Israel Economic Overview and Outlook

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Strong Fundamentals Help Weather the Storm

— Jonathan Katz, Israel Macroeconomist

The Main Points

Geopolitics: Israel has been embroiled in prolonged warfare on multiple fronts since the October 7th 2023 tragedy. There are optimistic signs that hostilities are winding down and Israel's geopolitical reality has greatly improved. A ceasefire with Hezbollah is being maintained, Syria's collapse has weakened Iranian influence in the region, and cessation of hostilities in Gaza appear imminent with the recent ceasefire agreement

Strong economic fundamentals will support recovery

- Israel is a developed economy with a GDP/capita of $53.7k.
- Israel has a strong growth potential supported by positive demographics and a vibrant high-tech sector.
- Israel entered the war with a low fiscal deficit and manageable Debt/GDP.
- The fiscal deficit will be reduced in 2025 by fiscal adjustments of nearly 2% of GDP.
- Growth in 2025 will be fueled by investment spending and exports.
- Israel's strong external position including a Current Account Surplus and Foreign Direct Investment helps support a strong shekel.
- A tight fiscal policy, shekel appreciation and a weakening of supply constraints will support lower inflation towards mid-year.
- We expect three rate cuts this year from the Bank of Israel.
- Looking ahead, the major risks revolve around internal politics and division.
- On the upside, we could see an opening up of relations with Saudia Arabia.

POLICY RATES	
Current	4.50%
Q225	4.25%
Q425	3.75%

INFLATION	
12 y-o-y	3.2%
Jan-Mar	1.0%
NTM	2.5%
2026	2.3%

FX	USD	EURO
ILS	3.602	3.7074
Last week	-1.7%	-1.8%
YTD	-1.2%	-2.3%
NTM	3.57	3.67
2025	3.57	3.67

GOV. BONDS	JAN 25
Redemptions	1.3
Issuance (tradable)	15.0
Net redemption	-13.7

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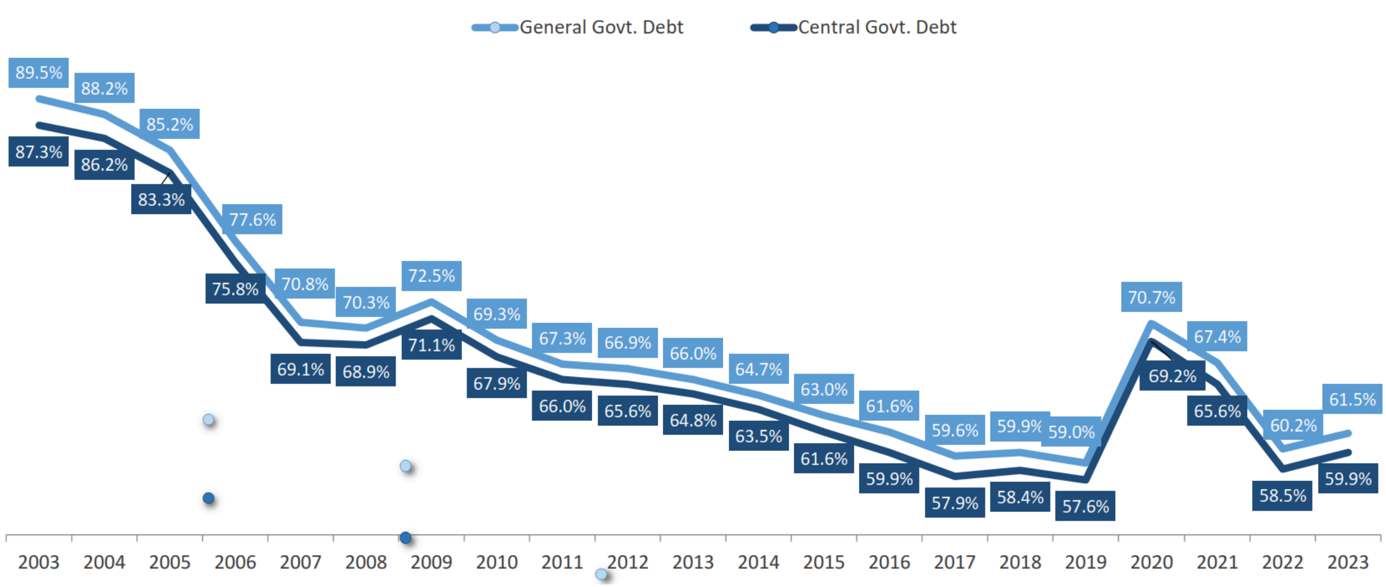
General Economic Data – *Israel is a developed economy which joined the OECD in 2010*

- Population (2024A): 10ml
- GDP/Capita (2024E): $53.7k
- Government Debt/GDP (2024E): 69%
- Fiscal Deficit (2024E): 6.9% GDP
- Current Account Surplus (annual thru Q3'24): 4.8% of GDP
- High-tech Sector (2024A): 18% of GDP, 58% of all exports, and 16% of all workers
- Unemployment (November 2024): 2.7%
- Inflation (2024A): 3.4%
- Interest Rates (2024A): 4.5%

Strong fundamentals help weather the storm

The tragic war that broke out on October 7th, 2023, caught Israel by surprise and escalated to multiple fronts. Clearly, the geopolitical risk factor spiked but the winding down of the conflict with a ceasefire in the North and recent agreement with Hamas, the overthrow of the Syrian regime and the weakening of Iran's position in the region all contributed to a reduction the geopolitical risk. Israel's economy has weathered the storm relatively well for the following reasons:

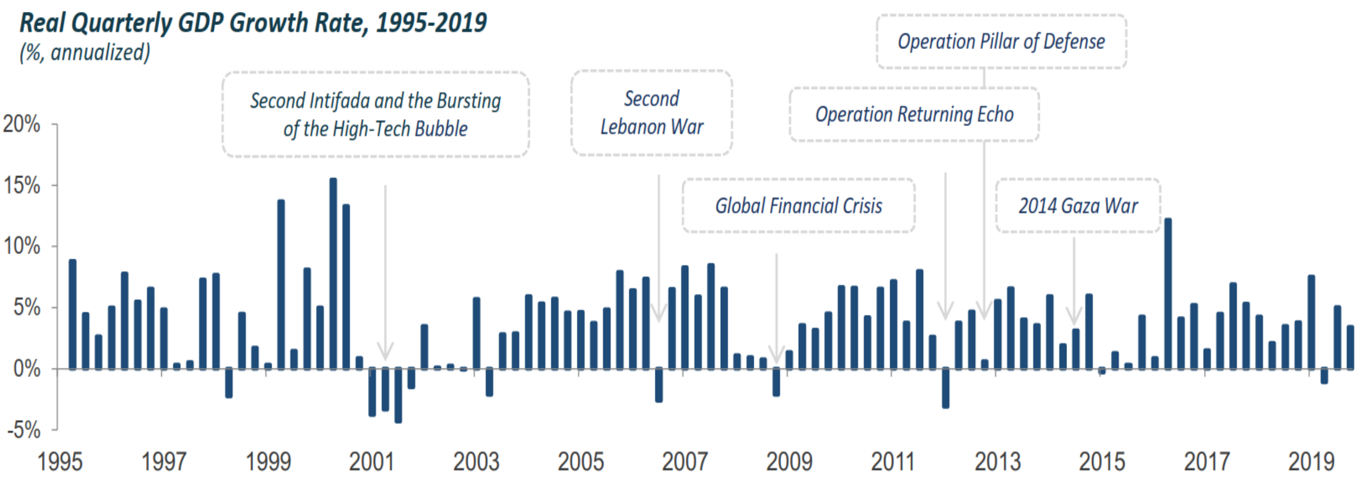
- **Israel's fiscal deficit in September 23 (pre-war) reached a relatively low level** of 1.5% of GDP and the public debt reached 60% (until Q4'23). In the past (Covid, for example), Debt/GDP declined sharply following the crisis.



Source: MoF

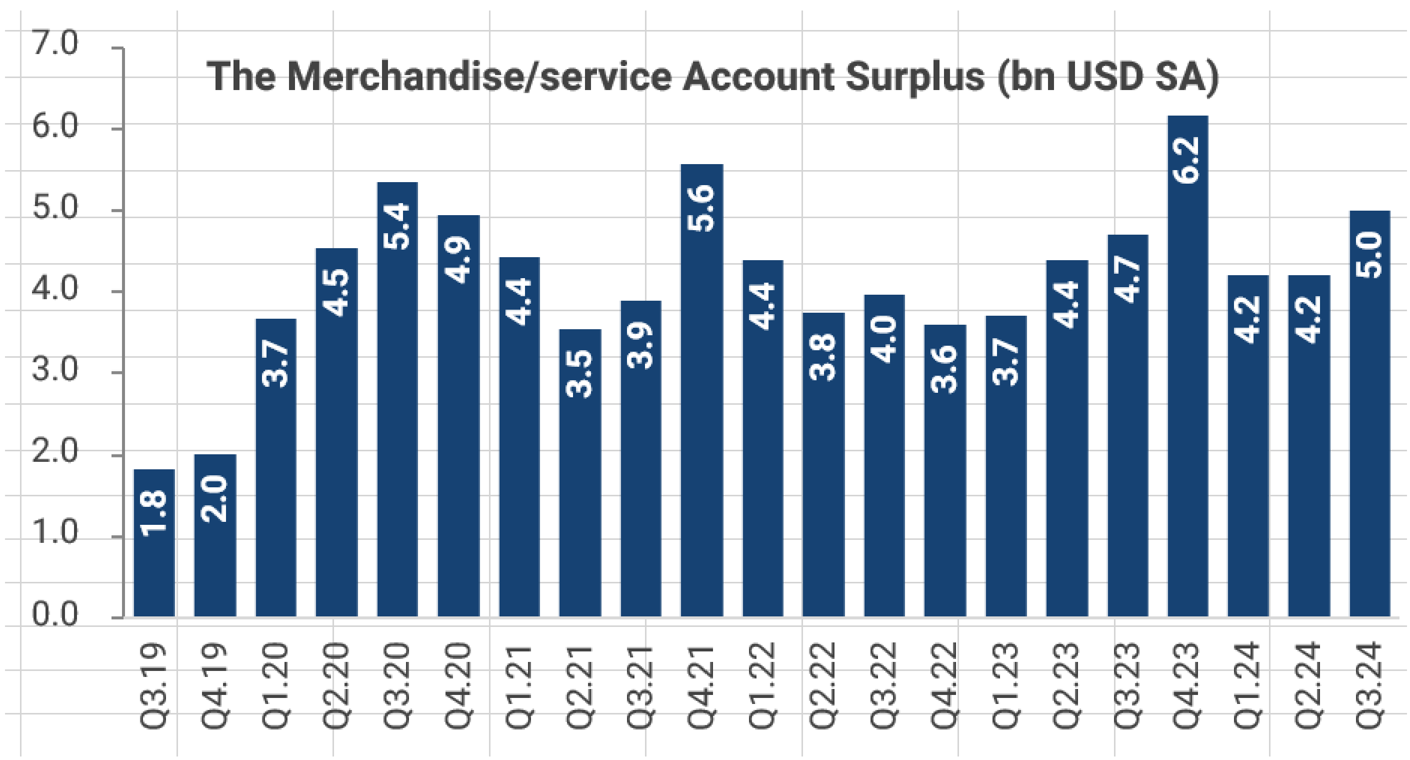
- **The Bank of Israel has huge FX reserves of $215bn (41% of GDP)** and committed $30bn (at least) to providing liquidity in the FX market. So far, only $8.5bn was utilized in the first two months of the war.

- Up until the war (the fourth quarter of 2023) **Israel enjoyed strong economic growth of 4%** (from Q2'22 to Q3'23). Israel's main economic driver is the high-tech sector making up 18% of GDP. In addition, Israel is one of the few developed economies with **positive demographics with population growth approaching 2%** annual in recent years, before slowing in 2024 to 1.1%. In the past, **Israel's economy has recovered rapidly from various shocks**, but most shocks were short-lived compared to the 15 months of warfare since October 2023.



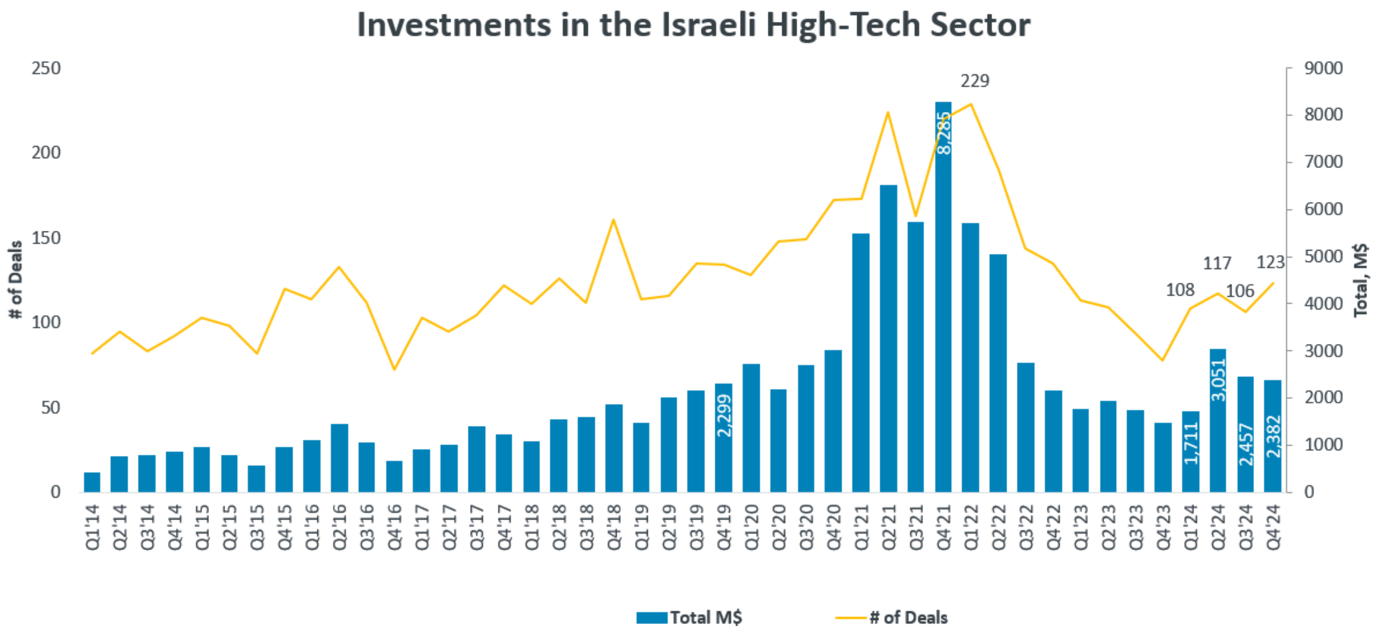
Source: CBS and MoF

- **Israel's net export account** (+$20bn from Q4'23 to Q3'24) and FDI ($17bn) remained strong during the war.



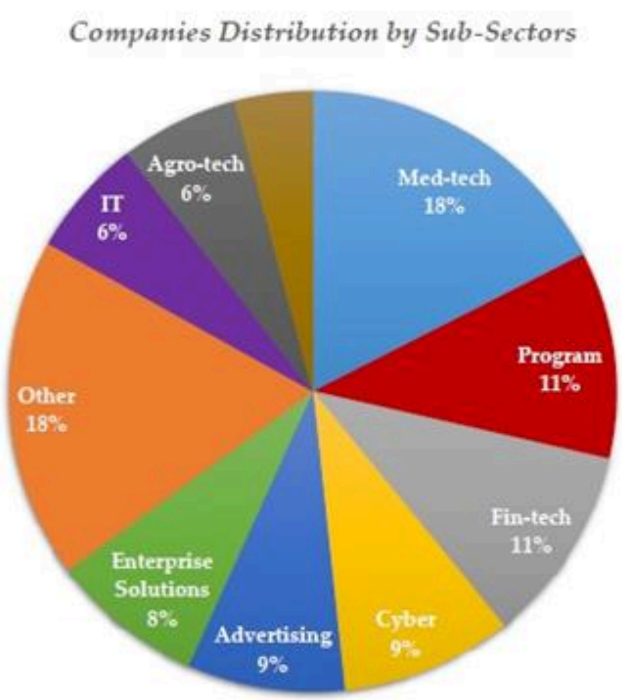
Source: CBS

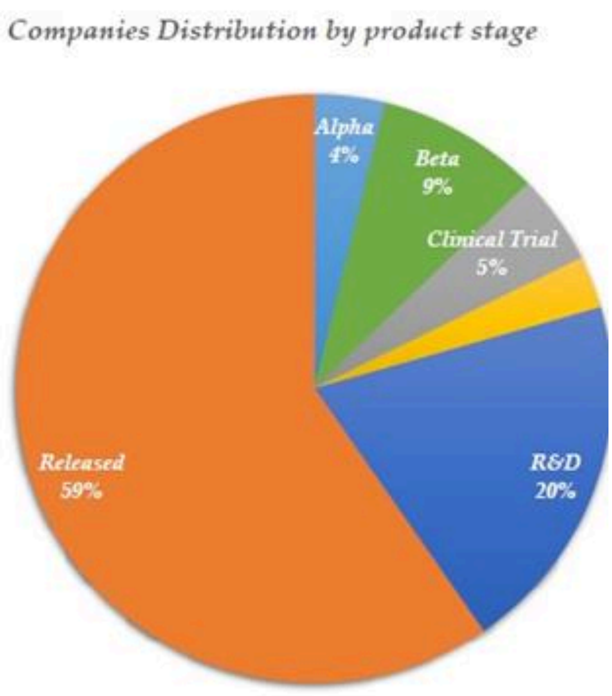
- Investments in the high-tech sector from abroad increased by 35% in 2024 to nearly $10bn. **External fundamentals remain shekel positive.**



Source: BoI

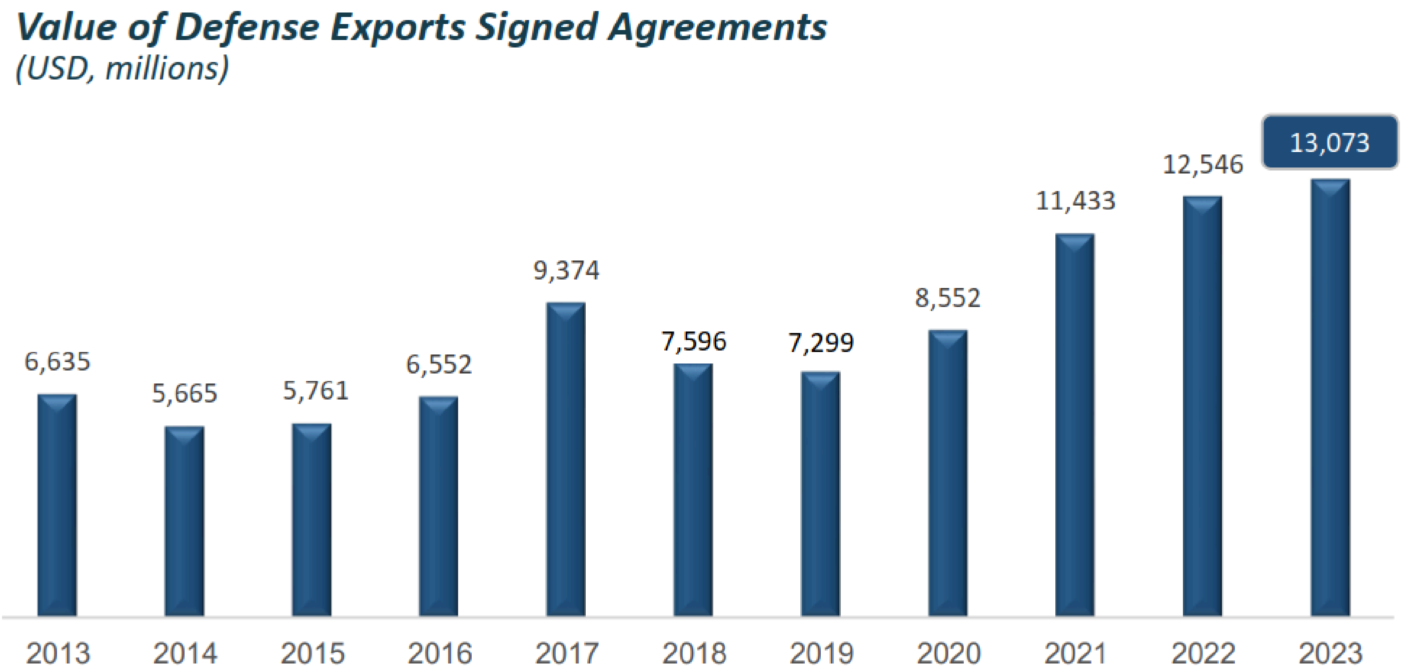
- The high-tech sector continues to function during the war, despite army mobilization. This sector is highly diversified with a large majority of companies in the production stages:





Source: BoI

- The defense export sector was already expanding rapidly before the expected boost in orders in 2024, including from several European countries:



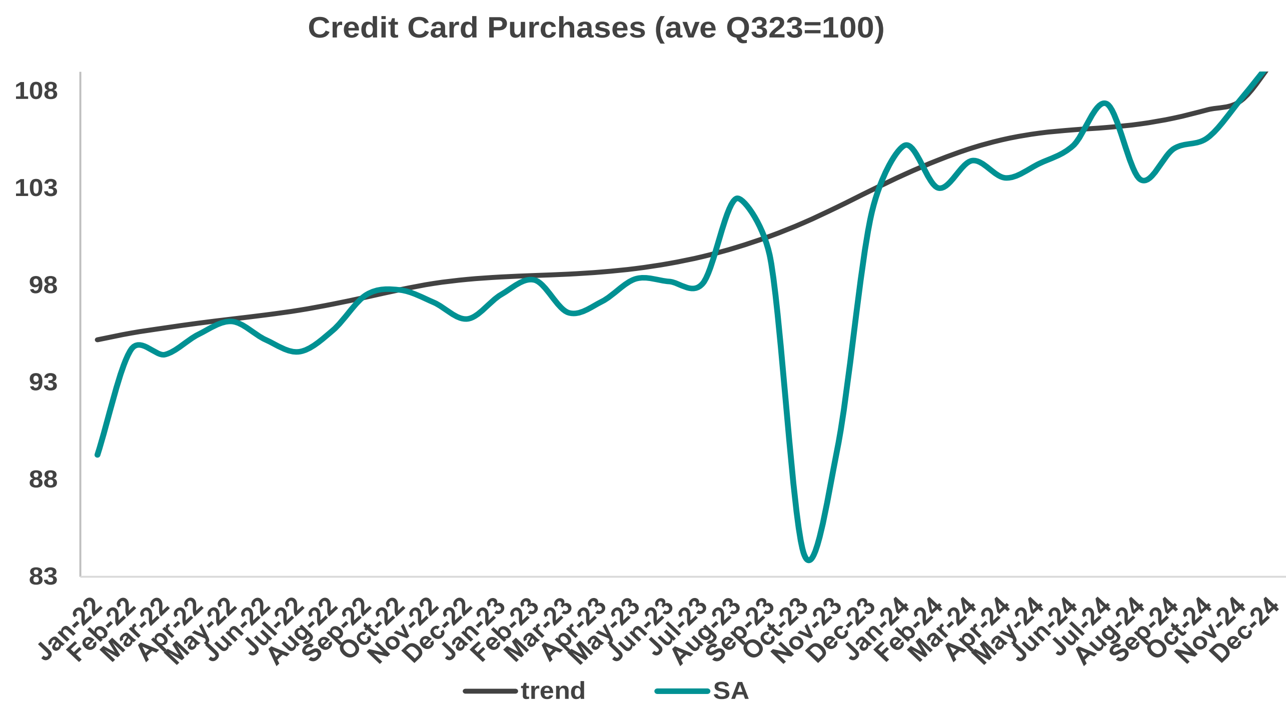
Source: MoF

- **The major long-term challenges** going forward include bringing more ultra-orthodox men into the workforce, increasing spending on education (improving mathematical results) and bridging the widening polarization and political animosity.

<u>We expect GDP growth to reach 3.5% in 2025</u>

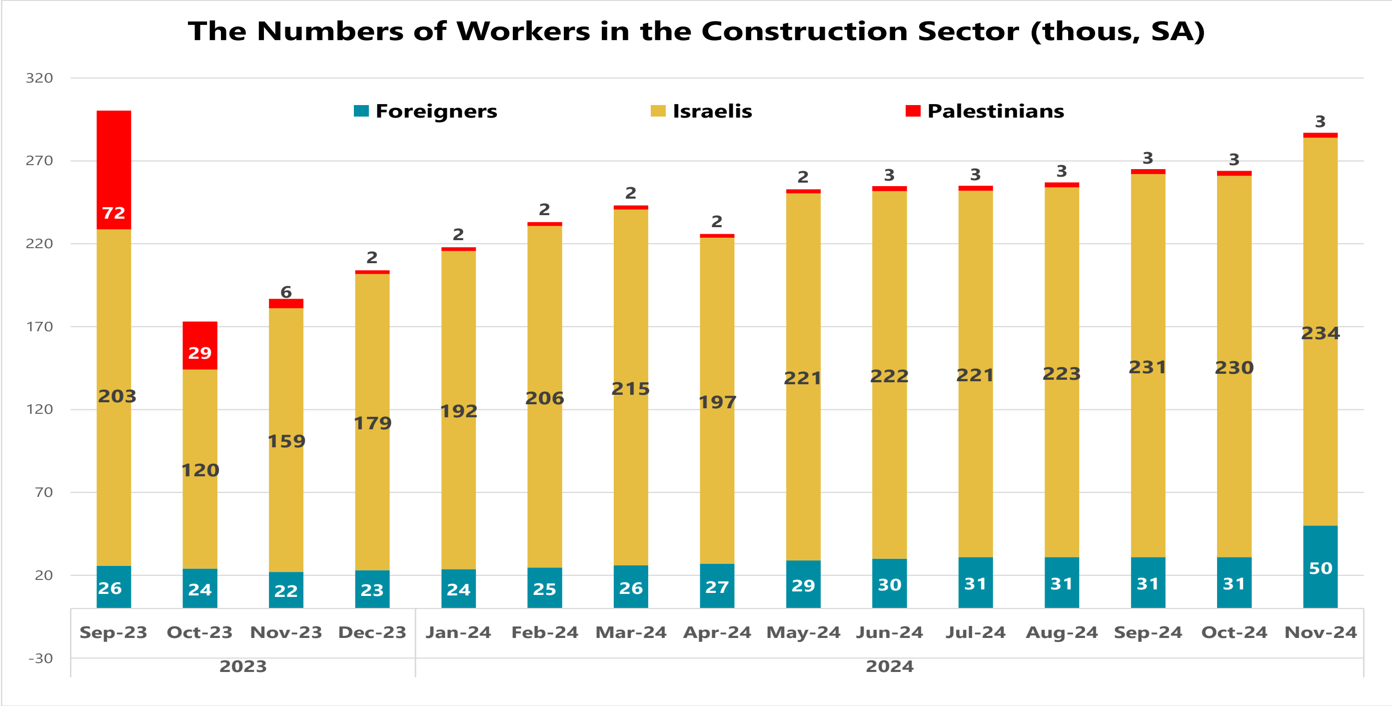
Assuming the cessation of hostilities towards mid-January (and no renewed hostilities), we expect a gradual recovery with GDP growth reaching 3.5% in 2025 following 0.6% in 2024E. 2026 will witness further expansion of 4.5%. We assume the following:

- **Government spending will contract sharply**, especially spending that was necessary to support the war effort and the mobilization of soldiers. This includes less defense spending as well as transfers to mobilized soldiers and evacuees. Nevertheless, defense requirements will remain elevated compared to pre-war, at least in the short run.
- **Private consumption will expand by a modest 3.2% in 2025** before accelerating to 4.0% in 2026. This will be impacted by a tight fiscal policy (higher taxation both on income and spending) as well as a wage freeze in the public sector. In addition, on a technical level: consumption surged (see graph) towards the end of 2024 (especially durables and new homes) in order to avoid the higher VAT and vehicle taxes in 2025, which will detract somewhat from consumption in 2025.



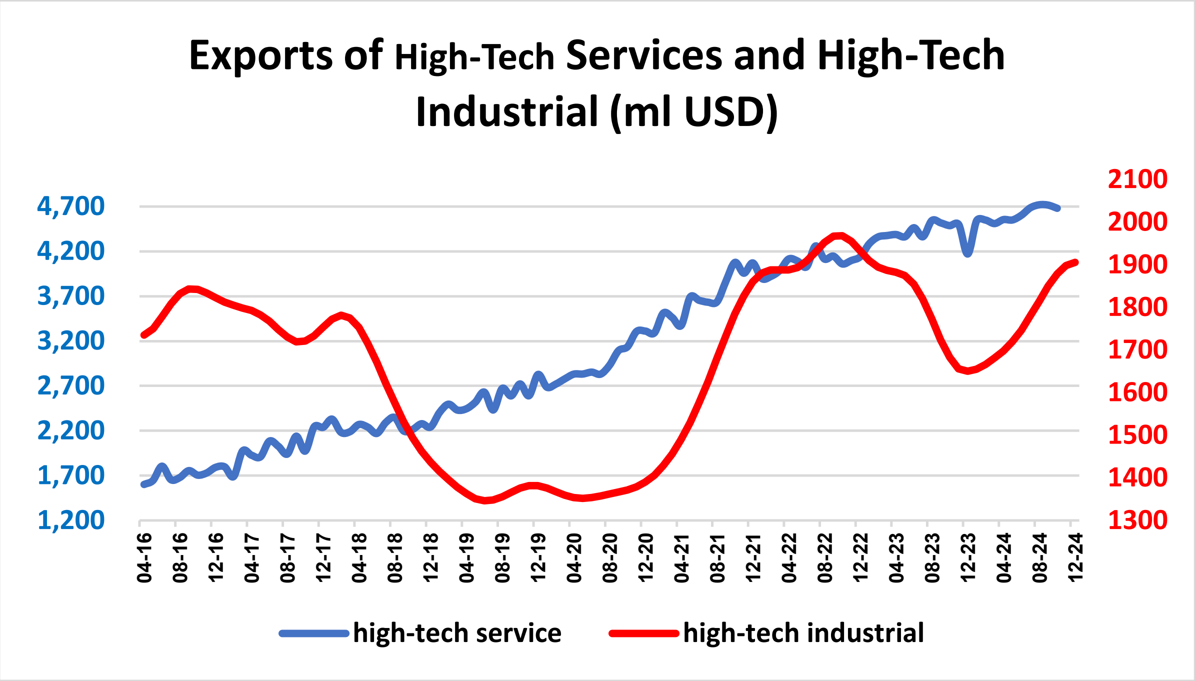
Source: CBS and BoI estimate from daily purchases

- **Investments will expand by 7.5% in 2025 and 9% in 2026.** The lack of Palestinian workers will slow the pace of construction investments. The repair of damages to housing and infrastructure due to the war will continue at least through 2026. Nevertheless, Israel still suffers from a shortage of workers due to the lack of Palestinians. Some of this labor shortage has been supplied by Israeli Arabs and foreign workers.



Source: BoI

- **Exports are expected to expand rapidly by 4.5%** in 2025 and 5.0% in 2026, on the back of robust high-tech exports. both services (such as cyber and other applications) and industrial (including defense). This upward trend was already pronounced in 2024 and is expected continue.



Source: CBS

Economic Forecast	2024E	2025F	2026F
GDP	0.6%	3.5%	4.5%
GDP per capita	-1.3%	1.6%	2.5%
Imports	2.0%	2.0%	5.0%
Private consumption	3.2%	3.2%	4.0%
Public consumption	13.0%	-2.0%	2.5%
Fixed Capital Formation	-11.0%	7.5%	9.0%
Exports	-4.0%	4.5%	5.0%
Unemployment rate (ave)	3.3%	3.5%	3.4%
Current account surplus	4.6%	4.0%	4.0%
Fiscal account	-6.9%	-4.8%	-3.5%
Inflation y-o-y	3.2%	2.4%	2.3%
ILS/USD end-year	3.618	3.572	3.550
ILS/EUR end-year	3.789	3.672	3.650
Policy rates-end year	4.50%	3.75%	3.25%

Recent Economic Developments:

December's CPI slows but core remains stable:

- Headline inflation surprised on the downside, slowing to 3.2% y/y from 3.4% while core inflation remained stable at 3.3%.
- The downward surprise came from a sharp decline in airfare and domestic vacation costs.
- Both rental prices (OER up 4.0% y/y) and non-housing services (3.7%) remained stable y/y.
- We expect inflation to slow to 2.4% in 2025.

The fiscal deficit reached 6.9% of GDP:

- Early (advanced) tax revenues before higher taxation in 2025 contributed to a lower-than-expected deficit.
- Assuming the fiscal budget for 2025 is approved, we expect a deficit of 4.7% this year. The winding down of the war will support revenues.

Economic data in December was robust:

- Credit card purchases increased sharply for durables (before higher taxes) in November and December.
- High-tech industrial exports were up 5% q/q in Q424.
- Although new home sales declined in November, December is likely to point to a sharp rebound (before higher VAT in January). New mortgages posted a record high 13bn ILS in December.

FX: The shekel has appreciated by 1.7% YTD (against the basket). Shekel appreciation intensified on January 17th afternoon on the news of the ceasefire agreement.

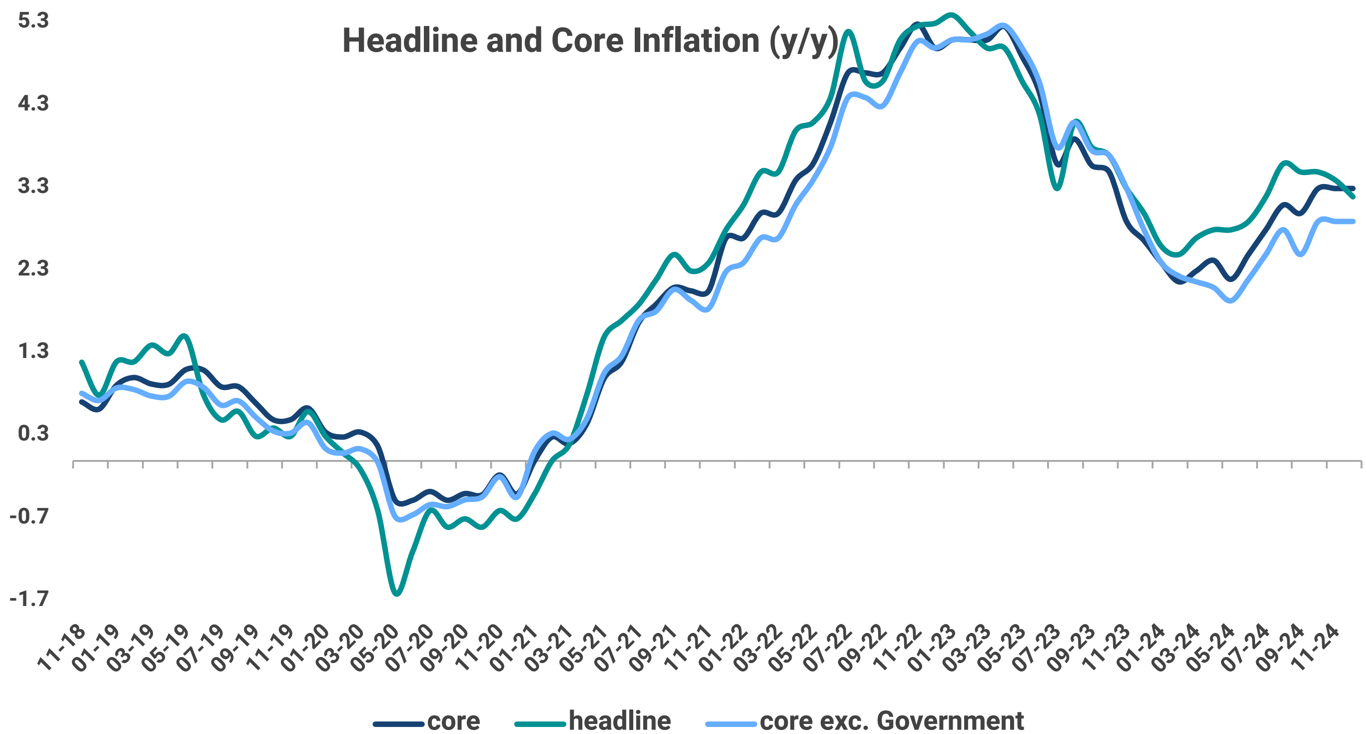
FI: Foreigners increased their domestic bond holding to 10% (of total debt) in November from 9.6% in October and 8.4% in July. In October 23 foreign holdings made up 14.7%.

The ceasefire and likely quantitative easing in early Q2'25 support the long end of the curve. We expect three rate cuts in 2025 to 3.75%.

Important data this week: Monday: Labor data (unemployment and employment, December). Tuesday: Manufacturing and Revenues from the various sector (November). Wednesday: The Bank of Israel Composite index of the economy (December).

Inflation surprises on the downside

Inflation in December (-0.3% m/m, 3.2% y/y, down from 3.4%) was below market expectations (and ours of -0.1% m/m). Some forecasters were expecting 0.0%. The inflation surprises came mostly from airfare abroad (-4.4% m/m) and domestic vacation (-9.2%), two items that have been rather volatile since the war (especially airfare). Core inflation remained stable at 3.3% y/y, similar to November. Rental prices (OER) continued to increase by 4% y/y, as did non-rental services excluding travel (3.7%). Core goods pushed slightly higher while travel abroad moderated. Core PPI moderated to 0.8% y/y from 1.3%.



Source: CBS and BoI

Housing purchase prices (a separate survey not factored into the CPI) increased by 0.6% m/m and 7.8% y/y (up from 6.7%). The shortage of workers in construction and weak housing completions continues to support sticky housing prices, both rentals and ownership. New home sales declined by 13% m/m in November (due to escalation in the North), but apparently rebounded in December before higher VAT kicked in.

Inflation outlook: We were in the inflation camp for most of 2024 on a tight labor market, fiscal expansion, higher housing prices and supply constraints**. Recently we shifted towards less inflationary pressure going forward** with inflation expected to reach 2.4% in 2025, due to the following factors:

- At the beginning of the year, **the government will be the main "culprit" contributing to inflation**. Higher VAT, public transportation costs, higher electricity and water prices, higher taxes on electric vehicles and higher municipality taxes will all contribute nearly 0.7% to inflation, mostly in Q125.
- **The labor market appears to be softening gradually**. Wage growth has slowed to 4% y/y from 6%-7%. According to the Business Tendency Survey, labor constraints are less acute.
- Assuming the 2025 fiscal package passes Parliament (Knesset), this will mean **a tighter stance in 2025 than in 2024**. Non-defense spending will increase by only 2.5% in 2025 compared to 6.5% in 2024. Several measures will hurt the consumer: a public sector wage freeze, tax brackets will not be adjusted for 3.6% inflation in 2024, neither will child allowances. Social security payments will increase by 1.6%. Municipal taxes and public transportation will also go up, in addition to 1% VAT. In short run, some of these fiscal measures will contribute to inflation (about 0.7%) but will be offset in part by a strong shekel and less supply constraints in the medium term.
- Therefore**, household purchasing power will weaken** in 2025, impacting the pressure for higher rental prices due to weak construction activity. We currently expect rental prices to increase by around 4% in the coming year.
- **Supply constraints will gradually dissipate** in the coming year (especially airfare, as foreigner airlines will return).
- **The jocker in the pack remains the shekel**, which has appreciated sharply recently. Our inflation forecast of 2.4% assumes shekel stability, but the risks are clearly towards **a stronger shekel in 2025.** On the other hand, the return of the judicial "reform" and social unrest could weaken the shekel.

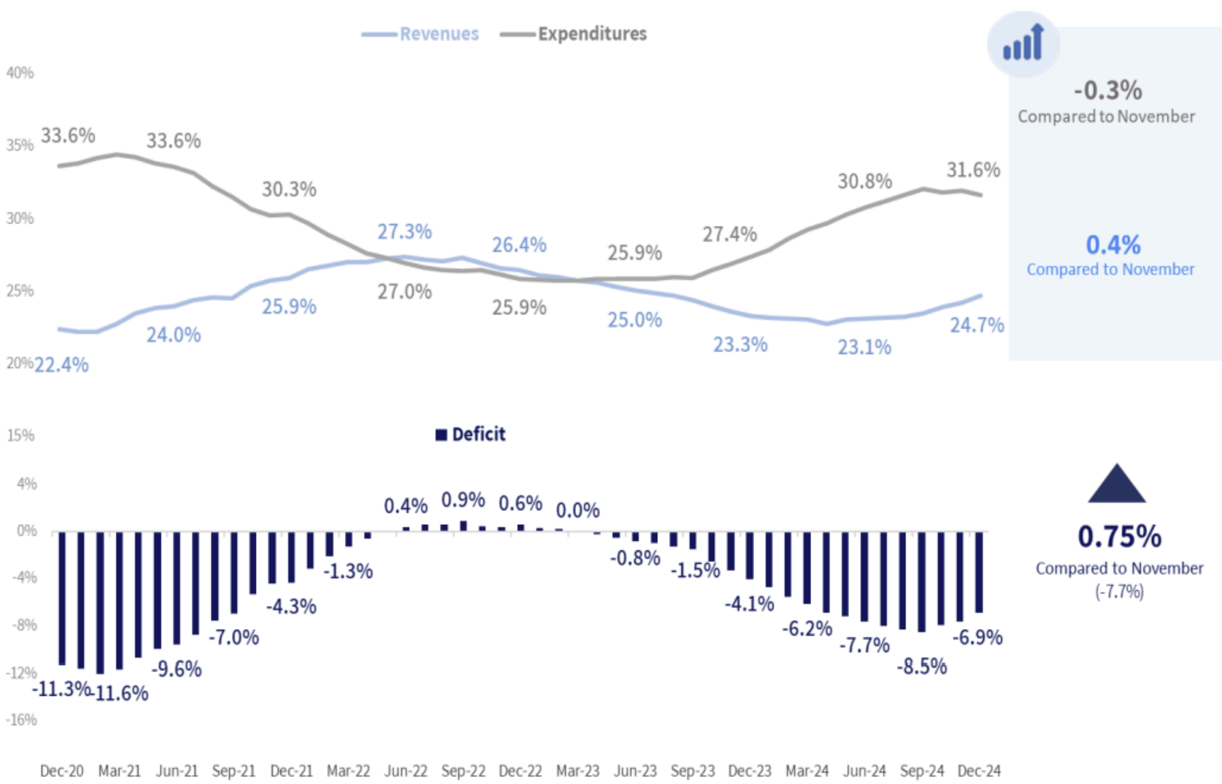
Implications for monetary policy: The Bank of Israel has presented a somewhat hawkish stance in the last rate decision, stressing the concern regarding "excess demand" as the war ends, possibly more significant than the reduction of supply constraints. Nevertheless, the recent decline in Israel's risk premium and shekel appreciation are significant developments. **We expect three rate cuts this year, with the first cut on April 7th.**

High-tech exports continue to expand

Trade numbers in the fourth quarter were generally positive, with exports up 0.8% q/q (SA). Defense exports were up sharply (22%, transportation equipment: mostly Israel Aircraft Industry) while pharmaceutical exports were down (-19%). **High-tech exports (defense included) expanded by 5% q/q**. Import growth was robust (in part due to imminent tax hikes in 2025) with consumer imports up 7% q/q and raw materials up 5%. The trade deficit in 2024 increased by 7%, but this was partially offset by a strong service account. **External fundamentals remain shekel positive.**

Early (advanced) tax revenues reduce fiscal deficit to 6.9% GDP

According to the Ministry of Finance's estimates, the surge in tax revenues in December to NIS 43.9 billion was partly due to the advance in taxes of about NIS 6-7 billion before higher taxation in 2025: NIS 5-6 billion in purchase taxes and another NIS 1 billion in dividend payments. Part of this impact will also be felt in an increase in taxes in January-February 2025. Without earlier taxes, the deficit in 2024 would have amounted to 7.2 percent of GDP instead of 6.9 percent. In 2024, expenditures increased by 20.4% and by 6.1%, excluding expenses due to the war. Total revenues increased by 10.5% (including the increase in tax revenues), with tax revenues reaching NIS 455.4 billion, compared to the Ministry of Finance's forecast of NIS 443.8 billion in October 2024. The 2025 forecast assumes revenues of NIS 489.2 billion or a nominal increase of 7.4% (including tax measures: VAT, trapped profits). **Even considering the advance of taxes in 2024, this is still a reasonable forecast, which lends credibility to the deficit target this year (around 4.7 percent). Strengthening fiscal credibility supports the bond market**.



Source: MoF

Inflation and FX Forecast:

	Inflation forecast			USD ILS Forecas	Policy Rates
	M-O-M	Y-O-Y	NTM		
12-24	-0.3	3.2	2.4	3.618	4.50%
01-25	0.5	3.8		3.614	4.50%
02-25	0.3	3.7		3.570	4.50%
03-25	0.2	3.4		3.572	4.50%
04-25	0.3	2.8		3.572	4.25%
05-25	0.4	3.0		3.572	4.25%
06-25	-0.2	2.7		3.572	4.25%
07-25	0.3	2.4		3.572	4.00%
08-25	0.3	1.8		3.572	4.00%
09-25	0.0	2.0		3.572	4.00%
10-25	0.2	1.8		3.572	4.00%
11-25	-0.2	2.0		3.572	3.75%
12-25	0.1	2.4		3.572	3.75%
Next 12 month		2.4			

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