Updated Macroeconomic Forecast – Aaron Institute for Economic Policy

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Abstract

In light of last week's events and the escalation in the fighting with Hezbollah, we update our forecasts for the growth of the Israeli economy in 2024 and 2025. We wish to remind that our economic forecasts are based on war scenarios. In the forecast we published in November 2023, we estimated that under a scenario in which the war ends in the third quarter of 2024, and without high-intensity fighting against Hezbollah, GDP growth in 2024 will stand at 1.5%. As the fighting draws on, we update our forecasts. If the international efforts to reach a ceasefire and an agreement between Israel and Hezbollah succeed, and the intensive fighting on the northern front ends in in the next two weeks – our updated GDP growth projection for 2024 is 0.2%.[1]

Assuming the de-escalation effort fails, we have devised two war scenarios with the help of national security experts,[2] and we analyze the economic implications of their realization. The main difference between the two scenarios for the northern front and their economic implications highlights the economic and security uncertainty of these days.

These are the two scenarios we analyzed:

- **War with Hezbollah Scenario:** High-intensity fighting on the northern front lasting about a month, including airstrikes in southern Lebanon and a ground incursion by the IDF into Lebanon. Hezbollah's counterstrike is focused primarily on the northern regions of Israel (Haifa and northwards), but inflicts some damage on central Israel as well. Its high intensity paralyzes economic activity in northern Israel and cripples transportation and energy infrastructures, including power outages, as well as essential services such as hospitals.
- **Multi-Front War with Hezbollah and Iran:** High-intensity fighting on the northern front lasting about a month, including airstrikes and a ground incursion by the IDF into Lebanon. Hezbollah's

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[1] The following economic analysis was conducted prior to Moody's credit rating downgrade on September 28, 2028. The outcomes of this analysis are not affected by this move, since they are based on interest rates reflecting the growing risks highlighted by Moody's report.

[2] We wish to thank the team at MIND Israel for their helpful comments.

counterstrike includes missiles targeting all of Israel. Iran joins in the fighting with sporadic missile attacks throughout the time of intensive fighting with Hezbollah. This combined attack paralyzes economic activity **across Israel** – the economy is in emergency mode, with a risk of damage to critical infrastructures.

For each of these scenarios, we calculated projections for the growth of the economy, for the national deficit, and for the debt-to-GDP ratio, in both 2024 and 2025. According to our analysis, in the **War with Hezbollah Scenario** the economy will undergo negative growth of 3.1% in 2024, meaning the GDP per capita will shrink by around 5%. The deficit will reach 9.2% of the GDP, and the debt-to-GDP ratio will stand at 71%. The projection for 2025 predicts a growth rate of 1.7%, a deficit of 7.8% of the GDP, and a debt-to-GDP ratio of 76%. Israel's credit rating will be downgraded and the interest on the debt will reach 6%-8%.

Assuming a scenario of **Multi-Front War with Hezbollah and Iran**, the projected GDP growth for 2024 stands at minus 4.8% (negative growth), meaning a loss of nearly 7% in GDP per capita. The high costs of the war will increase the deficit to 11.2% of the GDP, and the debt-to-GDP ratio will reach 74.5%. This substantial increase in the debt-to-GDP ratio may lead to further credit rating downgrades, beyond just one ranking, along with a sharp rise in Israel's risk premium, driving the yields of Israeli government bonds up to 8%-10% or even higher. Under this scenario, the GDP is projected to grow in 2025 by 1.5%, the deficit will be 11.3% of the GDP, and the debt-to-GDP ratio will reach 82.5%.

Realization of the multi-front war scenario, resulting in rapid economic and security deterioration, may generate enormous economic risks for the Israeli economy and its financial stability as early as 2025. Panic in the Israeli public may lead to a widespread wave of redemption of financial saving instruments, such as trust funds and study funds as well as retirement savings, and to divestment of funds to USD-linked instruments which will result in a rapid devaluation of the Shekel. Stabilizing the economy will require drastic contraction efforts by the government (particularly in regard to defense expenditure), and will be contingent on US guarantees for the debt, as was the case in 2003, for example. We would like to stress that undermining the stability of the Israeli economy will severely impact investments, particularly in the high-tech sector, and create a significant risk of a brain drain of young people with high-quality human capital who, lacking faith in the Israeli leadership or hope for a possible change, will elect to distance themselves from the ongoing economic and security threats.[3] **Accordingly, realization of this scenario may lead the Israeli economy to an even deeper economic crisis, so that it will take many years until the potential growth trajectory is resumed.**

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[3] Botticini, M. and Eckstein, Z. (2012). "Chapter 7: Educated Wandering Jews, 800-1250", in *The Chosen Few: How Education Shaped Jewish History, 70-1452*. Princeton, NJ: Princeton University Press.

To prevent a severe financial crisis, specifically one which is fueled by expectations for events which have not come to pass, and in the same vein as the policy undertaken in 2008, the Bank of Israel and the Israeli government should announce, as early as today, a range of measures which are due to be enacted in order to calm the economy, stabilize the exchange rate, and safeguard the public's savings. At the same time, the government must promptly adapt the state budget and its various sections to the expected situation of the national economy, similar to the profound budget corrections executed in late 2002 and 2003. As in the past, these measures should be done in coordination with the US government, while receiving guarantees which will reduce the risk and lower the interest on the debt.