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Israel and the Financial Crisis

While many European countries are experiencing hard economic times, Israel is sailing through the world-wide financial crisis relatively smoothly. In fact, Israeli leaders like to congratulate themselves these days on having come out of the crisis only slightly and briefly scathed. GDP growth declined from 4% in 2008 to 0.7% in 2009, but in 2010 it rose again to more than 4%. Unemployment increased from 5.7% in 2007 to 8.0% in 2009, but declined to 6.3% by mid-2010[2]. What lies behind the Israeli leaders' self-congratulation is the claim that the measures taken in the years 2001-2003 helped soften the impact of the financial crisis that erupted in 2008, shorten its duration and avert the fate now faced by countries such as Greece and Ireland. Shlomo Swirski analyzes the steps taken by the Israeli government during the above mentioned period and the impacts of this strategy on the short and long-run.

Elementary facts about Israel

The State of Israel has a population of 7.5 million, more than Denmark, Finland and Norway, and less than Austria, Sweden, Portugal and Greece. Its GDP, at $200 billion, is similar to that of Portugal and Finland, while its GDP per capita, at $29,000 (PPP) is similar to that of Greece and larger than that of Portugal. It has an export oriented economy, with high-tech products constituting about half of its industrial exports and more than half of its business service exports. The burden of defense expenditures is high, at 7% of GDP, compared to 1.2%-1.4% in most Western European countries; about 20% of that is funded by the US. Twice in the last two decades, the US also provided Israel with guarantees which allowed the Israeli government to raise loans at a relatively low cost. Inequality is higher than in most OECD countries, and so is the poverty rate, with two groups standing out: Orthodox Jews and Palestinians who are citizens of Israel. The social safety net resembles Western European ones, but benefits are considerably lower.

What happened in 2001-2003 in Israel?

First there was the burst of the world-wide hi-tech bubble – a crisis that did not last long - and then the Second Palestinian Intifada, which lasted longer and had a much more profound effect on the Israeli economy and society (as well as on the Palestinian side): There were two years (2001 and 2002) of negative GDP growth and three years (2001-2003) of negative growth in GDP per capita. What happened in 2001-2003 is a perfect example of

Ramat-Gan stock market. Photograph: Nadavi Noked.

Israel's double economic jeopardy: Like all other countries, it is exposed to the danger of world-wide economic crises, such as the present one. In addition, it is exposed to the danger of economic crises that are due to regional political violence, such as Palestinian uprisings against the continued Israeli occupation. In the early 2000's, while European and North American economies were coming out of the hi-tech crisis relatively fast, Israel plunged into an economic contraction, due to the Intifada. There was a fall in tourism, in foreign investments and in local consumption. In addition, there was a rise in military expenditure.

The Israeli government reacted by doing what Greece and Ireland are forced to do now: It cut social expenditures – on education, health and most of all on the safety net. Hardest hit were unemployment benefits, child allowances and income maintenance payments. Finally, retirement age for men was moved from 65 to 67 and for women from 60 to 64.

[1] Dr. Shlomo Swirski is a sociologist and the academic director of the Adva Center, Tel Aviv. His presentation was made on December 15, 2010 at the Rosa Luxemburg Forum, Tel Aviv, together with Dr. Thomas Sablowski, who spoke about "The World Financial Crisis: A German Perspective" (see www.rosalux.co.il/sites/default/files/Crisis of global capitalism - T Sablowski.pdf).

[2] All international statistics are taken from the IMF and the World Bank; Israeli figures are taken from the latest (2010) *Statistical Annual* of Israel's Central Bureau of Statistics and from the following publications of the Adva Center: *Israel, A Social Report 2010*; and *Workers, Employers and the Distribution of Israel's National Income*, 2009. Both publications can be found at www.adva.org.

Even at the time, it was clear that the government was overreacting. Many of those steps were not really vital; after all, the Palestinians never threatened Israel's national security. Furthermore, it was clear even at the time that Israel was overreacting militarily. But the government, then led by Prime Minister Ariel Sharon and by Minister of Finance Binyamin Netanyahu, seized the opportunity created by an atmosphere of national crisis to enact a series of steps that fit the fiscal recipes of the Washington Consensus: Downsize the state, cut down the state's budget, lower workers' compensation, minimize the cost of the safety net, privatize governmental functions. The shock of the Intifada helped present those not-really-vital steps as necessary to put the Israeli economy back on track.

That the severe budget cuts were not absolutely necessary is evidenced by the fact that at the very same time that the cuts were being made, Sharon and Netanyahu also embarked on an ambitious program of tax cutting, to last from 2003 to 2010 (and extended this year up to 2016), aimed at reducing the top marginal income tax rate from 50% in 2003 to 45% in 2010 to 39% in 2016, and the corporate tax from 36% in 2003 to 25% in 2010 to 18% by 2017. The cuts in the corporate tax were made in the hope of reproducing in Israel the by now failed "Irish miracle" while the cuts in the income tax were quite openly presented as a way of giving the entrepreneurial and managerial class a reason to stay in Israel – rather than emigrate to higher incomes and a more secure environment in the Californian Silicon Valley. To balance the cut, the government also introduced, for the first time, a tax on capital gains, but this tax has so far failed to produce significant income for the treasury.

There was more to come: Taking advantage of the atmosphere of national emergency, the government nationalized some of the pension funds, up to then run by the labor unions, then sold them to private insurance companies, and allowed them to invest a higher proportion of the savings in the capital market (as opposed to the previously obligatory investment in government bonds). The move had been long coveted by the treasury and by the big Israeli business groups, as a new source of business credit. The cost of credit did indeed go down, but so did the value of individual retirement pensions, due to much higher handling fees now charged by the insurance companies.

What did the "structural reforms" of the early 2000's accomplish?

The government likes to say that they brought about renewed growth: Beginning in the last half of 2003 and lasting until the last quarter of 2008, the Israeli economy grew at an average annual rate of close to 5%. But was this economic growth really the result of the severe budget and tax cuts? Not according to the research department of the Bank of Israel. According to the Bank of Israel, the reasons behind that impressive growth were, first, the military suppression [my wording] of the Intifada, and, second, the expansion of the world economy in those years, following the recovery from the burst of the hi-tech bubble. The Netanyahu fiscal reforms were placed by the Bank of Israel only third in the order of importance.

What else did those "structural reforms" accomplish?

First, they caused a steep rise in the poverty rate, from a high of around 17% in 2000 to an even higher rate of 20% in 2004; the poverty rate has remained at the new level ever since. The share of workers in the national income declined from 66% in 2000 to 60% in 2005, and has remained at that level ever since. There was a further shrinking of the middle class, which decreased from 28.7% of families in 2000 to 26.6% of families in 2009. Universities and colleges lost teaching positions equal to those of one full large Israeli university. Israeli workers lost significant chunks of their future pensions.

At the same time, capitalists gained a larger share of the national income, the compensation of senior executives doubled between 2000 and 2009, and credit became cheaper – a fact that did not necessarily benefit the local economy and Israeli workers, as Israeli investments abroad have topped foreign investments in Israel for much of the last decade.

Did the "structural reforms" help protect Israel from the severe downturn ?

Well, had Israel been hit by the financial crisis the way other countries were, then some of the results of the 2001-2003 "structural reforms" might have helped Israel stand up to the rules of game formulated and imposed by international finance: A low budgetary deficit, a national debt that declined from over 100% of GDP in 2002 to less than 80% in 2008, and a stable international credit rating. But the fact is that Israel was not hit the way European countries were. Israeli banks were only marginally exposed to US sub-prime mortgages; unlike Ireland, Israel did not suffer from an internal real estate bubble; and unlike Eastern European countries, Israel was much less indebted to foreigners. What was hit was the real economy, as Israel's main trading partners bought from Israel - a highly export-dependent economy - less than they did before the crisis. The Israeli leaders who congratulate themselves on the performance of the economy would have us believe that contrary to the proverbial generals who

always prepare for the wars of yesteryear, they had prepared in 2001-2003 for the future war – the present world financial crisis. The only problem is that as far as Israel is concerned, there was no such a war; that is, the crisis did not hit Israeli the same way it hit other countries. What the 2001-2003 reforms did do was not to prepare for a future crisis but rather to help achieve part of the long-standing agenda of the political and economic elite - to lower the cost of credit, to lower the cost of labor, and to roll back the safety net.

Was there an alternative?

Of course there was: Firstly, instead of contributing to the militarization of the Intifada, Israel could have made a bigger effort to contain the violence. Secondly, instead of financing the increase in military expenditures through cuts in social services, it could have been financed by a short-term tax hike; instead, the government opted for a tax cut. Thirdly, instead of placing exclusive emphasis on the well-being of business in a time of (greatly artificial) crisis, the government should have made an effort to safeguard the interests of the population as a whole, with a special emphasis on schoolchildren and students, the source of future growth. Fourthly, the government's increase of the military budget was only a typical knee-jerk reaction, causing social damage on a scale not seen in some of the previous full-scale Arab-Israeli wars. A more balanced policy taking into consideration social and economic interests, not only military ones, might have prevented much of the damage caused by the fiscal policy actually adopted.

Lessons for present-day economies affected by the financial crisis

Though the circumstances are obviously much different, the similarities between what many European countries are doing now and what the Israeli government did in 2001-2003 are too obvious to overlook. First and foremost, such steps are not necessarily aimed at preventing future financial crises but rather at implementing agendas that serve the present interests of the groups in political and economic power. A second lesson calls into question the reigning notion of "Business Above All" and the further notion of "Banks Above Any Other Business". Too many governments have submitted to the knee-jerk reaction of hurrying to save irresponsible banks, and then passing on the cost to the middle and working classes. In so doing, they neglect the social and social-economic costs of a panicky reaction: The loss of confidence in state institutions, amongst them the wage and pension system and the social safety net; the damage to future generations of workers and researchers; the purchasing power of pensioners. In Europe now as in Israel in 2001-2003, the crisis is being exploited to roll back the social achievements of the post-war generations. What Israel did in 2001-2003 fits what Germany is now demanding from Greece, Ireland and other countries in similar straits.

Are there alternatives? Let me point out just one, the most obvious one: To let the delinquent banks pay the price of the damage they have wrought. More and more observers, most of them coming from mainstream business and economic circles, say so. A logical next step would be to establish what the Americans call a public option: As Willem Buiter, a former member of the Bank of England's Monetary Policy Committee and certainly no Marxist, has proposed, the whole financial sector should be turned into a public utility. Because banks in the contemporary world cannot exist without public deposit insurance and public central banks that act as lenders of last resort, there is no case, he argues, for their continuing existence as privately owned, profit-seeking institutions.

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