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With Annexation Looming:

The Vulnerability of the Israeli Economy during Hostilities with the Palestinians

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Information on Equality and Social Justice in Israel

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At the time of writing, it is not at all clear how the much discussed annexation by Israel of occupied territories, currently set for July 2020, will play out. Will there be annexation or not, and, if so, what will it entail and how extensive will it be? Also unknown are the reactions to Israeli annexation by the Palestinians, Arab countries, European countries, and others.

Unilateral action at any time is a recipe for exacerbating the conflict and harming Palestinians. And harming Palestinians ultimately harms Israel as well.

This paper focuses on the vulnerability of the Israeli economy during active confrontation with the Palestinians, which could compound the economic crisis brought on by the coronavirus pandemic.

The Palestinians, as always, will be the main victims, whether due to the overwhelming Israeli military force or because most clashes take place on Palestinian territory.

Much of the data below relate to the period of the Second Intifada, which, combined with the 2000–2001 global hi-tech crisis, led to an economic recession that the Bank of Israel called the most prolonged in Israel's history. "In contrast with 2001," it noted, "when the loss of GDP due to the Intifada was similar to that incurred as a result of the fall in demand for Israel's exports, in 2002 the Intifada was the chief cause of the contraction of economic activity."[1]

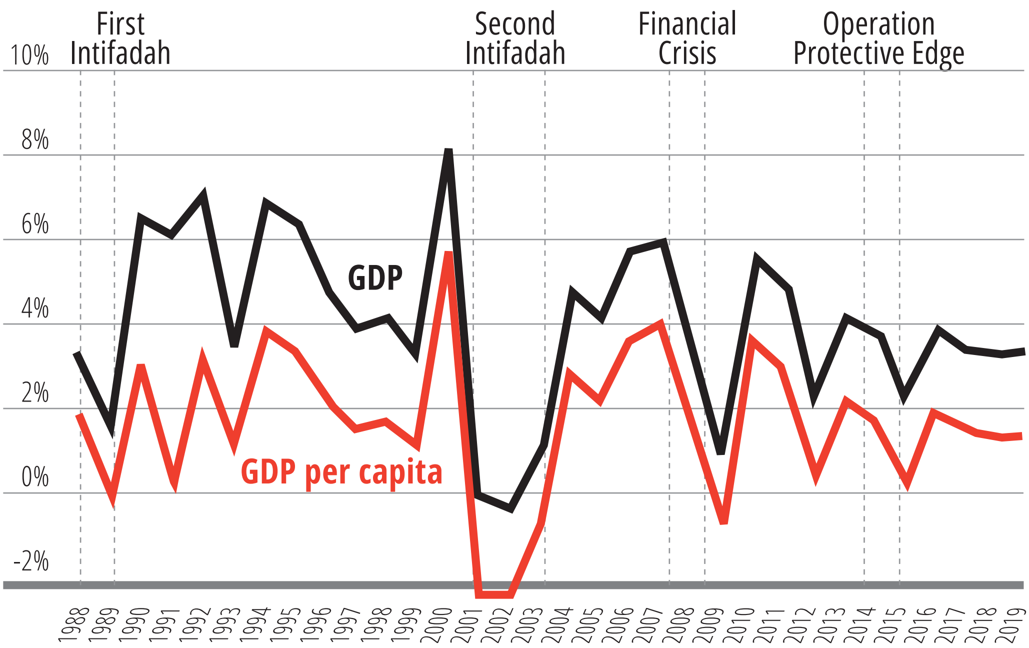
The Israeli economy, largely based on foreign trade, is vulnerable to double crises – those resulting from worldwide developments and those particular to Israel, triggered by endless violent clashes with the Palestinians. A similar dual crisis could happen again if Israel's declaration of annexation leads to widespread Palestinian resistance just when Israel is grappling with the economic fallout of the coronavirus pandemic.

1 Bank of Israel (2002). *Annual Report 2002*. Pg. 1. https://www.boi.org.il/en/NewsAndPublications/RegularPublications/Documents/Doch2002/pe1_2_1.pdf

On 6 April 2020, the Bank of Israel forecast that "gross domestic product (GDP) is projected to contract by 5.3% in 2020, and to grow by 8.7% in 2021." On 6th July 2020, the Bank published an update of its forecast, estimating that the contraction of the economy would be 6% and growth 7.5% in 2021.[2]

This forecast is based entirely on the economic repercussions of the coronavirus pandemic. If Israel's declaration of annexation leads to violent clashes, the numbers will certainly change. As shown in the figure below, the Israeli economy is affected by both global events and crises that occur in the wake of the Israeli-Palestinian conflict. In 2001 and 2002, the bursting of the global hi-tech bubble combined with the Second Intifada led to two consecutive years of negative economic growth and three consecutive years of negative per capita GDP.[3]

Economic Adversity: Roller Coaster Economic Growth and Losses in GDP and GDP Per Capita, 1988–2019



Sources: Adva Center analysis of data from the Central Database of the Central Bureau of Statistics, 15 March 2020.

2 Bank of Israel (6 April 2020). *Research Department Staff Forecast* April 2020. Press Release.
Bank of Israel (6 July 2020). *Research Department Staff Forecast* July 2020. Press Release..

3 Swirski, S. (2005). *The Price of Arrogance*. Tel Aviv: Mapa, pp. 114–116 [Hebrew].

A good credit rating fosters growth, as it lowers the cost of financing investment. To get a good credit rating, several criteria must be met, including financial stability and strong fiscal performance.

Political conflict undermines this stability. Israel has never had a perfect credit rating (AAA), but has generally made do with a rating of A, and has sometimes scored lower (A-) or higher (A+). Although Standard & Poor's, the largest international credit rating agency, did not lower Israel's rating during the Second Intifada, this was due to $9 billion in American loan guarantees to Israel.[4] When the Israeli economy began to recover after suppression of the Intifada, Standard & Poor's raised Israel's credit rating so that by August 2018, it was AA- – the highest in its history.[5]

The coronavirus pandemic threatens to lower this rating just as it threatens most countries. In the case of Israel, however, the proposed annexation adds a special risk in the form of political instability. "You would have received a higher credit rating were it not for the security issue," said the representative of Standard & Poor's on the occasion of upping the rating.[6]

4 In 2003, the US government authorized $9 billion in loan guarantees to Israel. These guarantees enabled Israel to issue bonds in the US market at low interest rates – the same rate as the US government – to raise capital for ongoing activity. The United States provided the guarantee that Israel would be able to pay when these bonds were redeemed. These loan guarantees greatly improved Israel's position in international capital markets.

5 https://tradingeconomics.com/israel/rating.

6 Barkat, A. (5 August 2018). You would have received a higher credit rating were it not for the security issue, *Globes* [Hebrew].

Tourism is the economic sector that is most adversely affected by the lack of political accommodation with the Palestinians. When Israel closed its borders due to the coronavirus pandemic, tourism virtually ground to a halt, as did tourism in other countries. Today there are indications that the borders may be re-opened and flights resumed. If annexation goes forward, violent clashes could thwart the recovery of the tourism industry, unlike tourism's recovery in other countries.

During the Second Intifada, the number of tourists entering Israel annually dwindled to fewer than one million. It took years to reach the point where Israel hosted as many as three million tourists a year. This number then held steady for about a decade, until 2017, 2018, and 2019, during which tourism steadily grew, reaching 4.6 million entries in 2019.[7] To regain the loss caused by the coronavirus pandemic, Israel needs not only to beat Covid–19, but also to remain free of conflict.

7 Rozen, A. (6 January 2020). 2019: 4.6 million tourists visited Israel, 4.3 million Israelis travelled abroad. *Ynet* [Hebrew].

Economic recession generates unemployment. At the time of the coronavirus outbreak, the unemployment rate in Israel was a low 3.4%,[8] thanks to years of economic growth, even though the growth itself was low. With coronavirus, more than a million women and men suddenly found themselves unemployed – dismissed or sent home on unpaid leave.[9]

Unemployment also soared during the economic crisis of the Second Intifada, but at a much reduced rate – just over 10%.[10]

Should a violent conflict erupt over annexation, lowering the unemployment rate will be more difficult than it is today. Even without annexation, the Finance Ministry finds itself repeatedly extending the period of entitlement to unemployment insurance.

8 This was the average rate of unemployment at age 25–64 in 2019. Bank of Israel (25 May 2020). *Research Department Staff Forecast May 2020*. Press Release.

9 In April 2020, the number of job seekers was 1,151,185 men and women. Government Employment Service (2020) [Hebrew]. Keshet Ha-ukhlusiyot – April 2020, data file.

10 For complete statistics, see the *Statistical Abstract of Israel 2019*: https://www.cbs.gov.il/he/publications/doclib/2019/9.shnatonlabourmarket/st09_01x.pdf

Unemployment insurance is one of the most important components of the social safety net. The modern economy is subject to regular fluctuations, even in normal times. In Israel, as we saw, economic crises are the product not only of the cyclical fluctuation of economic activity, but also of frequent clashes with the Palestinians.

Unemployment insurance is meant to assist those who have lost their income and to allow them to live in dignity during these periods. And yet unemployment insurance in Israel was slashed as part of the austerity policies adopted by the government after the Second Intifada. In 2002 and 2003, the allowance was cut by 4%, eligibility during vocational training was greatly reduced, the period of employment that enabled entitlement was doubled, and the term of eligibility was shortened.

Today, the government is grappling with unemployment by extending eligibility for insurance beyond the period set by law.[11] If the economic crisis caused by the pandemic continues through a government's decision to annex Palestinian territories, the rate of unemployment is expected to remain high and many of the unemployed may find themselves without government support.

11 This was set until the end of May for those who claimed unemployment insurance, based on calculations of individual eligibility for those dismissed during the lockdown or not yet back to work after leave without pay. National insurance Institute, 23rd June, 2020
https://www.btl.gov.il/About/news/Pages/haract-avtala.aspx.
As of June 30th the Israeli government announced unemployment insurance entitlement will be extended until mid August, but has not yet authorized it.

An economic crisis reduces a country's revenues from taxes. And lower revenues undermine the government's ability to provide services.

The Second Intifada lowered state revenues from taxes, increased the deficit to 5.7% of GDP, and saw government debt climb to 104% of GDP in 2003.[12] These numbers damaged Israel's credit rating. As we have seen, a previous remedy was US loan guarantees. In response to this crisis, the government embarked on a policy of fiscal austerity of the type adopted by the European Union following the global financial crisis of 2008, which affected many countries, most notably Greece.

Fiscal austerity helped lower the national debt from more than 100% during the Intifada years to 60.5% of GDP in 2018, along with a small budget deficit – 3.7%.[13]

These austerity policies had a serious adverse effect on social services.

Political instability that might follow a declaration by Israel of the annexation of Palestinian territory could further deepen the fiscal crisis in which Israel has already found itself due to the pandemic. The Bank of Israel already expects the national debt to rise to 74% of GDP in 2020 and the budget deficit to grow to 11.5% of GDP,[14] based solely on the adverse effects of the pandemic. Adding an economic crisis due to renewed Israeli-Palestinian clashes would only worsen the numbers and further harm social services.

12 Swirski, S. (2005). *The Price of Arrogance.* Tel Aviv: Mapa, pp. 114–116 [Hebrew].

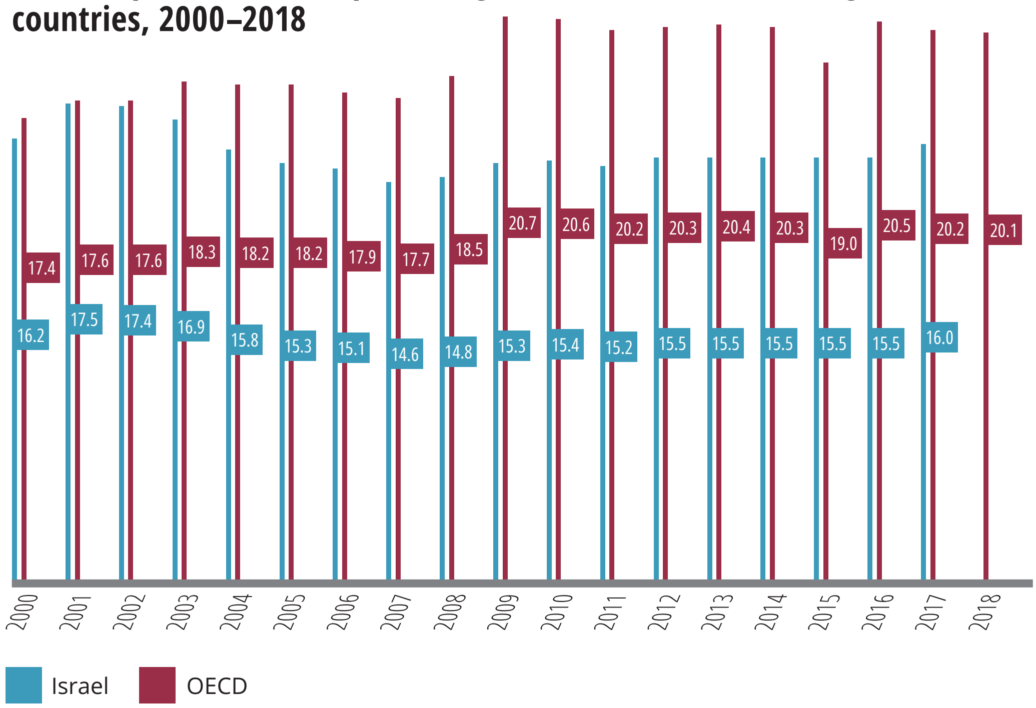
13 Ministry of Finance. Accountant General. Debt Management Unit, *Annual Report*, various years [Hebrew].

14 Bank of Israel (25 May 2020). *Research Department Staff Forecast May 2020.* Press Release. [Hebrew].

Fiscal austerity led to a rapid decline of the national debt, from 104.9% of GDP in 2004 during the Second Intifada to 60% of GDP in 2019.[15] A small public debt may calm investors, but it reduces the state's ability to invest in education, health, housing, and social security.

Israeli government spending on social programs is one of the lowest among OECD countries. In 2001, before instituting fiscal austerity policies, Israel's spending on social programs stood at 17.6% of GDP – equal to the average in OECD countries – while in 2007, following fiscal austerity, social spending amounted to only 14.6% of GDP. This figure did increase over time, but less than the increase in OECD countries, and the gap remains large between Israel and these countries.

Social expenditures as a percentage of GDP, Israel and average of OECD countries, 2000–2018



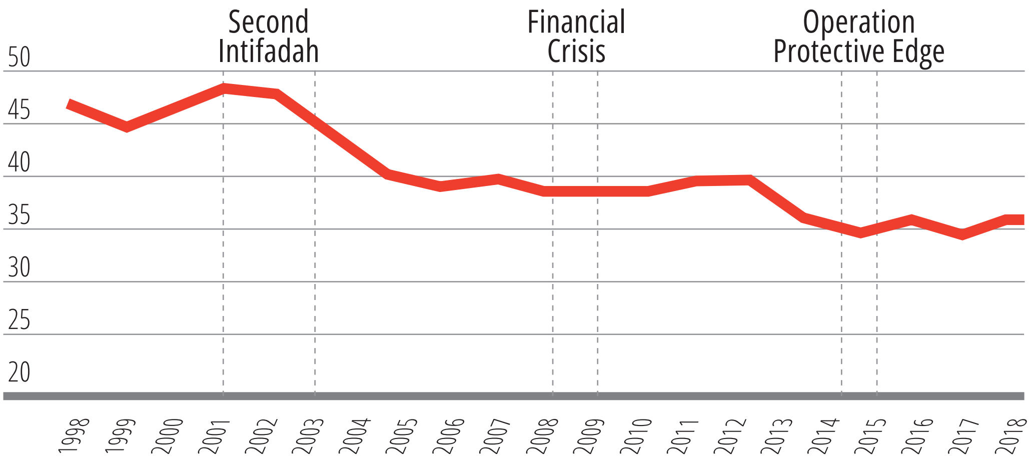
Notes:
1. Social expenditures include transfers (allowances, earned income tax credits) and expenditures on in-kind services provided by the national and local governments for education, health, welfare, employment, and housing.
2. The most recent figures for Israel are for 2017.

Source: OECD (2020), Social spending (indicator). Doi: 10.1787/7497563b-en (accessed 7 May 2020).

15 Public debt includes local authorities. Finance Ministry, Accountant General, Debt Management Unit, *Annual Report 2004* [Hebrew]; Finance Ministry, Press Release. The Accountant General published the first estimate of the debt-to-GDP ratio in 2019, 20 January 2020 [Hebrew].

The main casualty of the fiscal austerity policies has been the social safety net. This was the result of the long-term erosion of almost all the allowances due to a change in the mechanism for updating the allowances, from linkage to the average wage to linkage to the Consumer Price Index, which rises more slowly than the average wage.

Effect of government transfer payments and taxes on reducing the incidence of poverty, 1998–2018 (In percentages)



Source: National Insurance Institute. *Poverty and Social Gaps – Annual Report*. Various years.

As noted by Esther Toledano of the National Insurance Institute, "In 2002–2003, the government profoundly altered its social policies – deeply rooted welfare conceptions formed over two and three decades, such as ensuring an adequate standard of living for recipients relative to the entire population, were suddenly abandoned... The new policy riddled the social safety net with holes and erased the achievements of many years."[16] The social safety net, which is supposed to help lift families out of poverty, now fails to reduce poverty to the extent that it once did: If on the eve of the Second Intifada the safety net managed to extricate 47% of families from poverty, fiscal austerity following the Second Intifada brought that number down to 35% (2018).

16 National Insurance Institute. *Annual Survey 2004*. Jerusalem.

In recent years, improvement was recorded in some of the allowances. However, if annexation evolves into a conflagration, it will be hard to cope with deepening poverty as low-income earners are already disproportionately affected by the coronavirus pandemic.[17]

17 Bank of Israel (14 June 2020). Research Department Special Analysis: *An analysis of the adverse impact on households' employment due to the coronavirus.* Press Release [Hebrew].

The Israeli economy is heavily tilted toward export. About a third of Israel's production is exported, the largest portion to Europe: In 2019, 43% was sent to Europe – 36% to countries of the European Union and another 7% to European countries not in the EU.[18] Over the past decade (2009–2019), export to EU member states grew by 5%, while export to North America, Israel's second largest trade partner, declined from 37% in 2009 to 27% in 2019.

It's no secret that the EU has serious reservations about Israeli settlements and favors establishment of a Palestinian state. At a discussion of foreign ministers of EU countries on May 15 this year (2020), possible responses were discussed to the US-backed Israeli annexation of settlements. Several countries called for the EU to begin an inventory of joint ventures with Israel that could be affected if Israel undertakes unilateral measures that contravene international law.

Sanctions on trade with Israel by the EU or other European countries would damage Israel's economy. Although Israel has had some success in diversifying its export targets, particularly increasing exports to Asia by 4% over the past decade, dependence on exports to Europe still looms large.

On 10 June this year, the German foreign minister visited Israel. Based on media reports, the main message of his visit to Israel was opposition to annexation and a warning of sanctions under consideration by some EU countries.

18 Ministry of Economy and Industry 30 December 2019, *Foreign Trade 2009-2019* [Hebrew]. https://www.gov.il/he/departments/news/2010s-israeli-export-summary;

Annexation could jeopardize Israel's ongoing cooperation with the EU and selected countries in research and development.

Since 1996, Israel has participated in a number of European, multi-national, R&D projects. These collaborations are a growth engine for industry and innovation in Israel, and vital for Israeli academia. This cooperation, which came in the wake of the "Oslo Accords," is based on the Essen Declaration from 1994 in which economic relations between Israel and the EU were to be upgraded.

Since 2014, Israel has been a member of the now-ending Horizon 2020 program, even though the membership specifically excluded Judea and Samaria, the Golan, and East Jerusalem. This was preceded by vigorous diplomatic efforts spurred by the desire of the Israeli academy and industry to be part of Europe's foremost R&D program. Over the years, Israel has won the respect of its partners and become a significant player. Indeed, this is one of the European programs in which Israel has an equal standing with the European countries even though it is not a member of the EU.

Horizon 2020 is Europe's eighth R&D program, with a budget of €77 billion over seven years. Israel paid into the program about €1 billion and in return received approximately €1.5 billion for various projects. The program has become one of the growth engines of Israeli R&D for industry and basic research in academic frameworks. In addition to the money, it provided opportunities for cooperation with European research projects in industry and education, as well as direct access to European markets for products and technologies. Israel was an auxiliary member of the program, like Switzerland and Norway, who are not members of the EU.

Thus, annexation also threatens the international standing of Israeli science and research.

Growth

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ment

Unemploy-
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Fiscal
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