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## PROSPECTS FOR THE ISRAELI ECONOMY IN LIGHT OF THE GLOBAL CRISIS

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*Floating with the World? / The Peace Process / More Aspects of the Peace Process / Multinationals and Venture Capital / Privatization / Monopolies / Tax Reform and Currency Liberalization / Where is the Economy Going? / Entrepreneurship / The Role of the Diaspora / A World of Uncertainty*

During the High Holidays earlier this year, an Israeli journalist visited synagogues in Washington and spoke to senior Jewish executives of major financial institutions such as the Federal Reserve Board, the International Monetary Fund (IMF), and the World Bank. Later he reported that these economists had so misjudged world developments that this year they felt they had to ask for special forgiveness for their sins.

Nobody knows what is going to happen to the world's economy. The virtualization of money and the liberalization of money flows have made the world's financial system almost uncontrollable. Experts can offer no concrete solutions for existing problems, let alone future ones. As always, political leaders hope that issues can be dragged out over time, that partial solutions will mitigate the problems, and that with certain maneuvering, one can avoid a breakdown.

If all the economic grandmasters have

dramatically misread global economic developments and are doubtful about what the near future will bring, what forecasts should one expect from an Israeli economist? Israel is a small country with about six million inhabitants, heavily dependent on international trade, and thus subject to economic turbulence on the global scene.

### **Floating with the World?**

The further liberalization of Israel's currency, which occurred last year, has increased its vulnerability; major economic forces at play in the rest of the world must affect the shekel's exchange rate. The shekel's devaluation of over 10 percent against the dollar in Fall 1998 is partly an indication of this vulnerability.

Israel cannot escape what is happening elsewhere; however, its economy is not as vulnerable as one might think. Israel is not predominantly dependent for its exports on a sin-

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gle market, having developed a well spread out geographic base. The European Union accounted for a third of Israel's 1997 exports, the U.S.A. for 27 percent, EFTA countries 7 percent, the rest of Europe 8 percent, America outside the U.S.A. 6 percent, Japan 3 percent, and the rest of Asia 9 percent. There is no country—not even the U.S.A.—whose economic problems will make Israel's economy collapse in response.

Neither are Israeli exports dependent on a single industry. Of the approximately \$21 billion in Israeli exports in 1997, a variety of branches such as metals, machinery, and the like together accounted for some 40 percent of the total; cut diamonds represented another 20 percent; chemicals and oil products 15 percent; electronics and related products 7 percent; textiles 5 percent, and agriculture 4 percent. This is quite a reasonable spread, particularly if one considers that these broad categories involve many unrelated outlets, a fact which further decreases vulnerability.

Furthermore, Israel's external debt is about 20 percent of its GNP, which should be considered a healthy figure. The country's overall vulnerability is far from that of many emerging markets. Though it is often put in this category, Israel not only has economic characteristics distinctly different from most emerging markets, but also different political characteristics, especially its consistent democratic record.

### **The Peace Process**

There are other reasons why Israel's economy stands somewhat apart from what happens in the rest of the world. Specific political developments in this region are such that Israel's economy and stock exchange do not necessarily perform in line with world trends.

The most publicized specific factor influencing Israel's economy is the so-called Peace Process, a factor that merits further analysis from several perspectives. Common international media wisdom holds that when the mood about the Peace Process is upbeat, foreign investment pours in, and when that mood declines, investment stops. This led to the perception that after 1993, during the Rabin years (and also during the short Peres period) after the first Oslo agreement, foreign investment in Israel was high, and under Netanyahu's prime ministership it has been lagging.

However, the opposite is the case. In 1996 and 1997 under Netanyahu, the inflow of foreign in-

vestment exceeded that of the years of the Rabin government. In 1997 alone, foreign investment in Israel was \$3.7 billion, which is greater than during the entire Rabin administration. In 1998, though, it has much decreased, mainly due to developments in world financial markets.

Overall economic growth was much greater during the Rabin government. In 1994 and 1995, growth far exceeded the forecasts of all the macro-economists. Yet here, again, some perspective is required. A few years ago at one major Israeli investment company (on whose Board of Directors I sat), an outside economic consultant was criticized because his forecasts had consistently proven too pessimistic. His defense was that no reasonable economist could foresee that the Rabin government would continue to follow an irresponsible policy based on far too high a balance of payments deficit. The punishment for that, resulting in much lower economic growth, would have to come in the future, he insisted, and this has proven to be true. Whoever had won the 1996 elections would have had to cool down the economy.

One very unpleasant fact about governments and macro-economists is that while they know how to cool down economies, they are not very good at revving them up again. Thus, today, the Israeli people are still paying the price for the sins of the previous government. The Manufacturers Association estimates that 1998 has shown a 1.4 percent growth in GNP, which means a negative growth of 1 percent on a per capita basis. While there is going to be some very modest growth in the GNP in 1999—an estimated 1 percent—there is likely to be a decline again in per capita growth, as was also the case in the last two years.

### **More Aspects of the Peace Process**

Since the Peace Process is so heavily debated in Israel, we must consider more of its aspects. The economy of the Palestinian Autonomy accounts for about 7 percent of Israeli exports. Were the Palestinians to stop importing from Israel, their society would most probably collapse, especially if, in retaliation, Palestinian workers were barred from entering Israel. By contrast, Israel would, at most, suffer the loss of 1.5 to 2 percent of its Gross National Product, or one year of growth.

What about the potential of other Middle Eastern markets? Today, the other Arab countries are minor markets for Israeli exports, directly or indirectly. More importantly, even if there were full

peace in the Middle East, a rather utopian scenario, the potential of Israeli exports to Arab markets remains limited for several reasons.

The first involves the mismatch between the structure of Arab demand and what Israel makes. Our country is not a significant producer of the consumer goods they import. There is little demand in the Arab world for the sophisticated industrial products made here and, obviously, Israel does not want to sell them weapons. It is also not easy to compete with foreign suppliers who are already well established in these markets. A global crisis will make penetration even more difficult as the undiversified economies of the oil-producing countries are likely to be hit even harder than is the case with today's low oil price.

Furthermore, even in countries to which Israel can export, many Arabs are not keen to buy Israeli products. Some integration into Middle Eastern markets is possible, but no matter what scenario one works from, no major change in Israel's economy will result from the total opening of all Arab markets to Israeli products. A new economically powerful Middle East or a Middle Eastern Common Market as a significant international economic power is a fantasy.

### **Multinationals and Venture Capital**

This does not mean that the Peace Process, particularly the first Oslo agreement, did not initially influence the Israeli economy. With the demise of the Arab boycott, a number of multinationals which formerly refused to invest in Israel have become interested in Israel. This process is continuing.

Is it good or bad to have multinationals acquire participation in local companies? This development is actually a very mixed blessing. Provided there are not too many such cases, the main benefit has been to bring more sophisticated management techniques into the country. Such relationships also provide important outlets for exports. However, the acquisition of too many Israeli firms by multinationals becomes dangerous because major decisions, such as with regard to investment and divestment, are made elsewhere. Corporate headquarters decisions also usually include where to locate the more advanced activities like research, which are often kept in the multinational's country of origin.

Other foreign investors that have increased their involvement in Israel in recent years are the

venture capital companies. Even if they are also influenced by the caution now prevailing worldwide, they have realized Israel's potential in this field. They are unlikely to drop out totally, even if few companies have had the success of Mirabilis, an Israeli start-up without any sales, which was sold to America On Line for \$400 million.

One hears much now about venture capital companies becoming more selective in their investments and valuing Israeli companies much lower. This is part of the global change in market forces. It would be wrong to consider this as a radical turnaround in the international perception of the specific potential of Israeli high-tech.

A further reason why the Peace Process has been important in the past is the opening of markets in such major countries as China and India to Israeli exports. These countries were accessible before, but much less so. Whether the Peace Process now progresses or stagnates seems to be irrelevant for exports to these markets.

An additional positive aspect has been the appearance of the major international auditing firms on the Israeli scene, a development which further connects Israel to the mainstream of the international business community.

The gyrations of the Peace Process also influence where Israel's foreign workers come from. If terrorism remains high, the number of Palestinian workers will remain low, requiring the import of more workers from Romania, Thailand, etc. When terrorism declines, the number of Palestinian workers in Israel increases. In principle, this is preferable because these workers go home at night to sleep, in contrast to the situation in many European societies which are struggling to cope with and integrate foreign workers into their societies.

### **Privatization**

In this period of uncertainty, what can we expect from the Israeli government in the field of economics? One major area in which the government has taken a strong stand is that of privatization. With regard to this endeavor, there is no great difference between a so-called right-wing government like that of the Likud and a so-called socialist government like that of Labor. Both are in favor of privatization, mainly because they have understood that the government, with its unsophisticated management methods and bureaucracy, is not very well equipped to develop businesses.

Undoubtedly, the main achievement of the Ne-

tanyahu government in this area has been the privatization of Israel's largest bank, Bank Hapoalim. In August 1997, a consortium of investors acquired 43 percent of this bank's capital for \$1.4 billion. In the past five years, bank privatization revenues have reached \$4.5 billion (with an expected \$2-2.5 billion still to come from further holdings to be privatized in the future). The control of two other major banks, Discount and Leumi, is still in government hands. The privatization of Bank Discount began in mid-1998. However, in today's uncertain market, this seems to have come to a virtual standstill.

Bank Leumi, Israel's second largest bank, is scheduled to be privatized in 1999. Whether this eventually succeeds is much more dependent on world financial markets than on the speed at which the Peace Process develops. Let us recall that while it took little time to nationalize the majority of the banks in the early 1980s, it will take more than fifteen years to reprivatize them all. This is one more demonstration of how long it sometimes takes to remedy economic errors.

In addition, hardly any of the acquirers and candidates for acquiring the state-owned banks belong to the international banking community, where one would expect the likely candidates to come from. Big banks are conservative by nature, and thus not yet ready to invest in Israel (though, surprisingly, some of them do invest hundreds of millions of dollars in acquiring banks in Balkan countries which, in this author's opinion, are likely to be in for much greater future shocks than Israel). Most probably at a future date, when the political situation becomes clearer, major international banking groups will attempt to acquire control of these privatized banks, which are thus likely to change hands again. (In the meantime, the intermediary acquirers can streamline these—for Israel—large entities, increase their profits, and plan to exit in five to ten years with a sizeable capital gain.)

### **Monopolies**

Privatization's natural companion is the fight against monopolies. Perhaps the most spectacular development in recent years has been the privatization of the telephone monopoly, Bezek, and thereafter the introduction of competition in the field of international telecommunications. One can now call the U.S. and Western Europe from Israel at rates of between 15 and 25 U.S. cents per min-

ute, including a value-added tax of 17 percent, which is not an expense for a business. It costs less to talk from behind one's desk for an hour to a business contact abroad than to sit with him in a decent cafe somewhere for the same time and buy him and oneself a drink or two.

Similarly, the cellular telephone market, in which the Motorola monopoly ended a few years ago, is being opened up to a third competitor. It has also been announced that the Bezek monopoly in the domestic telephone market will be terminated.

There are still sizeable monopolies remaining in Israel, both in the business sector and outside it. Several of these pockets of inefficiency and bad management are substantial, although some of the most notorious ones, such as the companies formerly owned by the Histadrut trade union and, to a lesser extent, the Jewish Agency, have been drastically restructured and privatized during the last decade.

The disappearance of the Histadrut as a major owner of businesses has done the country much good; it has also strengthened the Histadrut as a trade union. Major remaining monopolies in Israel include the Electric Corporation and the bus companies. Eventually something must happen there as well, although it is not clear when that will be.

Government services in Israel are still largely inefficient. Sometimes, however, miracles do happen: if an Israeli applies for a new passport, it is sent to him by mail within a few days.

Another area of great economic inefficiency is the world of sport, now heavily intertwined with the world of business. It needs restructuring and better management as well.

### **Tax Reform and Currency Liberalization**

One major economic issue for the current government has been tax reform. In Israel, ministers of finance are not usually economic or financial experts but politicians. The main economics experience of the recently resigned finance minister, Yaakov Neeman, who was not a politician but a corporate lawyer, lay in the field of tax law. It was therefore not surprising that his priority was to overhaul the existing tax system by creating a broader tax base, abolishing many exemptions, and lowering the marginal corporate tax level from the present 50 percent to a rate somewhere in the high 30s. Neeman had announced such a tax reform early in 1998. More recently, however, it became

clear that this was not going to be approved before the forthcoming elections.

The Fall 1998 devaluation of the shekel and with it the acceleration of inflation, which undid part of the Central Bank's stabilization policy, has made it clear that another major government target—liberalization of the currency—is a particularly dangerous game in a small country that is not part of any major economic grouping. Israel is neither Europe nor the United States, which can put up a strong fight against currency speculation.

### Where is the Economy Going?

So where is Israel going economically? First, privatization will be heavily influenced by the situation in world financial markets, even if the prime minister's office has said that obtaining a high price is not the prime consideration in the further privatization of the banks. This had to be made clear as, for instance, the shares of Bank Leumi had by early December lost well over 25 percent of their dollar value over a few months and its market capitalization is below net worth. But if the world financial markets will be bad in 1999, the government may not be able to find the minimum number of candidates in a tender for its privatization.

Tax reform, as noted, has been delayed. Currency liberalization may have to be undone somewhat. Keeping inflation down also seems to have failed temporarily. While 4 percent was the 1998 target, the actual inflation rate is likely to be more than double that figure. At least, one should be careful not to let destabilization get too much out of hand.

The world financial community considers the control of inflation to be a key indicator of government competence. The IMF is no longer a very crucial player here as it has so often given bad advice in so many countries, but leading international merchant bankers hold much the same view. The latter have much more confidence in the Governor of the Bank of Israel than in the government. There are voices, many of which come from Israeli economic lobbies, to curtail the Central Bank's powers. In the long run, and perhaps even in the short run, this is not going to do the country's economy any good. Even if politicians may be tempted for short-term reasons to consider inflation control a secondary issue, the Bank of Israel is likely to stand firm on this point. This explains in part why the present governor enjoys higher credibility abroad than in Israel.

### Entrepreneurship

Israeli entrepreneurship has taken a quantum leap in the last decade. Many start-up companies have invested heavily in research and development in recent years. Their products will reach the markets in the coming years and increase Israeli exports. A new generation of entrepreneurs is ready to go out and start new companies, even if financing them may become increasingly difficult.

About 100 Israeli companies are listed on U.S.A. stock exchanges, with Israel being second only to Canada among the foreign countries listed there. It may reasonably be expected that additional Israeli companies will be introduced there in the coming years.

Venture capital investors, whom it was difficult to bring to the country, have seen that, in some cases, Israel is one of the best countries in the world to invest in. In the high-tech sector it is certainly more attractive than most European countries. High-tech development is an unstoppable process. Once people have acquired experience and a methodology in this sector, its overall growth is assured, from the present "start-up" level, whatever happens in the world market.

Yet we should not let ourselves get carried away. High-tech alone cannot lift Israel toward higher per capita GNP levels. However, its contribution toward changing Israeli business attitudes goes beyond its sheer economic aspects. Israelis coming into contact with the cutting edge of advanced technology and management methods have a multiplier effect on the whole economy through which their skills permeate over time. This is particularly important as Israel badly needs a much more rapid improvement in management culture in all segments of society.

One of Israel's handicaps in the high-tech sector may turn out to be an advantage. It is logical that high-tech companies first try to penetrate the domestic market with their products. One Israeli entrepreneur has pointed out that if he starts at the same time as a U.S. or German entrepreneur, his market would be saturated well before the others. Israeli companies are thus forced to acquire international experience rapidly. This is tough, but once you have done it, it puts you ahead of similar-age companies from other nations. Several hundred Israeli high-tech companies now have subsidiaries or offices in the United States. Two decades ago one probably could count these on the fingers of one's hands.

### The Role of the Diaspora

Israel's unique political situation has always influenced its economy. Riparian trade is the normal pattern, i.e., most nations supply goods and services mainly to their neighbors. In the early stages of its development, trying to create something out of nothing, Israel could not do this because of the Arab boycott. It had to find markets far away, making a major effort to use all the resources at its disposal.

The diaspora thus played a crucial role in the country's economic development. In the late 1960s, if one spoke about important foreign investors, one associated this with private American Jewish investors such as Victor Carter or Sam Rothberg, who certainly have made major contributions to Israel's development.

Today, when we speak of foreign investors, we mention Volkswagen, Siemens, and Assicurazioni Generali, even if Jews from abroad are still very important. Recently, more than seventy foreign businessmen received the Jubilee Award on the occasion of Israel's 50th anniversary. All had invested more than \$50 million in the country and many had no Jewish connection.

Similarly, twenty years ago there were hardly any foreign investors on the Tel Aviv stock exchange. The few were mainly foreign Jews. Some Israeli banks, almost pathetically, were trying to interest minuscule U.S. investment clubs into putting amounts as small as a few hundred dollars a week into the Israeli stock market. Today, the Israeli market is important enough that some major foreign financial institutions employ a special analyst for this market.

The more Israel develops, the less important the diaspora's economic contribution will become. This is not necessarily true for the overall connection with the diaspora, however, since economics is only one aspect of this complex relationship which includes political, religious, and academic connections.

### A World of Uncertainty

Israel finds itself today at a moment of great economic uncertainty in the world. Pessimists write about the collapse of the Chinese or even the Japanese economy. They forecast long periods of worldwide low growth of perhaps 1 percent per year or even less.

Any major global turmoil will undoubtedly affect Israel as well. Many specific impacts are possible as well. To mention one more, just to indicate how many factors are at play here, a major upsurge of anti-Semitism in the former Soviet Union may lead to a rapid increase in aliya.

With that may come economic growth as well as a further increase in unemployment. To the extent that one can be sure of something, it is clear that Israel has built itself an industrially diversified export market with a major geographic spread. It seems that its vulnerability to future world events is not too serious; nor is it likely to be able to escape what happens on the global scene. It is impossible to quantify the probability of anarchy ruling the world's financial markets. However, such a scenario cannot be altogether excluded.

In the final analysis, Israel's political and economic leadership will have to make a concerted effort to float in what may be stormy seas. However, Israel's situation is not so bad compared to that of many other countries.

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