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The Israel-Hamas War: Averting Another Lost Economic Decade

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The war between Israel and Hamas is expected to have a significant negative impact on the Israeli economy. Estimates place the direct cost of the conflict (armament and mobilization of the reserves) and the indirect costs (population evacuation, reconstruction of the western Negev, interruptions to the manufacturing process, and reduced aggregate demand) at around NIS 200 billion. If these predictions are accurate, Israel would experience a 10 percent drop in GDP in the fourth quarter of 2023 and won't experience any GDP per capita growth for the year. In order to minimize the future potential damage to the economy, the government must take responsibility and cut the budgets intended for certain sectors and divert those funds into the war effort. The State of Israel must not repeat the mistakes of the post-war handling of the economy following the Yom Kippur War, which economically led to a "lost decade."

One of the main goals of global terrorism is to disrupt the population's daily routine and damage the economy of the target country. Nonetheless, despite the many rounds of fighting with Hamas in the Gaza Strip since the days of the second intifada, major security incidents have not caused significant damage to the Israeli economy. The war in Gaza is changing this pattern, given the intensity of the combat, the massive mobilization of forces, and the war that has been ongoing for almost 12 weeks. While Israel is busy fighting with varying degrees of intensity on several fronts, the economic front is especially active on two levels. First is the issue of direct military expenses. This is primarily in the context of procuring armaments and mobilizing reserve forces. The second issue is the indirect cost of the war, including the future expense of reconstructing the communities in the western Negev, which compounds the cost of evacuating civilians from that area and from communities adjacent to the border with Lebanon. There will also be a general decline in consumption as a result of changing consumer behavior during wartime, which has an especially harsh impact on the business sector.

To analyze the economic front, it is important to understand the economic conditions that existed before the war broke out on October 7. Despite widespread disruptions to the Israeli economy since the government of Prime Minister Benjamin Netanyahu unveiled its proposed judicial overhaul in January 2023, the main indices that attest to the macroeconomic robustness of a given country suggested that the Israeli economy was performing relatively well before the war started. The country's debt-to-GDP ratio shrank by 7.1 percent in 2022, reaching almost 61 percent – the same level as before the COVID-19 pandemic. The unemployment rate was just 3.5 percent, with inflation at 3.8 percent. The Bank of Israel held foreign currency reserves exceeding $200 billion. The significant drop in foreign investment in Israeli hi-tech during the first three quarters of the year contributed to a devaluation of the shekel and an exchange rate of NIS 3.85 to the US dollar. Nonetheless, the projected growth rate for the Israeli economy was positive compared to other developed nations – around 3 percent, which translates to around 1 percent in per capita growth.

Notwithstanding this positive starting point, the war in Gaza represents a macroeconomic shock that will reverberate for many years to come. This impact is expected to continue even if the IDF fights a high-intensity war on one front only, for the following reasons:

a. The use of ammunition: In order to achieve the goals of the war, the IDF is using greater firepower than ever before, which requires massive quantities of munitions. The intensity of the conflict also means that Israel uses more Iron Dome interceptor missiles than ever before, and also, for the first time, uses the Arrow 3 missile defense system. As of early December, some 11,000 rockets and missiles were fired at Israel from the various fronts.

b. The mobilization of nearly 350,000 reservist soldiers reduces the Israeli workforce by around 7 percent. This has a dual effect: not only does it divert human resources that are hard to replace from businesses and companies, but the state also has to pay the salaries of these reservists.

c. The evacuation of 125,000 Israelis from their homes means that the state has to subsidize housing and living costs for those evacuated.

d. Compensation to people whose property is damaged by rocket fire at Israel.

e. Financial assistance for workers and businesses adversely affected by the war, from unemployment benefits to compensation for loss of income due to the fighting.

f. A decrease in state income, both because of lower revenue from income tax and also because of the halt of foreign direct investment.

In effect, the shock to the macroeconomic system is already reflected in disruptions to aggregate supply and demand. On the demand side, there has been a nationwide drop in credit card spending. In cities that were evacuated, like Kiryat Shmona and Sderot, for example, there was an 80 percent decline in credit card spending in the first week of November, while in cities like Raanana and Tel Aviv there was a 20 percent decrease. Differences also emerge in the various sectors affected. In the first weeks of the war, for example, there was a 40 percent increase in spending at grocery stores and supermarkets, while in the entertainment and leisure sectors there was barely any activity at all during October. On the supply side, there were difficulties in the production of various goods and the supply of services, since many employees were called up for reserve duty and many foreign workers left the country. In addition, thousands of Palestinian workers from the West Bank were denied entry into Israel. All of this has created problems in supplying certain goods – problems that have been exacerbated by import issues, in part because of the attacks by Houthi forces in Yemen against maritime traffic in the Red Sea.

It is assessed that as a result, there will be a 10 percent decrease in GDP in the fourth quarter of 2023 and that annual growth will drop to around 2 percent for the year (which would translate into zero per capita growth). Similarly, the increase in public expenditure is likely to lead to a deficit of over 5 percent in the state budget, which will increase the debt-to-product ratio by the end of the year to 64 percent. Therefore, the initial estimate for a year of combat at the levels of intensity that is currently underway on various fronts – taking into account security expenditure, loss of state income, compensation, and reconstruction – is around 200 billion shekels. One-time assistance in the amount of $14 billion from the United States will help Israel deal with the steep cost of the war and the security expenses that will pile up in the coming years, but will only cover around a quarter of the total cost of the war.

Despite these bleak figures, credit card use has increased since the sixth week of the war and the various stock indices and the dollar-shekel exchange rate are no longer falling at the sharp rate noted in the first week of the war. The Tel Aviv 125

index has regained the level it was at the day before the war broke out, and the dollar-shekel exchange rate ($1=3.60 shekels) is currently lower than the level on the eve of the war. It seems that two factors prevented greater harm to the Israeli exchanges and the currency rate. The first was the maturity exhibited by the Israeli public. During the first month of the COVID-19 pandemic, more than a quarter of Israeli mutual funds were redeemed. Many people learned the lesson, and were not so quick to do the same this time, despite the severity of the situation. The second factor was the Bank of Israel's massive intervention in the foreign currency market, which created a sense of trust in the public. Governor of the Bank of Israel Prof. Amir Yaron announced that the Bank of Israel would allocate $30 billion to stabilize the Israeli currency. In practice, it has used less than $10 billion thus far, but the very fact that the Governor made the Bank's intentions abundantly clear was highly significant. Similarly, Israel's CDS value (credit default swap – a kind of insurance policy against insolvency) dropped from 143 points at the start of the war to 110 points, which is indicative of a degree of relative moderation.

More than two months into the war, it can be said that the Israeli economy has once again proved its resilience when confronted with a major challenge. The COVID-19 pandemic caused global macroeconomic upheaval, from which the Israeli economy emerged more strengthened than other countries that also went through the crisis. The domestic crisis over the judicial overhaul harmed investments in Israel, but even 10 months into that nationwide crisis the Israeli economy was still performing well. Thus far, it appears that the Israeli economy is once again managing to stand firm in the face of an unprecedented challenge. There is no guarantee, however, that this will remain the case. On the contrary – it is possible that the Israeli economy will not meet its challenges during 2024, which will have a direct impact on the combat.

The new state budget for 2023, which is currently debated in the Knesset, is 510 billion shekels, an increase of 30 billion shekels over the previous budget. This increase is earmarked for the military campaign and includes payment for reservists and other civilian wartime expenses, including housing for those forced to evacuate. There is no argument over the need to increase expenditure, since beyond routine wartime costs, the state must provide adequate compensation for all those affected by the war. This is an essential element in Israel's social resilience. That said, it is clear that the primary funding for massive government expenditure will come from increased national debt, which will increase the deficit in coming years – especially given the high level of interest Israel will have to pay in light of the current interest climate. In addition, the government is unwilling to make tough decisions that would entail reducing budgetary allocations to various

sectors of the Israeli population and to the many superfluous ministries, instead channeling those funds to the war efforts. The reallocation of funds cannot cover all of the money needed, but fiscal responsibility displayed by these necessary measures is important to Israel for domestic reasons, and particularly for foreign audiences – especially the credit rating agencies.

Currently, given that the three largest credit rating agencies – Moody's, Fitch, and Standard & Poor's – have already placed Israel's credit rating on negative watch, the government must display fiscal responsibility. If these agencies do not see that Israel enacts significant cuts given the circumstances, and instead continues to make unreasonable allocations with a sense of "business as usual," prioritizing coalition considerations over the national interest, they will downgrade the country's credit rating. This development could have ramifications for the Israeli economy and also impact negatively on the war effort. The Israeli public would feel it in its pockets, which could lead to a reduction in public support for the war. Moreover, as was the case during the second intifada (2000-2005), war efforts require tough decisions and painful cuts – which Benjamin Netanyahu was responsible for when he was finance minister. The Israeli economy and the war effort itself would benefit if similarly tough decisions were taken today, rather than waiting until next year, when the price will be even steeper.

Looking at the Israeli economy from a broader, longer-term standpoint, as a direct and immediate consequence of the current war, we will likely see a combination of a challenging security environment, higher defense spending, a negative impact on personal consumption, and a decline in foreign direct investment. All of these could be harbingers of another "lost decade" for the Israeli economy, as occurred in the immediate aftermath of the Yom Kippur War until the implementation of the economic stabilization plan in 1985. In order to avoid this negative scenario and to minimize the future damage to the Israeli economy, the government must show utmost responsibility as soon as possible. In other words, on the strategic level, the State of Israel was surprised on the morning of October 7 just as it was surprised half a century earlier on Yom Kippur in 1973. On the economic front, the correct economic measures now could prevent a repeat of the postbellum "lost decade."

Editors of the series: Anat Kurtz, Eldad Shavit and Judith Rosen