Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

By: Joseph Zeira

Because of the wars, the Israeli economy suffers from a prolonged recession



Israel's election results make weeks of political negotiation all but certain. What is equally clear is that whatever government eventually takes office will need to begin reckoning with the mounting costs of Israel's ongoing wars.

Although Israel has been at war since October 2023, many observers argue that its economy has held up remarkably well, pointing to the booming stock market and the strength of the shekel as evidence. Has it?

The answer depends on how we measure the economic costs of war. Direct budgetary costs are measured primarily by the increase in defense expenditures.

But then there are indirect costs, reflected in the impact on the business cycle, and the precedents are clear: Since the First Intifada in 1987, every major flare-up of the Israeli-Palestinian conflict has triggered a recession.

Israel's defense expenditures have risen from roughly 4.2% of GDP in 2022 to 7.8%, adding more than $1,600 per person in annual costs.

The government has financed this increase through borrowing. Since the economic stabilization program of 1985, Israel's budget deficit has remained low, averaging 3% of GDP, which kept government debt at around 60% of GDP. But the deficit rose from 1.8% of GDP in 2022 to 7.1% in 2023 and 9% in 2024, before declining to 6.5% in 2025.

The total increase in the deficit above its long-term average was therefore about 13% of GDP, far exceeding the increase in defense spending.

This likely reflects other war-related expenses, including the evacuation of large populations from border areas, which was also funded by deficit spending.

Debt financing shifts the fiscal burden of war onto future generations while massively increasing it through higher interest payments.

That was the case in the 1970s, when the 1968–70 War of Attrition and the 1973 Yom Kippur War pushed the fiscal deficit to 15% of GDP.

Two recessions

Until 1980, Israel experienced only two recessions, thanks to rapid economic growth during the country's early years and the wars against the conventional armies of Egypt, Syria, and Jordan.

Sustained growth required heavy investment, which boosted aggregate demand, as did the rise in military spending.

Those conventional wars ended following Israel's 1979 peace agreement with Egypt, as the other Arab countries could no longer form a viable military coalition against Israel.

Defense spending fell from approximately 20% of GDP in 1980 to around 5% in the decade before October 2023.

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The First Intifada was followed by the 1989 recession, which ended because of the increased demand that followed the arrival of nearly a million immigrants from the former Soviet Union beginning in 1990.

Prime Minister Yitzhak Rabin's assassination in 1995 and the subsequent resumption of hostilities with the Palestinians led to another recession in 1997–99.

A third recession, in 2001–04, was triggered by the Second Intifada, which erupted in September 2000.

These bouts of violence are more likely to trigger recessions because they tend to have

no clear end, which increases uncertainty and thus discourages investment.

Unlike wars fought beyond Israel's borders, conflicts with the Palestinians directly affect Israelis' daily lives.

People visit shopping centers less frequently and postpone purchases of durable goods, and tourism also suffers.

The Gaza War

The Gaza War appears to be no exception. In the fourth quarter of 2023, Israeli GDP shrank by 5.4%.

It took more than a year to recover to its previous level, and it remained below its long-run trend at least until the second quarter of 2026.

Business-sector GDP fell by 9.9% in the fourth quarter of 2023 and is still below trend.

Investment also fell by 25% after October 2023 and has not yet returned to its pre-war level.

Meanwhile, Israel's unemployment rate has risen only slightly since October 2023.

This can be explained by the extensive mobilization of around 200,000 reservists—5% of the labor force—since the start of the war.

With reservists' wages covered by the National Insurance Institute, their employers could avoid layoffs despite falling demand.

> Lower investment reduces the amount of capital in the economy, boosting returns

One might expect increased wartime risk to drive down stock prices. But lower investment also reduces the amount of capital in the economy, boosting returns.

This compensates investors for taking greater risks, which helps explain why stocks have remained relatively stable over the past three years.

Consider the long-run effects of the Israeli-Arab conflict on capital intensity. For more than 50 years, the average capital-output ratio in Israel's business sector has been one, compared with 1.6 in the United States.

As I show in my 2021 book, this gap can be attributed to higher risk. The gross return on capital in Israel is around 33%, while in the United States it is only 21%.

Beyond stock prices, the shekel, and the labor market

Thus, Israel's high stock prices do not necessarily signal a strong economy. They may instead reflect capital scarcity that drives up profits.

To understand why the shekel is so strong, we must turn to another consequence of the war: increased US aid to Israel.

Before the war, annual US aid amounted to nearly $4 billion, less than 1% of Israeli GDP.



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Maintaining this ratio while the economy grows at its average annual rate of 3% requires annual dollar purchases roughly equal to what the US sends Israel each year in military assistance.

But the war has led to a sharp increase in US aid. While in office, former President Joe Biden approved $20 billion in arms sales to Israel. President Donald Trump has also expanded US support.

This more than doubles the inflow of dollars to Israel, pushing up the shekel's exchange rate.

To assess Israel's economic performance over the past three years, then, we must look beyond stock prices, the shekel, and the labor market.

The data on output, investment, and actual employment show an economy suffering from a prolonged recession, as has always been the case when the Israeli-Palestinian conflict flares up.

Joseph Zeira is Professor Emeritus of Economics at the Hebrew University of Jerusalem.