March 29, 2026

Stagflation concerns mount

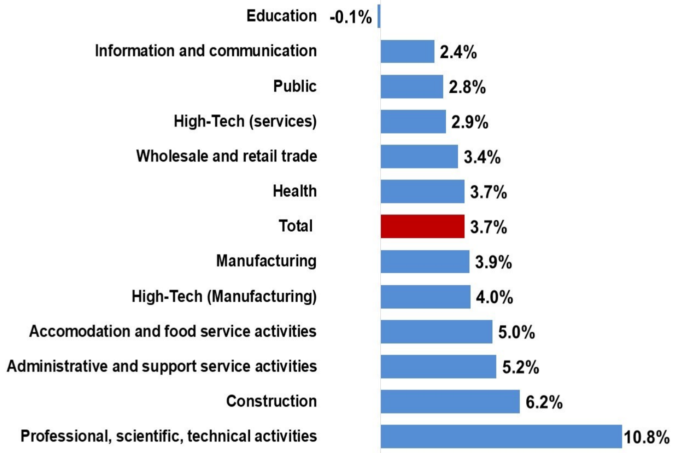
- **It is sufficient for the war to continue until the end of Passover for annual growth to fall below three percent, and possibly much lower.**
- **In a scenario in which the war continues for several more weeks, the government will be forced to implement spending cuts and tax increases in order to prevent the deficit from getting out of control and reaching 6% or even higher.**
- **Bond yields, which have so far increased mainly because of global trends, may continue to rise because of the fiscal situation.**
- **We estimate that inflation risks skewed to the upside due to the long-term effects of the war, such as future tax increases, supply chain disruptions, and similar issues.**
- **We believe that if the war ends by the end of the holiday, we will see a reversal in inflation trends in the second half of the year, and interest rate cuts will be back on the agenda.**

The Finance Committee approved the fiscal budget, and it is expected to be approved by the Knesset as well. Some of the budget assumptions have become almost irrelevant from day one. The war is continuing far beyond what was assumed in the budget, and it has even expanded to the north, including the mobilization of more than one hundred thousand reservists. Given that we do not know how long the war will last, it is almost impossible to produce a reasonable forecast: **it is sufficient for the war to continue until the end of Passover for annual growth to fall below three percent, and possibly even lower.** Because of the proximity to the war in June 2025, there is a tendency to think that events will repeat themselves, and that immediately following the war ends there will be a major economic rebound that will largely compensate for the wartime period. But global conditions are currently rather different from those that existed a year ago. The wealth effect created by rising stock markets has reversed, there are no expectations for interest rate cuts, and the tax burden is expected to push higher; therefore the assumption of a surge in activity following the cessation of hostilities is, in our view, far from certain.

Even when looking at the medium term, there is a cumulative negative impact from the war period. The latest Bank of Israel report notes, for example, that the population of reservists has reduced its participation in the labor market, and young people are less inclined to look for permanent employment. In other words, the war has an impact on the economic recovery far beyond the duration of the war itself.

In a scenario in which the war continues for several more weeks, the government will be forced to implement spending cuts and tax increases in order to prevent the deficit

Wage growth remains rapid
Average wage, rate of change, last three months compared to the same period last year
Source: CBS



Inflation expectations have risen
Break-even inflation
Source: Bloomberg

from getting out of control and reaching 6% or higher. At that stage, the markets will assess to what extent the deficit is temporary and attributable to the war, and to what extent it is structural. Israeli governments have a positive track record, including the current government, which carried out a significant fiscal adjustment at the beginning of 2025. On the other hand, this is an election year, and a government that has avoided cutting controversial expenditures. This policy may undermine investor confidence as well as **bond yields which have so far increased mainly due to global trends but could continue to rise because of the fiscal situation.**

There has been an increase in short-term inflation expectations. One-year inflation expectations have increased to about 2%, compared with approximately 1.4% before the war. Expectations for longer duration are still anchored around the midpoint of the target range. The government will have to decide whether to moderate the increase in petrol prices at the end of the month by reducing the excise tax. Without subsidies, petrol prices are expected to increase by about 16% in April. Assuming fuel prices rise by only 10%, the April CPI is expected to increase by 1.2%. **We estimate that inflation risks skewed to the upside due to the long-term effects of the war, such as future tax increases, supply chain disruptions, and similar issues.**

The pace of wage growth in the business sector remains fairly rapid. The average wage has risen over the past year at a rate of about 3.7% (three-month average), but in most private sector branches, wage growth is much higher. In sectors such as hospitality services, construction, and professional, scientific, and technical services, wages are rising rapidly. The pace of wage increases also supports relatively high inflation.

Israel has joined the global trend anticipating a shift in monetary policy and a halt to interest rate cuts. The market expects interest rates to remain stable over the coming year. Much depends on whether the price increases expected in the short term develop into a sustained inflationary process. At this stage, We note that inflation expectations have increased moderately, which reduces the risk of a self-reinforcing cycle of price increases. On the other hand, the burgeoning deficit and tight labor market still pose risks. **We believe that if the war ends by the end of the holiday, we will see a reversal in inflation trends in the second half of the year, and interest rate cuts will be back on the agenda.**

BOI Rate and CPI Forecast

BOI Rate		CPI	
December 2026	3.75%	Mar 2026	0.5%
12M Forecast	3.75%	Apr 2026	1.2%
		12M Forecast	2.2%

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