RANE ASSESSMENTS

How Will the Gaza War Impact Israel's Economy?

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A photo taken on Nov. 5, 2023, shows a man working at a printing factory in southern Israel that recently resumed business following Hamas' Oct. 7 assault. (ARIS MESSINIS/AFP via Getty Images)

The immediate impact of the Gaza war on Israel's economy will depend on the conflict's duration, but future potential issues — like a prolonged Israeli occupation of the Gaza Strip and the resumption of controversial judicial reforms — could further hinder economic growth in the medium-to-long term. The Oct. 7 Hamas attack on Israel sparked an unprecedented military mobilization of the country's economy, pulling 300,000 reservists from the workplace, drying up tourism, and halting many business deals and projects. Israel's finance ministry recently estimated that the war was costing the country $260 million a day. Not long after fighting began last month, the central bank also pledged to support the shekel with some $45 billion, or 20%, of the country's currency reserves. According to pre-war projections, the Israeli economy was set to grow 3% this year, but the fallout from the military conflict will now almost certainly result in a sharp contraction in the fourth quarter. Depending on the length of combat operations and the subsequent speed at which demobilization takes place, the country's first-quarter economic growth may also be impacted. But despite this disruption, Israel's sound economic fundamentals — including manageable government debt and strong external finances — have provided a large enough buffer to preserve its overall financial stability in the immediate aftermath of the war.

- Israel's labor ministry estimated the Israeli workforce had declined by 20% since the onset of hostilities, as reservists were called up and civilians were evacuated from the battle zones in the country's north and south. On the demand side, economic and political uncertainty, along with the ongoing war, have weighed down private consumption, even as the government and the central bank offered significant amounts of financial support.
- Israel entered the latest war in Gaza with a manageable government debt-to-GDP ratio of 60%, which had previously been expected to decline to 55% of GDP by 2024-25, thanks to years of fiscal conservatism even during the COVID-19 pandemic.
- In its 2023 Article IV report published in June 2023, the International Monetary Fund assessed that Israel's banking sector was “broadly robust,” and said the systemic risks emanating from the sector were not a significant concern.

If Israel's major combat operations end later this year or early next year, demobilization and a return to pre-war security dynamics will lead to a relatively quick economic rebound, in part because of Israel's preexisting economic strengths and in part because of external support from the United States. On top of the expected steep drop in economic activity in the fourth quarter, increased discretionary government expenditure will also significantly widen Israel's fiscal deficit and increase government debt levels in the coming months. However, these conditions will ease once major combat operations wind down and security and military conditions return to the pre-war baseline. The fact that Israel's government debt largely consists of shekel-denominated or- linked debt, the bulk of which is owned by Israeli residents, will sharply limit financial risks related to debt as well. Additionally, despite ongoing political dysfunction in the U.S. Congress, Washington will likely supply Israel with necessary military aid to both replenish its arsenals and support future combat operations, further mitigating the economic fallout from the war. Israel also benefits from a strong external financial position, with its external solvency and liquidity both robust. In recent years, the country has run substantial account surpluses and has substantially increased its foreign exchange reserves as well.

- The U.S. House of Representatives has approved $14 billion worth of aid, or 2-3% of Israeli GDP. According to the Congressional Research Service, Israel was earmarked to receive $3.3 billion of military and $500 billion of missile defense-related aid this year. Should the war last longer than expected, Washington will likely increase aid to Israel.
- International rating agencies assign Israel high credit ratings of A+ to AA-. These ratings already incorporate an elevated degree of geopolitical risk.
- A variety of financial indicators suggest market faith in Israel's underlying economic strength. Credit default swap spreads increased from a very low 58 basis points to 137 basis points, reflecting a very low implied default risk. Ten-year domestic bond yields initially increased from 4.24% to 4.67% in late October, but have since fallen to pre-war levels. The shekel fell from 3.84 per U.S. dollar on Oct. 6 (the day before the Hamas assault) to a low of 4.0 per dollar on Oct. 26 but has since rallied to near the pre-war level of 3.89 per dollar.
- The Bank of Israel sits on $200 billion of foreign exchange reserves, up from $126 billion in March 2020. Foreign exchange reserves currently cover more than a year's worth of imports.
- Exports and imports may be disrupted due to hostilities and the sharp decline in domestic production, at least this quarter. But the disruption will be manageable. Total exports of goods and services amounted to $164 billion last year. Tourism-related exports are substantial, but so are tourism- and travel-related imports. Per the World Trade Organization, travel and transportation-related services exports roughly matched imports. Israeli arms exports, which is perhaps the sector that will be most affected by the war, amounted to only 2% of GDP or 5% of total exports.

Macroeconomic risks are more likely to manifest in the longer term, which could be caused by a prolonged conflict in Gaza and/or the region, an interruption of U.S. aid to Israel, and the resumption of protests over the Israeli government's planned judicial reforms. Even if major combat operations end in Gaza and the majority of reservists return home by early 2024, there will be a sizeable defense outlay for the reoccupation of the strip, as a significant number of troops will remain in the territory until Israel finds a solution to Gaza's governing crisis following Hamas' removal from power. Not all reservists will necessarily return to the workforce even after major combat operations end; some may stay in Gaza as part of an Israeli occupation, while others could be deployed to the West Bank and/or be redeployed to Lebanon and the Syrian border if fighting continues between Israel and Palestinian militants, Hezbollah and other Iran-backed proxies. In the event of continued violence, the ongoing deployment of Israel's air defenses and offensive weapons systems to deter and respond to further attacks would also further strain the country's military budget An extended conflict would likely continue to dampen tourism rates as well, depriving Israel of a key source of foreign exchange currency — especially if violence lingers into the Easter and Passover holiday season, which typically brings an influx of travelers to the country's holy sites. Additionally, prolonged violence may further delay the return of normal business activity in Israel as reservists remain away from work, and as businesses avoid deals and investments in the face of continued uncertainty. U.S. aid may also not arrive in a timely manner or at a scale needed to mitigate the economic impact of an extended conflict and an Israeli occupation of Gaza, as lawmakers in Congress may not perceive the matter to be urgent once major combat operations are over, especially as they turn their attention to the 2024 elections. Finally, there are early signs that the war has not kept the Israeli government from pursuing controversial reforms that would reshape the country's judiciary by giving the Knesset the power to override Supreme Court decisions — a trend that, if sustained, could restart the paralyzing protests that erupted across the country that took place over the spring and summer of 2023, posing further economic risks to Israel. However, even if these developments were to occur, the Israeli economy is largely well-positioned to ride out longer-term challenges. This means any economic harm will be limited to domestic impacts, which could lead to a more challenging business environment and further socioeconomic inequalities in 2024, but no major economic crisis.

- Israel's force size needed to control the Gaza Strip's 2.1 million people would likely be expansive and extend beyond the standing army's ability, especially if there continue to be skirmishes between Israel and Iranian-backed militias, making it likely some reservists remain mobilized for an extended period.
- Even before the war began in October, the West Bank was experiencing the highest level of violence since the end of the Second Intifada in 2005. The end of the current Hamas-Israel war may not alleviate this situation, which would require more troops to remain mobilized in the West Bank.
- Budget negotiations in the U.S. Congress remain fraught, and while Israel retains widespread bipartisan support in the legislature, government shutdowns and future in-fighting between political factions may result in a delayed aid package, especially if the conflict continues after Gaza is reoccupied.
- On Nov. 12, Israeli media reported that Justice Minister Yariv Levin had started negotiations to place justices picked by Prime Minister Benjamin Netanyahu's Likud party on the country's Supreme Court, deviating from the typical appointment process. This signals that the Israeli government has not abandoned its overall goal of weakening the judiciary in favor of the government-controlled Knesset.