fluctuations. (For more details, see Chapter 3 and the Financial Stability Report for the second half of 2023.)

Israel's risk premium, as measured by the CDS, rose sharply at the outbreak of the war, and from the beginning of 2024 until October, it moved in a slight upward trend (Figure 1.1). At the end of 2024, the economy's risk premium fell sharply, similar to the development of the exchange rate, but remained higher than before the war. The decline in the risk premium was also reflected in the decrease in yields on government shekel bonds.

Economic growth was impaired mainly due to the shortage of workers.

The Israeli economy grew by only 0.9 percent in 2024, a rate that implies per capita growth of -0.4 percent. This is in contrast to global growth and the expansion of world demand, reflected in the increase in global trade volume. Business output was much more affected—falling by 0.8 percent compared to the whole of 2023 and by 2.3 percent compared to its prewar level (Figure 1.2 and Table 1.2). The gap between the decline in business output and the measured increase in total GDP reflects a significant change in the composition of GDP. Many reservists were mobilized this year to meet the war's needs at the expense of business activity. Moreover, a larger-than-usual portion of business output was allocated to defense this year, reflected in local purchases by the defense establishment[3] and a reduction in supply for other uses. During the year, private consumption recovered significantly, while investment and export levels were lower at the end of the year than before the war.

Figure 1.2 | Deviation from the GDP Trend in Israel and the OECD Average, 2015–2024 (percent)



SOURCE: Bank of Israel and based on OECD.

[3] For an explanation of the recording of defense expenditures in the National Accounts, see Chapter 2.

The main impediment to higher growth this year was supply constraints. The government banned the entry of Palestinian workers. The impact of this situation on the supply of business product is estimated at about 3.4 percentage points, with activity slowing mainly in the construction industry. The process of bringing in foreign workers to replace the Palestinians took time and only partially addressed the shortage. (For more information see Chapters 2, 5, and 8.) Intensive mobilization of reservists weighed on activity, mainly affecting the available labor input for the business sector, with its impact on the supply of business product estimated at about 1.5 percentage points. The total impact on labor supply in business output through these channels is therefore estimated at about 4.9 percentage points. Additionally, evacuated civilians and the families of reservists and war casualties did not work to the extent they did before the war, and the economy's production capacity was somewhat affected by the temporary closure of factories and workplaces, mainly in the north. The impact on the business sector's production capacity is likely close to about 5 percent. (For an expanded analysis, see Chapter 2.) Demand fell significantly at the beginning of the year in the tourism, food service (especially at the beginning of the war), and accommodation industries, and fell sharply in the north due to the war's focus in that area.

Table 1.2 | Main Developments, 2019–2024

	2019	2020	2021	2022	2023	2024
Population (yearly average, million)	9.17	9.33	9.48	9.65	9.85	9.97
Nominal GDP (NIS billion, current prices)	1,428.1	1,414.0	1,582.3	1,764.4	1,878.4	1,999.3
Per capita GDP (NIS thousand, current prices)	155.7	151.6	166.9	182.8	190.8	200.5
GDP (real rate of change, percent)	3.7	-2.0	9.4	6.3	1.8	0.9
Per capita GDP (real rate of change, percent)	1.9	-3.6	7.6	4.3	-0.1	-0.4
Private consumption (real rate of change, percent)	4.0	-7.4	11.4	7.6	-1.2	3.7
Fixed Capital Formation (real rate of change, percent)	3.9	-3.4	13.8	10.6	-1.8	-6.1
Public consumption (real rate of change, percent)[a]	2.9	2.5	4.6	1.0	7.2	11.4
Goods and services exports (annual rate of change, percent)[b]	4.3	-0.6	12.2	10.3	0.0	-4.6
Goods and services imports (annual rate of change, percent)[c]	3.5	-5.1	18.3	12.9	-7.0	-1.9
Current account of the balance of payments (surplus, $ billion)	13.7	16.9	16.2	17.4	19.0	17.1
Overall government deficit (percent of GDP)[d]	4.5	11.4	5.3	1.9	6.9	9.4
Gross Public debt (percent of GDP, end of year)	59.1	71.1	67.8	60.5	61.5	67.8
Employed Israelis aged 15+ (yearly average, rate of change compared to the previous period)	1.6	-1.3	1.1	5.8	3.3	1.1
Nominal wage per employee post (yearly average, percent rate of change)	2.9	6.5	2.5	2.8	6.2	6.2
Unemployment rate, aged 15 and up (yearly average, percent)	3.8	4.4	5.0	3.8	3.4	3.0
Job vacancy rate (yearly average, percent)	3.5	2.4	4.5	4.8	3.8	4.4
Inflation (December compared to the previous December, percent)	0.6	-0.7	2.8	5.3	3.0	3.2
Bank of Israel interest rate (yearly average, percent)	0.25	0.14	0.10	1.25	4.50	4.50
Bank of Israel interest rate (last figure in the period, percent)	0.25	0.10	0.10	3.25	4.75	4.50
Real one-year interest rate (yearly average, percent)	-0.81	0.07	-1.89	-1.40	1.55	1.29
Real one-year interest rate (last figure in the year, percent)	-0.77	-0.52	-2.49	1.04	1.08	2.00
Nominal yield on 10-year government bonds (yearly average, percent)	1.59	0.82	1.25	2.62	3.92	4.68
Real yield on 10-year government bonds (yearly average, percent)	-0.01	-0.50	-0.77	0.07	1.24	1.99
Real effective exchange rate (yearly average, percent rate of change)[e]	-2.5	-3.6	-4.9	0.1	9.2	-0.5
NIS/$ exchange rate (yearly average)	3.6	3.4	3.2	3.4	3.7	3.7
Tel Aviv 125 index[f]	21.3	-3.0	31.1	-11.8	4.1	28.6

[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
[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.

Government assistance and the relief measures led by the Bank of Israel mitigated the war's economic impact on the population, particularly on those who were directly hurt by the war.

The economic impact on the population in conflict zones, which is about 2.5 percent of Israel's population—both those evacuated (about half of the conflict zone population) and those who remained in their homes—was the most severe. However, government assistance, and to some extent the relief measures led by the Bank of Israel, mitigated the impact.[4] (For more details, see Chapter 7 in the Bank of Israel's Annual Report for 2023, as well as Figure 2.9 in this report, which shows the impact on activity during the year by region.) For example, borrowers from conflict zones who were evacuated and received economic assistance managed to significantly reduce their consumer debt and overdrafts, compared to an increase in debt burden among borrowers who were not evacuated. The positive correlation between the proportion of bank loans in the borrower's total debt and the likelihood of reducing the payment burden indicates the effectiveness of the banking relief measures that supported the evacuees (Box 4.2 in this Report).

The year was characterized by excess demand, as the shortage of workers continued throughout the year, while demand recovered gradually.

The year 2024 was characterized by excess demand, as the impact on supply, mainly due to a shortage of workers, was more prolonged than the impact on demand. At the beginning of the war, companies reported a significant worsening of demand constraints, but since then, such constraints have moderated, while the supply constraint has eased only slightly (Figure 1.3).[5] The moderation of inflation at the beginning of the war, the stabilization of financial markets as the geopolitical situation appeared to improve, and concerns about a prolonged impact on demand led to the lowering of the Bank of Israel's interest rate in its first decision of 2024 (on January 1, 2024). Later in the year, the ongoing war, its associated expenses,

Table 1.3 | Indicators of the Development of Excess Demand in 2024

percent

	Q1	Q2	Q3	Q4
Total domestic uses excluding inventory[a]	-2.4	-1.2	1.9	3.1
Total domestic uses excluding inventory (nominal)[b]	4.7	4.0	6.4	7.7
Private consumption[a]	-2.5	0.8	3.0	4.3
Imports, excluding defense, ships, aircraft, and diamonds[a]	-10.1	-9.1	-1.1	1.6
Broad unemployment rate (percentage of labor force)	4.5	4.0	3.4	3.2
Ratio of job vacancies to unemployed	0.89	0.94	1.13	1.17

[a] Real change in percent relative to the same period in the previous year. Q4 is relative to Q3 of 2023, in annual terms.

[b] Nominal change in percent relative to the same period in the previous year, not seasonally adjusted. Q4 is relative to Q3 of 2023, in annual terms.

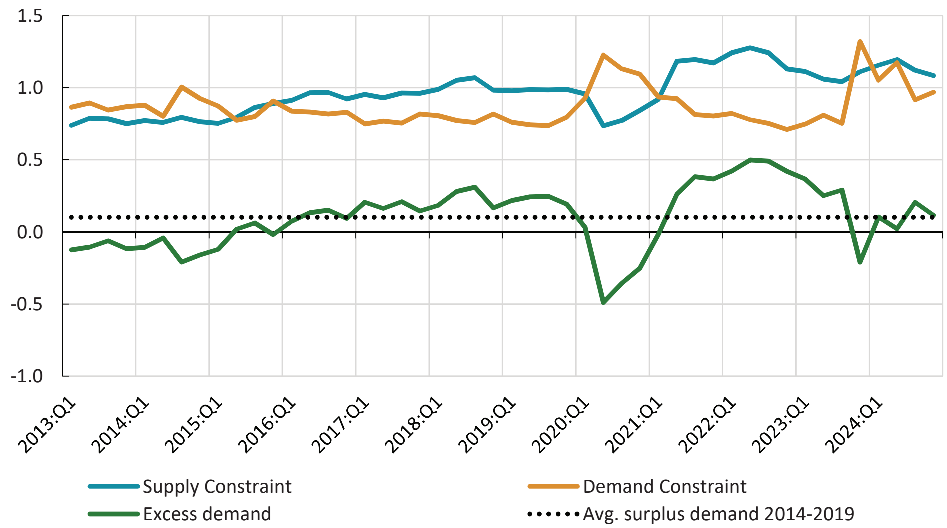
SOURCE: Based on Central Bureau of Statistics data.

[4] See the Bank of Israel press release: "The Bank of Israel's Comprehensive Outline, Adopted by Banks, to Help Customers Deal with the Ramifications of the Swords of Iron War, October 2003. https://www.boi.org.il/en/communication-and-publications/press-releases/c15-10-23/

[5] Figure 1.3 presents supply and demand constraints in the business sector only, as it relies on the Business Tendency Survey conducted by the Central Bureau of Statistics.

and supply constraints led to the development of excess demand in the economy. This was also reflected in the increase in imports during the second half of the year, in response to growing demand, and the decline in both broad and narrow unemployment rates, which led to a tightening of the labor market. (See Table 1.3 and further discussion in the section on the labor market and in Chapter 5.) All these were key considerations for keeping the Bank of Israel's interest rate unchanged throughout the year.

Figure 1.3 | Supply and Demand Constraints and the Gap Between Them, 2013–2024 (reported constraint level)



Notes: The demand constraint is the weighted average of orders constraints in all business sector industries. The supply constraint is the weighted average of the labor constraint. The gap between the supply constraint and the demand constraint represents excess demand in the economy, and it is very highly correlated with various output gap indices.

SOURCE: Based on Central Bureau of Statistics Business Tendency Survey data.

Another indication of the increase in excess demand is the decline in the current account surplus this year, mainly in the second half, as the decline in savings was sharper than the decline in investment in the economy. The decline in savings was led by a sharp drop in public savings, a result of the large war expenditures, and the decline in investment was mainly due to a decrease in construction investment, due to a shortage of workers, following the prohibition on the entry of Palestinians to work in Israel without a sufficient short-term replacement.

GDP has still not returned to its trend line, due to the prolonged nature of the war.

Following a strong shock to activity with the outbreak of the war, there was a sharp recovery at the beginning of 2024, as the war's intensity decreased (Figure 1.1). However, unlike after the outbreak of previous security events, GDP levels did not return to the trend line, due to the prolonged fighting. In line with the continued moderate growth and increased private demand in the second half of 2024, and despite the high-interest rate environment, business credit grew significantly. (For more details, see Chapter 4.)

Gross investment, particularly in the construction industry, was significantly impaired due to the shortage of workers.

Regarding uses, the component most affected was gross investment, particularly in the construction industry, due to a shortage of workers. The decline in investment is also expected to have a negative impact on medium-term growth, labor productivity, and potential output, as it reduces the capital stock.

The impact on Israeli exports this year was unusual and contrary to the growth in world trade.

Exports declined this year, even excluding tourism services exports, which were particularly hard hit. The impact on Israeli exports after years of prosperity was unusual and contrary to the growth in world trade. This can be explained by a decline in production capacity due to labor constraints, difficulties in closing export deals due to the war situation (including the Turkish boycott), and a decline in global demand for products and services in which Israel specializes, but it is difficult to isolate the impact of each factor.

Another channel that contributed to the decline in growth this year (by about one percentage point) is the sharp decline in the output of startup companies, mostly explained by a global cyclical decline in demand for venture capital investments after the peak of recent years. (For more details, see Figure 2.5 in Chapter 2 of this Report.)

Private consumption recovered rapidly.

In contrast to exports and investment, private consumption recovered quickly, and by the end of the year, it had surpassed prewar levels by about 5.6 percent.[6] This was influenced by fiscal expansion, which increased household disposable income, supported by the increase in the value of the public's asset portfolio and by the fact that in 2024, the war was less restrictive of activity in central Israel. (See Figure 2.9 in this Report, detailing revenue development throughout the year by region.)

b. The labor market

The labor market was affected by a shortage of workers.

The labor market was affected by four main shocks: a reduction in labor supply due to a sharp decline in the availability of non-Israeli workers; the mobilization of reservists (including the impact on the labor supply of their spouses); restrictions on activity in conflict areas; and a decline in aggregate demand due to a drop in consumer and investor sentiment and/or impacts on specific industries—mainly those dependent on tourism. The impact on aggregate demand was particularly significant in the last quarter of 2023, followed by a gradual recovery. However, the impact on labor supply, which began in that quarter, continued throughout 2024.

The peak of these developments was at the outbreak of the war, leading to a one percentage point drop in the employment rate in the fourth quarter of 2023.[7] The shortage of workers, along with the recovery in demand, was reflected in a slight decline in the unemployment rate throughout the year to historically low levels (Table 1.4). Total labor input in the business sector fell by 5 percent compared to prewar

[6] The level of total private consumption in the last quarter of 2024 compared to the third quarter of 2023, at fixed prices.

[7] The mobilization of workers for reserve duty and the prohibition on the entry of Palestinian workers to Israel do not affect the employment rate, since reservists are considered employed, and Palestinians are not part of the population for which the employment rate is calculated.

levels, due to the decline in the number of non-Israeli workers, extensive reserve mobilization, and a moderate decline in the number of hours worked per employee.

Table 1.4 | Labor Force Participation, Unemployment, and Employment Rates (Aged 25–64), 2019–2024

percent

	2018	2019	2020	2021	2022	2023	2023:Q4	2024
Labor force participation rate	80.3	80.4	79.2	79.3	81.2	81.6	80.6	80.7
Unemployment rate	3.5	3.4	3.8	4.6	3.3	3.1	3.0	2.8
Employment rate	77.5	77.7	76.2	75.7	78.6	79.1	78.2	78.4

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

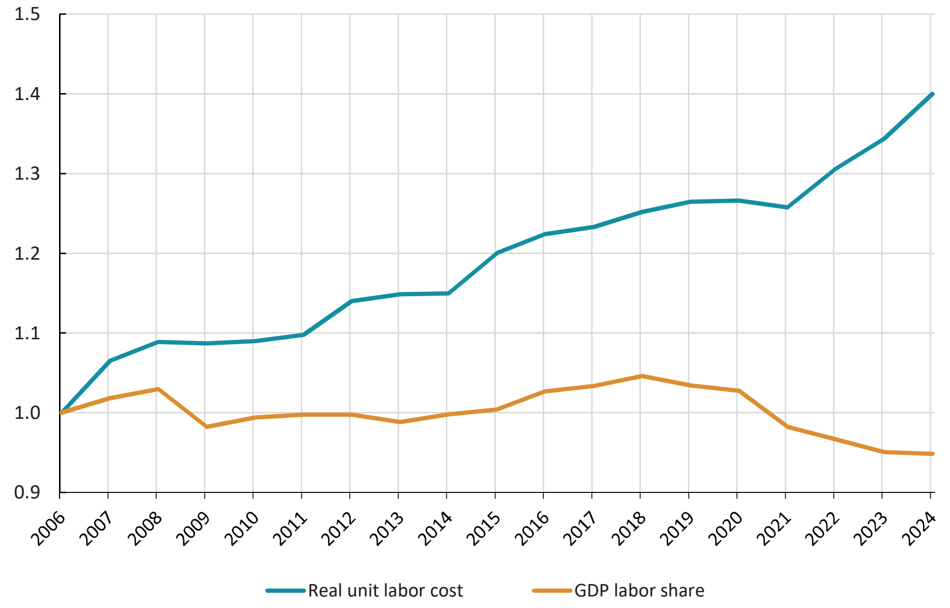
Tightness in the labor market contributed to an increase in inflation.

The decline in the number of unemployed, along with a slight upward trend in the number of job vacancies, indicated a tight labor market. This tightness was reflected in a 5.2 percent increase in the cost of labor per hour in the business sector, compared to a 1.0 percent increase in labor productivity. The resulting 4.2 percent increase in the real unit labor cost was higher than the inflation target, thereby contributing to inflationary pressures. However, firms managed to maintain high profit margins, thanks to a decline in energy and commodity prices and through price increases supported by strong demand for products, resulting in a continued decline in wage payments as a share of GDP (Figure 1.4). From workers’ perspective, real wages per employee (adjusted for the consumer price index) increased by about 2.6 percent. (For more details on the main developments in the labor market this year, see Chapter 5.)

The relative stability of the economy was also supported by an agreement between the Histadrut (General Federation of Labor) and the government to postpone the continuation of the wage increases stipulated in the public sector framework agreement[8], despite the ongoing erosion of wages in this sector (Figure 1.5). An estimation using a multivariate regression, which adjusts for the impact of other observable human capital characteristics of the workers, highlights this erosion. The hourly wage gap between workers with similar characteristics employed in public services and those in the business sector has widened in recent years. A decade ago, the gap was not statistically significant, whereas in recent years, a statistically significant negative gap of about 10 percent has emerged (Figure 1.5).

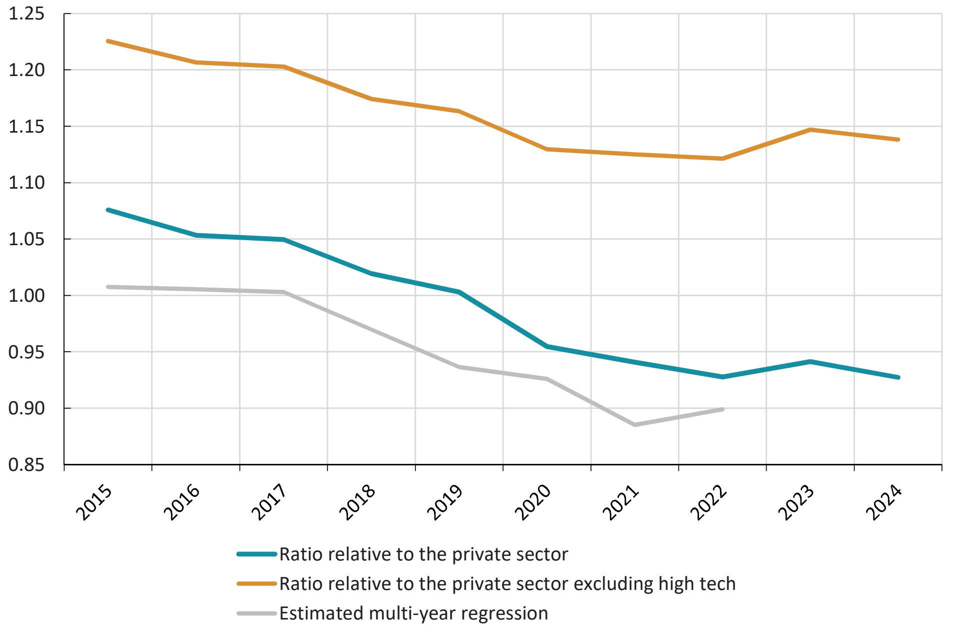
[8] Formally, it was agreed to temporarily reduce wages in 2025 by the amount of the increase given in the December 2024 increment.

Figure 1.4 | GDP Labor Share and Real Unit Labor Cost in the Business Sector, 2006–2024 (yearly average of quarterly data, index: 2006=1)



SOURCE: Based on Central Bureau of Statistics.

Figure 1.5 | Ratio of Public Sector Wages to Private Sector Wages, 2015–2024



SOURCE: Based on Central Bureau of Statistics and Expenditure Surveys.

This responsiveness of public sector workers this year once again demonstrates the flexibility of the Israeli labor market—the ability to reach agreements between labor organizations and the government during crises, thereby creating fiscal space for necessary expenditures during crises.[9] The fact that public sector wages did not increase in real terms (Figure 5.12) also led to a reduction in wage pressures in the business sector[10], thereby contributing to a decrease in price pressures originating from the labor market. However, it is important to remember that if the relative wage erosion in the public sector (after adjusting for worker characteristics) is prolonged and not just a temporary response to the crisis, it could affect the quality of public services, and thus the economy's growth potential.

The behavior of the business sector also contributed to the economy's resilience. Despite the sharp decline in demand and the difficulties in operating workplaces at the beginning of the war, employers were slow to lay off workers. This phenomenon was likely influenced by the experience during the post-COVID-19 period when employers struggled to recruit workers, but the government also played an important role in mitigating the impact on demand through the furlough mechanism and compensation to employers. (For more details on government and Bank of Israel actions to stabilize the economy at the beginning of the war, see Chapter 1 in the Bank of Israel's Annual Report for 2023.)

The rate of high-tech jobs as a share of total jobs remained stable this year. Wages in the sector increased slightly more than the average wage in the economy.

The high-tech sector holds a particularly important place in the Israeli economy, contributing nearly a third of the growth in recent years. This year, the growth of this sector slowed, due to both supply constraints and a global slowdown in its growth rate.[11] The number of salaried positions in the high-tech sector remained stable—similar to their number in 2023. The number of job vacancies in the sector also remained stable, at a high level, throughout most of the year, and began to rise in the last third of the year. Accordingly, nominal wages in this sector increased by 7 percent, more than in the rest of the economy (Table 1.5). It should be noted that although the growth rate of all aggregates in the industry moderated significantly this year, it remains at a high level, following exceptional growth rates in 2021–2022.

9 Agreements on temporary wage reductions were also reached in previous crises. For example, during the COVID-19 pandemic, the business sector, the Histadrut, and the government agreed on a measure that included a wage freeze. In the 2003 fiscal plan, the Histadrut agreed that public sector workers would pay a "growth encouragement" tax for the benefit of the business sector. A Bank of Israel publication formally estimated the flexibility of the Israeli economy and showed that it is high by international comparison. See: Adi Brender, Yuval Mazar, Guy Navon, and Ella Shahar (2012), "The Cyclically Adjusted Deficit in Israel", in Recent Economic Developments, 132, Part B, Bank of Israel.

10 Yuval Mazar (2022). "The Development of Public Sector Wages and the Connections Between Them and Business Sector Wages," in: Amir Yaron and Michel Strawczynski (editors), Monetary Policy in a Period of Price Stability, Bank of Israel, pp. 167–210.

11 For more details on the development of the high-tech sector's output this year, see Chapter 2.

Table 1.5 | Main Developments in the High-Tech Industry, 2019–2024

	2019	2020	2021	2022	2023	2024
Number of high-tech positions[a]	303	305	331	372	379	383
High-tech positions as a share of total positions[b]	7.6	8.4	8.7	8.9	8.9	9.2
Number of job vacancies	13,593	10,794	20,738	22,185	14,212	14,649
Job vacancies as a share of total positions	13.8	17.9	16.6	15.1	12.0	10.8
Wages[c]	24,130	25,438	26,996	28,307	30,370	32,430
Ratio of high-tech wages to the average	2.30	2.26	2.35	2.41	2.42	2.45

[a] Number of salaried positions in high-tech, excluding information and communications, Israelis only, in thousands, original data.

[b] Number of high-tech positions divided by the total number of positions.

[c] In thousands of shekels.

SOURCE: Based on Central Bureau of Statistics and IVC data.

c. Inflation

The increase in inflation during the year was contrary to the downward trend globally, and was affected by the development of the war.

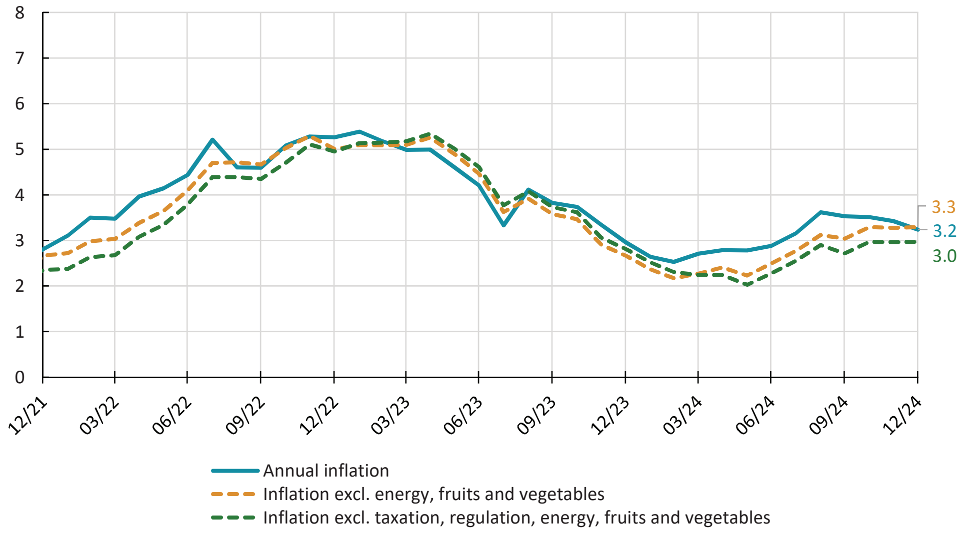
The consumer price index rose by 3.2 percent in 2024 (Figure 1.6), slightly more than in 2023 (3 percent). The increase in inflation during most of the year, after it had already fallen to 2.5 percent in February, was contrary to the global trend of declining inflation and was influenced by the development and intensity of the war. The rise in inflation was led by price increases in the food and housing components, which together account for nearly half of the consumer price index, and were affected by the war. (For more details, see Chapter 3.) The contribution of government taxation and regulation to the annual inflation rate was 0.4 percentage points. (For more details, see Box 3.1.) The rate of change of various core indices also settled near the upper limit of the target (Figure 1.6).

Inflation increased beginning in the second quarter, and moderated toward the end of the year.

The development of inflation during the year was not uniform. At the beginning of the year, it declined, as mentioned, due to a drop in demand because of the war. From the second quarter, annual inflation rose, and toward the end of the year, it stabilized slightly above the upper limit of the target, led by increases in the prices of nontradable goods (Figure 3.1). The factors contributing to the rise in inflation were: (1) the persistence of supply constraints alongside a recovery in demand (Figure 1.3)—influenced by the weakening of the war's intensity, the nonmaterialization of many security concerns, and continued fiscal expansion; (2) the lagged impact of the depreciation that occurred at the beginning of the war due to the rise in the risk premium at that time, an impact that was mainly felt in the first half of 2024 (Figure 1.1 and see more details in Chapter 3 of this Report).

Alongside the development of inflation, inflation expectations for the year from all sources ranged around the upper limit of the inflation target for most of the year (Figure 3.9 in this Report), and toward the end of the year, with the improvement in the security situation, they fell to a range around 2.5 percent. This indicated the credibility of the Bank of Israel's policy to maintain the inflation target.

Figure 1.6 | Annual Inflation and Adjusted Indices, December 2021–December 2024 (monthly data in annual terms, percent)



SOURCE: Based on Central Bureau of Statistics.

The development of inflation is consistent with empirical findings regarding the Israeli economy, which indicate that a military conflict has a deflationary impact on the economy in the short term—due to a dominant drop in demand alongside a significant decline in activity due to supply-side disruptions—and an inflationary impact in the medium to long term, with the recovery of demand.[12] (For more details, see Box 3.2 in the Bank of Israel's Annual Report for 2023.)

d. The exchange rate

From October, the economy's risk premium declined, and the shekel appreciated to a stronger level than before the war.

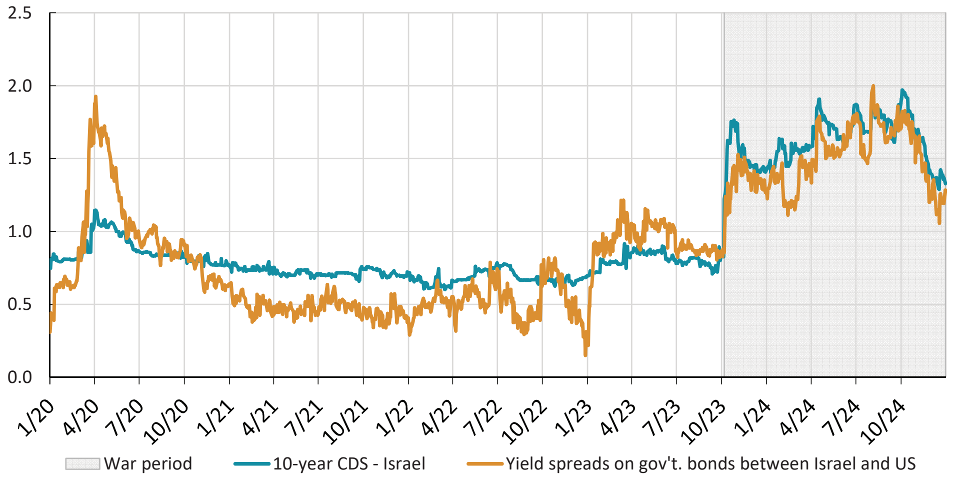
The shekel traded within a range of approximately NIS 3.6 to 3.8 to the US dollar for most of the year, a range similar to the months before the war, with volatility corresponding to geopolitical developments (Figure 1.1). The Bank of Israel did not intervene in the foreign exchange market during 2024, partly due to its intervention at the beginning of the war and the credibility of its commitment to maintaining stability in the foreign exchange market, backed by a high level of foreign exchange reserves.[13] Until the second Israeli strike on Iran on October 26, the shekel depreciated by 0.8 percent in terms of the nominal effective exchange rate (October 2024 average compared to December 2023 average). After the strike, the shekel appreciated, strengthening significantly after the ceasefire in the north a month later and the collapse of the Assad regime in Syria. At the end of the year, the shekel had

[12] Although the war is unusual in its length, since the peak of the fighting was in the first quarter after its outbreak, the development due to it appears to "fit" the empirical analysis that is based on previous wars (Figure 1.1).

[13] For more details, see the Bank of Israel's Annual Report for 2023, Chapters 1 and 3.

appreciated by 5.1 percent in terms of the nominal effective exchange rate, and was stronger than its prewar rate. The sharp appreciation at the end of the year reflected the improvement in the security situation, which was also reflected in the decline of various risk indices (Figure 1.7), although to levels higher than before the war.

Figure 1.7 | Yield Spreads on 10-Year US Dollar Bonds Between Israel and the US, Compared with the Risk Premium Based on the 10-Year CDS, January 2020–December 2024 (percentage points)



SOURCE: Bank of Israel and based on Bloomberg.

The relative stability in the foreign exchange market was also reflected in the real effective exchange rate.[14] After the excess real depreciation that began in early 2023, the real exchange rate remained stable in 2024, according to various models developed by the Bank of Israel, which estimate the real equilibrium exchange rate based on the long-term relationship between it and per capita GDP, as well as other variables such as terms of trade and the weight of fuel in imports.

e. The financial markets

In view of the positive developments in the war, Israeli equity prices soared toward the end of the year.

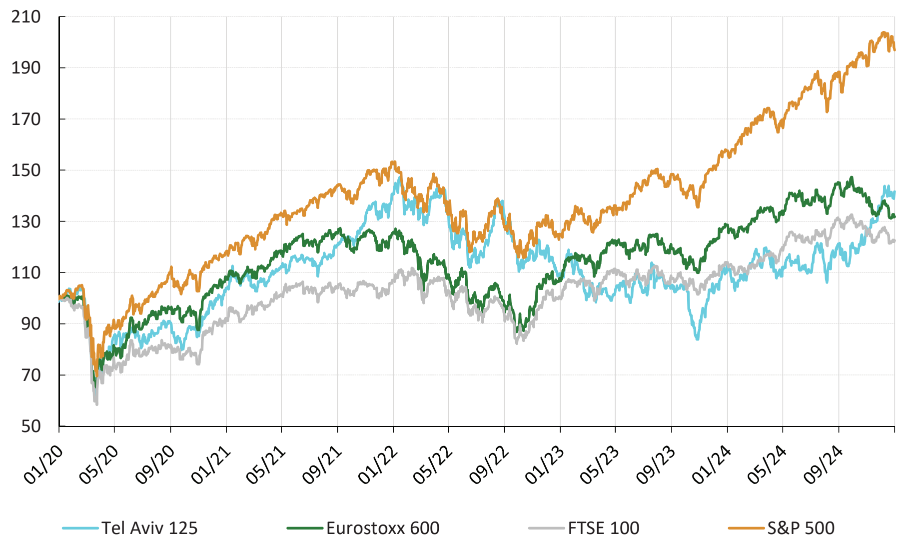
The development of equity prices in 2024 was influenced, like other variables, by geopolitical developments. Until mid-October, Israeli equity prices underperformed and remained stable, while global equity prices rose (Figure 1.8). From mid-October—amid positive developments in the war, the advancement of adjustments to the 2025 state budget (discussed in Chapter 6), and a decline in the economy's risk premium

[14] The real effective exchange rate is calculated as the geometric average of the shekel's exchange rates against 21 currencies, representing 29 countries—Israel's main trading partners by weight—adjusted for the inflation rate differentials between Israel and these countries. See: Lior Gallo and Yoav Friedman (2015). "The Effective Exchange Rate in Israel", Bank of Israel Research Department.

(Figure 1.1)—Israeli equity prices soared. They rose by about 18 percent (in dollar terms), nearly closing the gap that had opened since early 2023 with comparable indices in Europe, and partially closing the gap with the US.

The volume of new equity issuances (IPOs) increased moderately in 2024 compared to 2023 but remained low—about a fifth of the average volume in 2017–2022. Corporate bond spreads (excluding financials) fell during the year (except in the manufacturing sector) to below their prewar levels. This was similar to the narrowing of bond spreads globally, supported by increased risk appetite among investors during the year. (For more details, see Chapter 4.) The decline in bond spreads supported bond issuances (across all industries) at significantly higher volumes than in 2023 and even above the annual average in previous years. This year, the volume of high-tech company fundraising from venture capital funds—a major source of financing for the high-tech industry in Israel—resumed growth, with the growth rate of fundraising in Israel slightly higher than globally. (For more details, see Chapter 2.)

Figure 1.8 | Selected Equity Indices in Israel and Abroad, January 2020–December 2024 (in US dollar terms, index: January 2020=100)



SOURCE: Based on Bloomberg.

f. The housing market

In the housing market, the volume of transactions, home prices, and mortgage borrowing increased.

There was a marked recovery in the housing market in 2024—increased transaction volumes and prices—alongside a continued shortage of construction workers, which gradually narrowed but was not fully resolved. The prohibition on the entry of Palestinian workers at the beginning of the war, most of whom were employed in the construction industry, led to a severe worker shortage in the industry and, at the beginning of the war, even to the closure of many construction sites. Similar to the situation during the Second Intifada, this shortage was gradually filled with the entry of Israelis and foreign workers into the industry, partly supported by government programs that have not yet fully matured. (For more details, see Chapters 5 and 8.)

The shortage of workers moderated the volume of construction, delayed projects, and increased the cost of financing for contractors.

At the beginning of the war, contractors accelerated building completions. However, the ongoing worker shortage in the industry led to a reduction in construction volume, delays in project completions, and thus a decline mainly in building completions. (For more details, see Chapters 4, 8, and the Financial Stability Report for the second half of 2024.) To increase demand, contractors and developers launched financing campaigns, which included deferring mortgage payments and increasing their financing costs. (See the Financial Stability Report for the first half of 2024.)

Alongside the decrease in the war's intensity and amid concerns about a housing shortage, a turnaround occurred, and from the first quarter of the year, demand began to recover. The number of transactions during the year increased by about one-third compared to 2023, which, as mentioned, was weak, and was slightly lower than in 2022, when the interest rate environment was significantly lower. The volume of mortgages increased at a similar rate, with an increase in the proportion of mortgages taken at high repayment and leverage rates. Housing prices increased by 7.3 percent annually, after falling last year.

The increase in rent prices was more moderate this year than before the war.

Rental prices (owner-occupied housing services[15]) increased by 4.0 percent during the year, a moderate increase compared to their rise before the war (5.5 percent in the twelve months ending in September 2023). At the beginning of the war, rental prices fell despite the evacuation of residents from the north and south, as a significant portion of the required housing was provided by housing evacuees in hotels, and possibly also due to a decline in demand from other renters, such as young people serving in the reserves. Rental prices, which remained moderate in the first half of the year, rose in the second half, with the recovery in demand.

g. Fiscal policy

Due to the war, the government adopted a very expansionary fiscal policy.

The costs of the war were reflected in a very expansionary fiscal policy. The government budget deficit reached 6.8 percent of GDP, and the broad government deficit reached 9.4 percent of GDP. Public consumption, excluding defense imports, grew by 13.5 percent, thereby increasing total demand by about 3 percentage points in real terms. Tax revenues also grew rapidly this year, driven by the rapid growth of nominal GDP, much of which was due to rising public consumption prices (mainly reservist wages) and improved terms of trade. (For more details on government activity this year and the development of state tax revenues, see Chapter 6.)

The government increased the budget three times during the year.

During the year, the government increased the budget three times (Table 6.1) and raised the deficit target, mainly in line with the increase in war costs, some

[15] The owner-occupied housing services component measures the development of the price of housing services consumed by households in their owned homes by imputing changes in rental prices in new and renewed leases in similar dwellings.

of which were unexpected, totaling about NIS 106 billion. The first revision of the 2024 budget, in March, included a cut of NIS 9 billion against additional civilian expenditures unrelated to the war, but no further expenditures were reduced. The government's decision not to reduce additional expenditures or raise taxes against the large increase in war costs mitigated the impact on demand in the economy and on public services during the war.

The government's fiscal space to address the immediate needs of the war by increasing the deficit was made possible by the fact that before the war, the public debt-to-GDP ratio was low and declining, and Israel enjoyed a relatively high credit rating. It was also supported by the decision at the beginning of 2023 to adopt a conservative budget for 2023 and 2024, avoiding significant increases in expenditures and reductions in tax rates despite high tax revenues at the time of the budget approval. This was based on the understanding that much of the exceptional revenues were temporary—which proved correct when tax revenues declined even before the war.

The government's adjustments to the budget strengthened its credibility.

As it became clear that the war would be long and that a permanent increase in defense and some civilian expenditures would be necessary, the government decided on significant budget adjustments—some at the beginning of the year when revising the 2024 budget, and most within the 2025 budget framework. (For details, see Chapter 6.) These adjustments strengthened the credibility of the government's commitment to prevent a sustained increase in the debt-to-GDP ratio while addressing the permanent increase in security and civilian costs.

Delays in making the necessary fiscal adjustments during the year contributed to economic uncertainty and to the increased risk attributed to the Israeli economy.

Alongside the macroeconomic responsibility reflected in the budget framework, the composition of the adjustments made by the government did not contribute to the economy's ability to cope with the war's impact and its growth potential once it ends. In particular, the government did not focus on reducing expenditures in areas that harm employment incentives and fund activities that undermine the creation of human capital supporting employment and labor productivity. Additionally, the delay in the necessary fiscal adjustments during 2024 contributed to the economic uncertainty attributed to the Israeli economy, even though they were eventually implemented. Indeed, rating agencies noted that the government's fiscal and institutional conduct was among the factors leading to Israel's credit rating downgrade.[16]

The Nagel Committee recommendations included a significant increase in the defense budget.

Toward the end of the year, the Committee to Examine the Defense Budget and Force Building ("Nagel Committee") submitted its recommendations regarding the defense budget for the next decade, including a significant budget increment

[16] In most of the reports on Israel published by credit rating agencies during the year, in which they explained the reasons for the downgrades and the negative rating outlook, the government's fiscal conduct was noted as one of several factors. For example, Fitch noted in its August 2024 report that political conflicts, coalition politics, and military constraints could delay convergence plans and jeopardize the outlook. Moody's, in its report published on October 1, 2024, explicitly stated that the two-month delay in budget approval casts doubt on the government's commitment to a declining debt-to-GDP path.

beyond what was already approved by the government in the discussions on the revised budget at the beginning of 2024. The Committee also recommended that the government ensure that the debt-to-GDP ratio stabilizes in 2026 and begins to decline in subsequent years, but did not address possible funding sources for the additional expenditures. Such a decline will require further adjustments to the state budget in the coming years. (See Chapter 6.)

The debt-to-GDP ratio, which increased during the war, must be reduced.

It is important to stabilize the debt-to-GDP ratio, which soared by about 8 percentage points compared to its prewar level (for more details on the development of fiscal aggregates in Israel, see Chapter 6) and to bring it down as soon as possible in the coming years. This is primarily to maintain the financial stability of the economy, which is a necessary condition for real stability and any fiscal prioritization that will be chosen. It should also be noted that the war—which has been of surprising duration and intensity—once again highlights the importance of Israel's debt-to-GDP ratio being lower than in most other advanced economies, as it allows for fiscal flexibility in an economy where uncertainty is relatively high compared to other developed economies.

In addition to these recommendations, it is important to avoid reducing expenditures on civilian spending components that drive long-term growth—investment in education, transportation, and other physical infrastructure, where Israel suffers from shortages in both investment volume and capital stock. (For more details, see Box 6.1.)

h. Monetary policy

The interest rate remained 4.5 percent during the year, after one reduction at the beginning of January.

At the end of 2023 and the beginning of 2024, the assessment of the markets and of the Bank of Israel was that the war's impact on demand would be stronger than on supply, and that the intensity of the war was moderating. This assessment was reflected in expectations for a decline in inflation and significant interest rate cuts later in the year (Figure 3.8 in this Report). Accordingly, after the inflation environment moderated and financial markets stabilized at the end of 2023, the interest rate was reduced by 0.25 percentage points on January 1, 2024, to 4.5 percent. Later in the year, the Monetary Committee kept the interest rate at this level, given the ongoing war and the resulting supply constraints. Throughout the year, the Monetary Committee emphasized the high uncertainty surrounding the war and its implications for the economy, focusing on stabilizing markets and returning inflation to the target range, while adjusting the policy path to relevant developments (data dependent). The rise in inflation and the Bank of Israel's decision to keep the interest rate unchanged stood out against downward interest rate trends in other advanced economies during 2024.

The Monetary Committee emphasized the high uncertainty surrounding the war and its implications, and focused on stability of the markets.

A key consideration against further interest rate cuts was the concern about financial stability due to the prolonged war. That concern was reflected in the economy's high risk premium that led to the depreciation of the shekel, rising import prices, and inflation. Another key consideration was the very limited potential impact of interest rate cuts on stimulating activity, due to severe labor supply constraints. These constraints were mainly due to the prohibition on the entry of Palestinian workers, extensive reserve mobilization, and the evacuation of residents from areas near the conflict zones. Additionally, as described above, demand appeared to be recovering faster than supply (Figure 1.3), partly influenced by fiscal expansion (the sharp increase in government expenditures and the state budget deficit). Alongside not reducing the interest rate, the Bank of Israel led the continuation of the banks' relief measures for people affected by the war, which reduced their vulnerability to the high interest rate environment. (For more details, see Box 4.2.) The assessment was that the interest rate environment was sufficiently restrictive to bring inflation back to the target, while allowing the economy to continue recovering.

A further interest rate reduction would have been less effective in encouraging activity, since the impact to activity was mainly due to the shortage of workers.

One indicator of the restrictiveness of monetary policy is the Bank of Israel's (ex-ante) real interest rate, derived as the nominal interest rate minus one-year inflation expectations from the capital market. Another indicator of restrictiveness, referring to the interest rate environment, which also considers the expected interest rate over a one-year horizon, is the real yield on government bonds for a similar term in the capital market. The development of the derived real interest rate throughout the year matched the change in the economic environment and the assessment of the necessary restrictiveness considering the economy's conditions, particularly the excess demand and the inflation environment.

At the beginning of 2024, the Bank of Israel's derived real interest rate fell and was up to 0.6 percentage points lower than its prewar level. This was because the nominal Bank of Israel interest rate was reduced by 0.25 percentage points at the beginning of the year, and later in the year, inflation expectations rose and ranged around the upper limit of the target. Additionally, the real one-year yield fell by about one percentage point, in line with expectations at the time for further interest rate cuts given the expected moderation in inflation (Figure 1.9). The decline in the real interest rate was in line with the assessment that the impact on demand was significant, and with the moderation in the inflation rate, and the assessment that geopolitical risks had moderated compared to the beginning of the war.

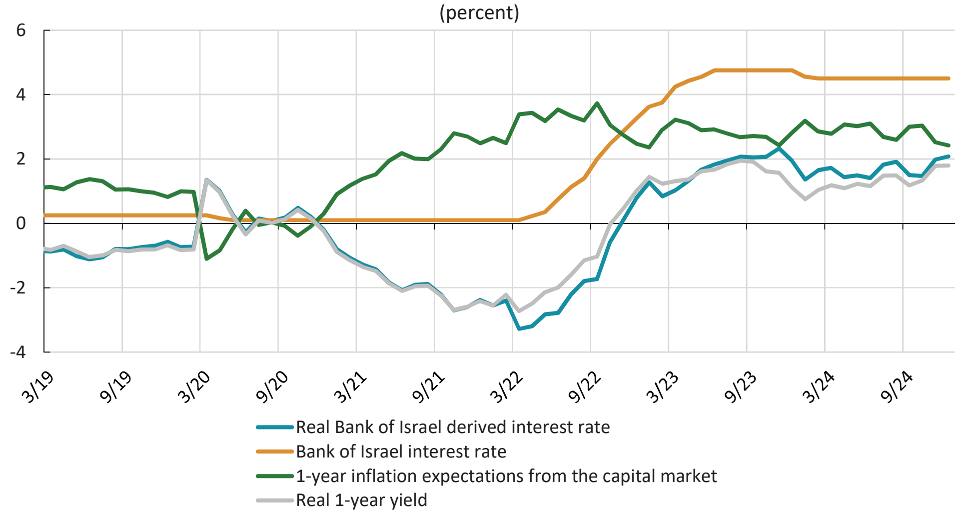
In the second half of the year, the derived real interest rate and the real one-year yield were volatile, with an upward trend, influenced by geopolitical developments that increased the inflation environment. This was against the backdrop of the assessment that the persistence of supply constraints alongside a recovery in demand would accelerate inflation, and therefore the projected path of the Bank of Israel's interest rate would decline less than initially expected at the beginning of the year.

In the last quarter, with the moderation of the risk premium, positive geopolitical developments, and expectations for the easing of supply constraints, inflation expectations for the year fell and entered the target range. The Bank of Israel's interest rate was kept unchanged, as was its projected path, and therefore the Bank of Israel's derived real interest rate rose slightly.

Keeping the nominal interest rate unchanged and the rise in the real interest rate in the market also reflected the Bank of Israel's emphasis on maintaining market stability, particularly considering the risk premium, which remained high until October.

Figure 1.9 | Bank of Israel Interest Rate, One-Year Inflation Expectations from the Capital Market, Real Bank of Israel Derived Interest Rate[a], and Real 1-Year Yield March 2019–December 2024

(percent)



[a] The real interest rate is the Bank of Israel interest rate minus one-year inflation expectations derived from the capital market.

3. LONG-TERM ECONOMIC POLICY IN THE CONTEXT OF THE SWORDS OF IRON WAR AND THE FUNDAMENTAL PROBLEMS OF THE ISRAELI ECONOMY

a. The fundamental problems of the israeli economy

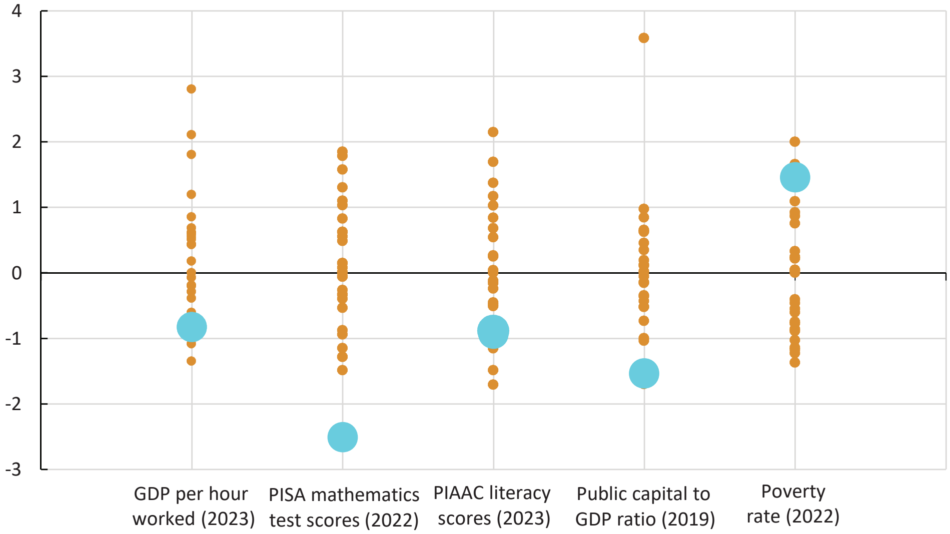
Before the war, the Israeli economy was in a good cyclical position, although there were several fundamental problems.

After the rapid recovery from the COVID-19 pandemic, and on the eve of the Swords of Iron War, the Israeli economy was in a relatively good cyclical state in many respects—full employment, rising real wages, a debt-to-GDP ratio similar to the pre-COVID level and on a downward trend, a significant and stable current account current account, high foreign exchange reserves, a high savings rate, an increasing investment rate, and an inflation rate converging towards the target range.

However, labor productivity in the economy, and consequently the standard of living, remained low compared to other advanced economies (78 percent of the OECD average in 2023). The low productivity largely reflected a particularly low stock of public capital[17] and workers' low basic skills (as indicated by recent results from the PIAAC survey[18]), alongside Israeli students' low achievements in various international tests (Figure 1.10). Gaps in human capital, along with low labor force participation rates among Arab women and *Haredi* (ultra-Orthodox) men, were also reflected in high poverty rates. During the war, some of these problems may even worsen. For example, the loss of school hours due to the war may harm students, similar to the COVID-19 period, especially those from disadvantaged backgrounds.[19]

Figure 1.10 | Productivity, Human Capital, Public Capital, and Poverty Indices: Israel Compared to the Advanced OECD Countries

(Israel in blue, OECD in orange, in terms of standard deviations)



SOURCE: Based on OECD and World Bank data.

[17] The stock of public capital is the total physical assets and resources owned by the state or local authorities, used to support the public's economic and social activities. These assets include infrastructure—roads, bridges, ports, airports, water and sewage systems, schools, hospitals, sports and cultural facilities, and more. Public capital stock is critical for economic development and public welfare, as it provides the basis for essential services and business activities. Investment in public capital stock can improve quality of life, increase productivity, and lead to long-term economic growth.

[18] For more details on the achievements of adults in the second round of PIAAC and comparison to the first round, see Sefi Bechar and Elad De-Malach (2024). "Skills of the Population in Israel in International Comparison: Initial Findings from the PIAAC Survey for 2022–2023," Bank of Israel, Policy Analysis and Research Issues Collection.

[19] See Chapter 8 in the Bank of Israel's Annual Report for 2020, which showed that disadvantaged households were more affected during the COVID-19 period than other households, both in terms of employment and wages and in other areas such as health and education services.

A further increase in the debt-to-GDP ratio involves risks.

Before the war, the Bank of Israel recommended increasing public investments in infrastructure and human capital and implementing important structural reforms that do not require significant budget additions to address these issues.[20] One of the financing strategies examined was a mix of raising tax rates, reducing expenditures that do not support growth, and moderately increasing the deficit and the debt-to-GDP ratio. However, the war and its economic and budgetary implications, some of which are long-term, reduced the available fiscal space that is necessary for these investments. Thus, the increase in the debt-to-GDP ratio and the raising of taxes to finance the expected ongoing increase in defense and war-related civilian expenditures make further tax rate increases more challenging. Additionally, the margin for cutting civilian expenditures is not large, as indicated by their already low level by international comparison and the difficulty in making such cuts, which has been evident in recent years. (For details on the scope of civilian expenditures in Israel by international comparison, see Box 6.1.)

An important way to increase GDP, and thus the tax base for financing public needs, is to increase the earning capacity and participation of all parts of society in the labor market in general, and in the high-tech sector, which leads growth, in particular. These are not new directions of action but long-term strategies, the importance of which has been highlighted by the war and its ongoing implications for security needs, growth, and the state budget. We expand the discussion on these directions below.

b. Differences in economic involvement of different population groups

The average level of basic skills in Israel is low, particularly among the Arab population.

The average level of basic skills in Israel is low, particularly within the Arab community (Figure 1.11), and there has been a regression compared to the level found in the previous survey in 2013. The skill level of the non-*Haredi* Jewish population, which leads the economy, is similar to the OECD average, though slightly below it.[21]

The population in Israel is much younger than in the other advanced economies.

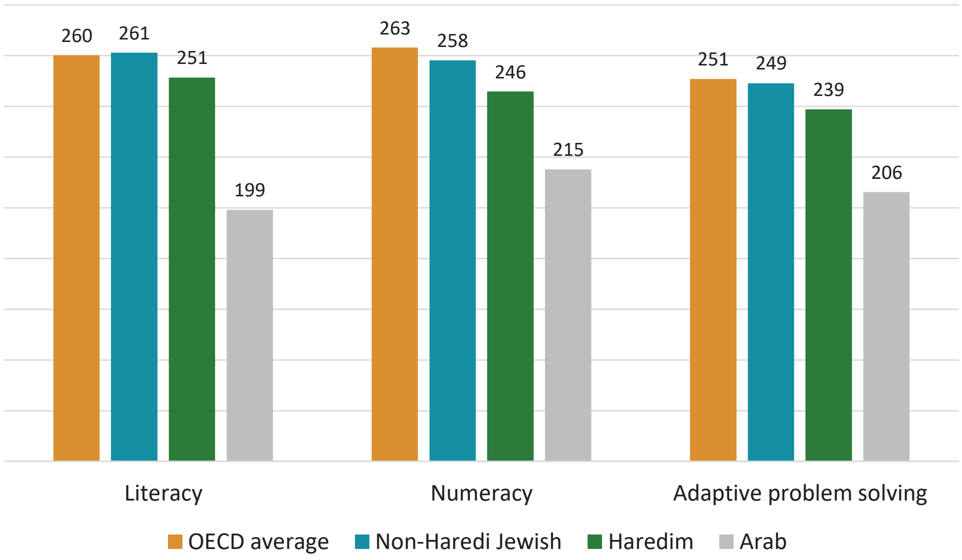
Israel's potential lies in the fact that its population is much younger than that of other advanced economies, which are aging. This could give Israel a relative advantage in adopting new technologies[22], especially with the expected penetration of artificial intelligence into the labor market and its implications. (For more details, see Box 5.1.)

[20] The latest document among these publications is: The Bank of Israel's Plan to Accelerate Economic Growth—Recommended Strategic Pillars of Action for the Government, January 2023.

[21] This comparison is biased in favor of Israel, as it does not exclude disadvantaged populations from the data in other countries.

[22] Using annual household expenditure surveys, we examined the wage development of workers in certain age groups between 2012 and 2022. We found that in recent years, the age group that experienced the highest wage growth is young non-*Haredi* Jews (aged 25 to 35). We also found in international PIAAC surveys that the basic skills of older workers are lower than those of younger workers.

Figure 1.11 | Results of Second PIAAC Wave by Population Group, Compared to the OECD Average, 2023



SOURCE: Based on PIAAC.

However, without proper training for young people, this significant growth potential will not be realized. Israel may even regress, given the demographic forecast.[23] Among the non-*Haredi* Jewish population—both men and women—the gaps (compared to benchmark countries) are smaller among the young than among the older population. The same is true among young *Haredi* women. However, among *Haredi* men, a group whose share of the population is rapidly increasing, the gaps are larger among the young than among the older population, as is also the case among Arab men (Table 1.6).

The population in Israel is much younger than in the other advanced economies.

An examination of wage income gaps among working-age individuals in different population groups reveals that these gaps are significant and have hardly changed in recent years (Figure 1.12).[24] Among all groups of women, there is a slight trend of narrowing wage income gaps compared to non-*Haredi* Jewish men, but the improvement is significant only among *Haredi* women, resulting from a sharp increase in their employment rate. In contrast, among Arab men, there is a regression, stemming from a decline in hourly wages.

Without appropriate training for young people, and in view of demographic expectations, the Israeli economy may be harmed.

[23] The loss of per capita GDP due to the nonconvergence of *Haredi* men's employment and education levels to those of the non-*Haredi* Jewish population is expected to reach about 6 percent by 2065.

[24] Average wage income was calculated by multiplying the employment rate by the average wage per worker in that group.

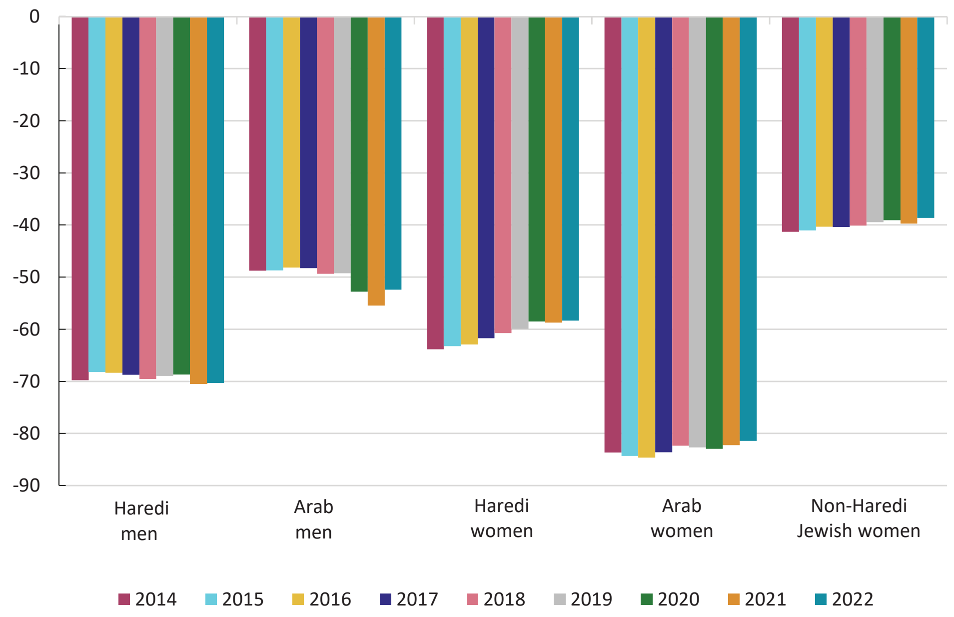
Table 1.6 | Skills Gap Relative to the OECD Average, by Gender, Age, and Population Group[a]

Age group	16–34	35–44	45–54	55–64	Graph over time
Men					
Haredi	-0.44	-0.30	-0.54	-0.21	
Non-Haredi Jewish	-0.01	-0.02	-0.15	-0.23	
Arab	-1.04	-1.06	-0.90	-0.82	
Women					
Haredi	-0.17	-0.18	-0.20	-0.45	
Non-Haredi Jewish	-0.05	0.09	-0.17	-0.23	
Arab	-0.88	-0.88	-0.97	-0.94	

[a] Average scores in numeracy, literacy, and adaptive problem solving. The OECD average was calculated by age group.

SOURCE: Based on the second wave PIAAC survey.

Figure 1.12 | Relative Per Capita Labor Income by Population Group Over Time Compared to Non-Haredi Jewish Men, 2014–2022 (percent)



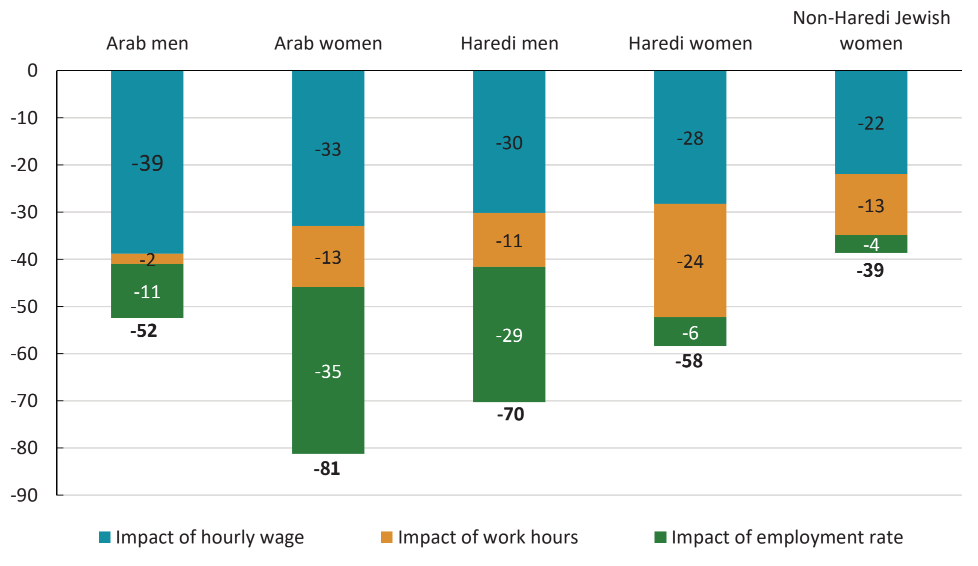
SOURCE: Based on administrative data for 2022, from the Haredi Institute for Public Affairs report.

Using a logarithmic decomposition, we examined the contribution of the three main components[25] to the differences in per capita labor income for each population group in 2022 (Figure 1.13). Most of the difference in labor income between Arab men and non-*Haredi* Jewish men is explained by the lower hourly wages of Arab men, which may reflect lower labor productivity. Among Arab women and *Haredi* men, the low hourly wage and low employment rate together, in similar portions, explain over 80 percent of the gap. Among *Haredi* women, the low hourly wage and the low number of working hours account for about 90 percent of the gap, and among non-*Haredi* Jewish women, the low hourly wage explains more than half of the gap in average wage income compared to non-*Haredi* Jewish men.[26]

Israel has very large labor income gaps between various population groups.

Figure 1.13 | Differences in Per Capita Labor Income and Their Sources Relative to Non-Haredi Jewish Men, 2022

(percent)



Note: In the prime working ages (25–64).

SOURCE: Based on administrative data for 2022, from the Haredi Institute for Public Affairs report.

The analysis indicates that unique and different solutions are required to raise wages in the various groups. Research and policy analyses have pointed to different barriers and possible solutions for each group. For Arab men, the main barrier to

The government must act to significantly increase the labor force participation rates of Arab women and *Haredi* men.

[25] We made a simplifying assumption that the three components of output—employment rate, working hours, and hourly wage—are independent of each other.

[26] There is also a non-*Haredi* Jewish population group, particularly in the periphery, whose labor income is low. See: Avi Fleishon and Yuval Mazar (2023), "Analyzing Wage Variance in Israel Relative to the OECD, Focusing on the Lower Part of the Wage Distribution", Discussion Papers Series 2023.18, Bank of Israel Research Department. The proportion of this population in Israel is relatively high compared to its proportion in other advanced economies.

higher-quality employment is low basic skills (Table 1.6). To improve these skills, the quality of the education system in the Arab community must be improved, so that its particularly low achievements[27] improve, and efforts must be made to enhance Hebrew language studies. Among Arab women, although there are positive trends—their employment rate has risen over time, and young Arab women are much more educated than the older generation—their employment rate remains very low. Here, the main barriers are cultural, and to some extent, low accessibility to workplaces due to a lack of transportation.[28] Regarding the employment of *Haredi* men, there is a noticeable stagnation at a very low level. This phenomenon reflects economic incentives provided to those who can work but do not. Beyond correcting these incentives, it is important to increase the future earning potential of young *Haredi* men by providing the necessary skills and competencies through core studies—mathematics and English. This goal also requires correcting the current situation, where significant public funding, which is even expanding, is provided to institutions that do not teach core studies. For *Haredi* women, their labor productivity can be supported through targeted training, which will increase their access to high-wage professions that rely on high-level skills.

The education and skills of Arab and *Haredi* men and women must be improved in order to increase their labor productivity.

c. The high-tech sector: barriers to integration

To enable the continued growth of the high-tech sector, it is important to increase the supply of skilled manpower.

The high-tech sector is a central part of the Israeli economy, contributing about a fifth of GDP and accounting for nearly a third of the growth in recent years. High-tech workers account for an exceptionally high proportion of the top skill quintile by international comparison (26 percent, compared to 10 percent in the OECD), and the proportion has even increased compared to a decade ago. To enable the continued growth of the high-tech sector and maintain Israel's relative advantage in it, it is important to increase the supply of skilled labor. It is therefore necessary to expand access to high-level studies in subjects relevant to the high-tech sector—particularly mathematics, English, and sciences—to additional population segments. In the longer term, this process should be supported by improving the low basic skills of large parts of the population in Israel through investment in improving the quality of the education system at all levels.[29],[30] These measures also present an

[27] See the Bank of Israel's Plan to Accelerate Economic Growth—Recommended Strategic Pillars of Action for the Government, January 2023.

[28] A survey among Arab women showed that a dominant factor preventing work is childcare and family responsibilities. Among young women looking for work (nine percent of Arab women), transportation barriers were also a problem. For more details, see Arnon Barak (2020), "Is Low Public Transportation Service Level a Barrier to Employment? Findings from a Survey Among Arab Women," Selected Research and Policy Analysis Notes, Bank of Israel.

[29] Report of the Interministerial Committee to Increase Human Capital in High-Tech (Perlmutter Committee), 2022. https://www.gov.il/he/pages/rfp20221110 (in Hebrew).

[30] See the "High-Tech Funnel" diagram in Elad de-Malach (2021), "The Arab Population in the High-Tech Sector," *Selected Research and Policy Analysis* Notes. The diagram shows that among the young population (aged 18 to 35), Arabs make up about a quarter of the population, but only 4 percent of those with degrees in high-tech fields are Arabs.

opportunity to reduce the gaps between different population groups by increasing the integration of under-represented groups in the high-tech sector.

A further increase in the supply of labor to high-tech requires an improvement in the relatively low basic skills of the entire population.

A significant part of the potential for expanding the supply of skilled labor lies in population groups with low representation in high-tech, particularly the Arab and *Haredi* populations.[31] Currently, less than 10 percent of high-tech workers are Arabs or *Haredim* (Table 1.7 and Figure 1.14). This proportion has been stagnant in recent years and is much lower than their share of the working-age population, which is currently about 30 percent and is expected to increase by about ten percentage points by 2050.[32] *Haredim* account for 5.2 percent of the top decile in numeracy skills, and Arabs account for 1.7 percent.[33]

Table 1.7 | Distribution of Workers in the Israeli High-Tech Sector, 2019–2024

percent

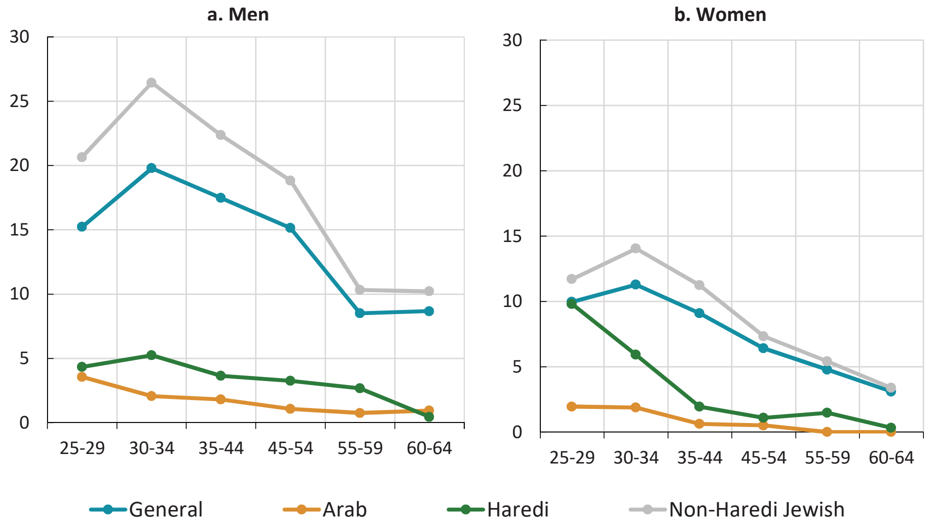
	2019	2020	2021	2022	2023	2024
Non-Haredi Jewish Men	61.5	62.2	62.3	61.4	61.6	60.9
Non-Haredi Jewish Women	29.9	29.6	29.6	29.9	29.5	29.8
Haredi Men	1.0	1.0	0.9	0.8	0.9	1.2
Haredi Women	2.4	2.3	1.9	2.0	2.4	2.5
Arab Men	1.4	1.4	1.5	1.5	1.5	1.5
Arab Women	0.7	0.6	0.4	0.4	0.7	0.7
Other	3.2	2.9	3.4	3.4	3.4	3.5

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

Figure 1.14 indicates the relatively high employment rate of young people in the high-tech sector, highlighting the high potential inherent in the fact that Israel's population is younger than that of other OECD countries. Conversely, the figure illustrates how this potential is not realized among women, and even less so among *Haredim* and Arabs. The relative improvement among *Haredi* women aligns with the improvement in their achievements in the PIAAC tests, as shown in Table 1.6. The government launched a national program in 2022 to integrate these population groups into the high-tech sector, but it is still too early to assess its achievements.

[31] H. Axelrad, A. Zilberman, H. Lifshitz, S. Somkin, and I. Crombie (2021). "Integrating Haredi Men in High-Tech", Aaron Institute for Economic Policy and the Institute for Strategy and Haredi Policy. The researchers show that only 3.4 percent of employed *Haredim* work in high-tech, that this rate has been stable in recent years, and that among *Haredim* employed in high-tech, more than half do not have a degree, meaning they work in relatively low-productivity fields within the industry, and their wages are low relative to the industry itself.
[32] According to the "medium" scenario of the Central Bureau of Statistics.
[33] Based on the latest PIAAC survey.

Figure 1.14 | Rate of High-Tech Employees by Gender, Population Group, and Age, 2022
(percent)



SOURCE: Based on Labor Force Survey data.

d. Additional challenges in the Israeli economy

The economic cost of not enlisting *Haredim* in required military service and mobilizing reserve soldiers in their place is very high.

The prolonged war and the need to expand the military over time present another challenge for the state: the need to expand the circle of those serving in the military from among the candidates for service. The very high economic cost associated with not conscripting *Haredim* and recruiting reservists in their place stems from both the relatively high cost of a reservist (or career soldier) compared to a regular soldier and the fact that the current servicemen also participate in the labor market at high rates, so their mobilization for reserve duty involves a loss of economic income of about half a percent of GDP each year due to their absence from the workplace.[34] This cost is expected to accompany Israel's security needs for many years.[35]

In addition to addressing human capital, discussed in Sections B and C, the need to continue improving the standard of living in Israel while reducing the cost of living requires the government to improve the quality of Israel's regulation (as indicated,

[34] "Focus—Pricing Alternatives for Increasing the IDF's Manpower", Chief Economist's Office, 2024. According to the analysis, the average monthly economic cost of recruiting a reservist is estimated at about NIS 48,000, compared to about NIS 27,000 for extending a regular soldier's service by a month. This means that adding 25,000 regular soldiers could save the economy about a quarter of a percent of GDP each year compared to recruiting reservists for a similar duration. If the regular soldiers are recruited from a population that is not expected to work if they do not serve in the military, even in later years, the savings are even greater.

[35] See the Bank of Israel Governor's presentation on the occasion of the publication of the Bank of Israel's *Annual Report* for 2023.

for example, by the international Doing Business index), reduce import barriers[36], and streamline bureaucracy. These recommendations, as well as the reference to them by international bodies, are constantly repeated. The required actions are not necessarily costly but require executive ability and long-term vision. In the current period, in which budget constraints have become more limiting, their importance is even greater.

[36] The “What is Good for Europe is Good for Israel” reform, approved by the Knesset in August 2024 and effective from January 1, 2025, stipulates that products that have received European standards approval will be exempt from testing pursuant to Israeli standards. The aim of the reform is to facilitate the process of importing products that meet European standards.