Move Over, Singapore

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It has become fashionable to assail Israel's economic policies during the last few years, especially since the onset of the current recession in 1996. Politicians, businessmen and journalists have regularly blasted the tight fiscal policy of the last three years, as well as the contractionary monetary strategy of the Bank of Israel. Yet politicians and businessmen have interests of their own, and it is often hard to tell how much of what they are saying is posturing and opportunism, and how much comes from an honest evaluation of our economic future. One wishes there were a reliable, disinterested source for opinion on just how much confidence one can place in the Israeli economy.

Actually, such a source exists. It is the foreign investor. Foreign firms, mutual funds and individual investors are usually interested in one thing: Making money. If they think a country's economy shows promise, they will invest; if they are skeptical, they will put their money elsewhere. By comparing how different economies succeed in attracting foreign capital, measured as a percentage of their annual Gross Domestic Product (GDP), one can get a rough idea of their relative reputations in international capital markets. Looked at from this angle, Israel's economic standing is surprisingly impressive.

Israel emerged as a target for foreign investors as a result of the economic boom of 1990-1995. After the economic stabilization program of 1985, the Israeli economy went through a period of restructuring; enterprises became more efficient, and whole new industries emerged in software and electronics. Newly competitive, the Israeli economy embarked on a growth spurt in

1990, powered by investment in new productive capacity and coming just in time to absorb the huge influx of immigrants from the former Soviet Union.

Sooner or later, this growth was bound to attract foreign attention. The development of new, technology-based industries meant plenty of opportunities for the smart foreign investor. Economic growth meant that the purchasing power of the Israeli consumer was rising, prompting multinational purveyors of consumer products to team up with local partners, usually by buying a stake in them. In 1995, rising foreign interest in the Israeli economy turned into a torrent of investment. According to the Bank of Israel, net foreign investment rose from about $350 million in 1994 to $1.6 billion the following year, reaching $2 billion in 1996, and climbing past the $2.5 billion mark in 1997. (Foreign investment in Israel fell back some in 1998, to about $1.9 billion, but that year was a bad one for foreign investment the world over; Figure 1.)

To see how Israel stacks up against other countries in this regard, the proper comparison is with its primary competitors for foreign investment dollars. These are the very best of the "emerging economies," a term used by the International Monetary Fund (IMF) for what used to be known as the Third World. In the mid-1990s, economists noted a number of emerging economies in the Asia-Pacific region that were among the world's fastest-growing attractors of foreign investment. Some of them—South Korea, Indonesia, Malaysia, the Philippines and Thailand—have since become the primary victims of the global financial crisis and have been collectively dubbed "crisis countries" by the IMF; others, such as China, are still among the major magnets of foreign investment. Figure 2 compares Israel's foreign-investment performance in recent years with that of crisis countries, as well as with the rest of Asia—the continent whose emerging economies attract more foreign investment than any other.

The first thing to note is that even though these countries are among the major targets of foreign investors, foreign capital amounts to only a small part of their annual domestic product, usually around 3 or 4 percent. Israel has been comfortably within that range since 1994.* More significant, however, is the way foreign investment in these countries was affected by the global financial crisis of the last two years. Foreign investment in the crisis countries turned negative in 1998, as investors fled these economies. Foreign investment in the rest of "emerging" Asia fell as well, to its lowest level during the period surveyed. Israel did better than either group. That means that investors looking for quality investments among the "emerging" economies preferred Israel over the economies hitherto considered the most attractive. Indeed, it is significant that taken as a percentage of GDP, foreign investment in Israel has outstripped both groups every year since 1995.

For some reason, investors in recent years have come to see Israel not as the tumultuous, nearly bankrupt economy it was two decades ago, but as a relatively secure place to put their money—more so than many of Asia's former "tigers." Suddenly, Israel has become a sound investment.

How did it happen?

Israel's performance in attracting foreign investment is not due to any particular policies designed to induce such investment. Rather, the key to attracting foreign capital seems to be the pursuit of sound policies regarding

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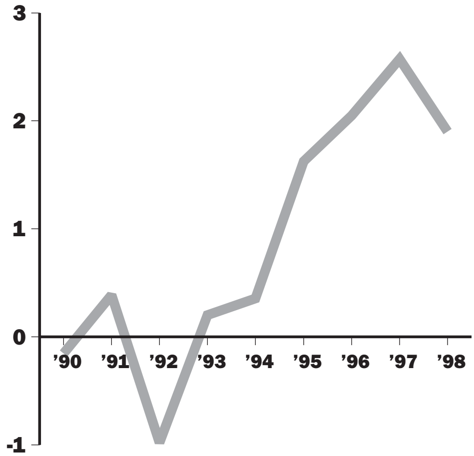
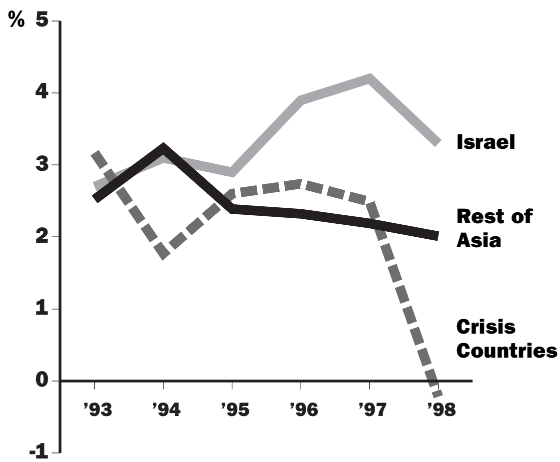
* The figures presented in Figure 1 are based on data from the Bank of Israel, while those in Figure 2 are based on data from the IMF through 1996, and author's calculations based on a modified IMF formula for 1997 and 1998. Different institutions employ different criteria in deciding what constitutes foreign investment. When calculating foreign investment in Israel, the Bank of Israel counts only foreign direct investment and foreign purchases of private firms' shares and bonds, but not government bonds sold abroad, which it does not consider to constitute "investment" in the Israeli economy. However, the IMF, whose data was used to calculate the numbers in Figure 2, does not distinguish between purchases of private and government securities in tallying foreign portfolio investment in a country. Thus, its figures for foreign investment in Israel differ from those of the Bank of Israel, resulting in a disparity in the foreign investment figures for Israel between Figure 1 and Figure 2.

Fig. 1. Net Foreign Investment in Israel, 1990-1998
In Billions of Current U.S. Dollars



Source: Bank of Israel, *1998 Annual Report*.

Fig. 2. Net Foreign Investment in Israel,
Crisis Countries and the Rest of Asia's Emerging Economies
As a Percentage of Gross Domestic Product



Source: Bank of Israel, *1998 Annual Report*; Israel Central Statistics Office, *Israel Statistical Annual, 1998*; IMF, *International Financial Statistics Yearbook, 1998*; individual country tables; and author's calculations. Figures for Israel have been recalculated to approximate IMF methodology.

the fundamentals of the economy as a whole, policies that would be advisable even in the absence of foreign investment.

A recently published IMF study of the causes of the financial crisis in East Asia tried to identify the characteristics of emerging economies that were savaged by the crisis compared to those that escaped relatively unscathed. The study's conclusion was that the crisis countries' overall economic policy was, on the average, notably worse. More vulnerable economies had somewhat higher inflation and looser bank regulation than those whom the crisis affected lightly. The trade deficit and the government's budget deficit tended to be on the increase, while in more fortunate countries their trend was to decline. Yet these moderate differences mattered crucially to countries' ability to retain investor confidence when the crisis struck.

Israel has outperformed most other emerging economies as an attractor of foreign capital because in recent years Israeli economic policy has been, comparatively, a model of prudence. Israel's trade deficit declined from about $12.5 billion in 1996 to half that in 1998. This is partly because the Israeli economy has been in recession, but it is also due to the decline in the government's budget deficit. (Budget deficits increase consumption and tend to increase trade deficits.) Government deficits usually rise in a recession, but cautious fiscal policy has caused Israel's government budget deficit to decline from nearly 5 percent of GDP in 1996 to a projected 2 percent in fiscal 1999, in accordance with the multi-year deficit reduction program adopted by the Netanyahu government in 1996.

Inflation in Israel has also been kept in check, halving between 1995and 1999 to the 4 to 6 percent range. This has been due partly to the declining deficit and partly to the monetary policy of the Bank of Israel, which has not hesitated to raise interest rates to choke off incipient outbursts of inflation. This policy has been unpopular, especially during a recession, but the point is that it has not proven *financially impossible*, as other countries, such as Thailand, have discovered to their cost: Higher interest rates have not undermined the financial stability of Israel's commercial banking sector, which remains, at bottom, robust. While higher interest rates may have delayed the Israeli economy's emergence from recession in 1999, they were not so high as to precipitate a deeper recession.

Fiscal and monetary policy have acted in synergy: Because the budget deficit is shrinking, reducing inflationary pressure on the economy, the Bank of Israel has not needed to raise interest rates as high as it otherwise might have had to in order to halt inflation. The sharpest recent increase in Israel's interest rates was a 4 percent rise in late 1998, a small fraction of the interest rate hikes that *failed* to stabilize the Malaysian or Thai economies in 1997.

A further reason for Israel's overall economic well-being has to do with the health of its commercial banking sector. Israel's banking sector is healthy because regulators—again at the Bank of Israel—have enforced prudent lending rules. Thus, for example, the Bank of Israel prohibits commercial banks from making more than 20 percent of their loans to the real estate sector. A downturn in the property market cannot threaten the solvency of Israeli banks, as similar downturns have in Japan, Thailand, Malaysia, Indonesia and a number of Latin American countries.

Israel has received more than its share of foreign investment in recent years because foreign investors find Israeli firms attractive and Israeli economic policy encouragingly safe. The global financial crisis has caused a worldwide "flight to quality," out of problematic economies and into economies that engender confidence. The flight to quality has meant, relatively speaking, a flight to Israel. In the midst of its own recession and international financial turmoil, Israel has been quietly establishing its reputation as an economy where sudden changes in economic climate seldom happen. Quite an achievement for a country that, fourteen years ago, suffered from triple-digit inflation and teetered on the verge of bankruptcy.

The importance of foreign investment extends beyond its role as an indicator of overall economic health. Investment ensures the future productivity and growth of the economy. When an economy is in recession, local businesses take a relatively dim view of the prospects of future revenue, and invest less. Future growth can suffer. When foreigners invest in the economy, their capital can make up part of the shortfall in domestically generated investment. Since 1994, domestically generated investment in Israel has fallen by nearly 22 percent, considered as a proportion of GDP, to under a fifth of the country's domestic product. Foreign investment has made good a third to a half of this decline, however, mitigating the effects of the recession on the Israeli economy's future growth. When the recession ends, Israel will be better placed to resume rapid economic growth because of this foreign investment.

Foreign investment also makes an important contribution to Israel's balance of payments. Israel regularly imports more than it exports. The excess of imports has to be paid for, usually by borrowing money abroad. If foreign borrowing rises too fast, however, foreign investors may become skeptical about Israel's ability to finance its debts. They may cut off credit to our economy, causing capital to flee, the value of the shekel to collapse and the recession to turn into a deep depression. This is what happened to the Asian crisis countries in 1997 and 1998. However, foreign investment represents an alternative to borrowing money. If foreigners pay Israelis dollars for a share in the ownership of Israeli firms, those dollars can be used to finance imports in place of borrowing. Thus the increase in foreign investment means a decrease in Israel's balance of payments deficit; this, in turn, contributes to the stability of the shekel vis-à-vis other currencies and should cause foreign investors to consider the Israeli economy an even safer bet than in the past.

Some might argue that foreign investment in Israel's economy can be a double-edged sword: After all, what happens if foreigners suddenly decide to liquidate their investments? Actually, this is unlikely. "Investment" means buying the shares or bonds of a foreign company with capital that then becomes available to fund the creation of new productive capacity. Foreign investors are usually reluctant to eliminate such investments. This is true even in the midst of financial crisis; many foreign investors would rather hold on to their investments than sell at a loss. A form of investment that is particularly hard to liquidate in a hurry is "direct" investment, where a foreign investor buys a large share in the ownership of a specific company, rather than a "portfolio" of the securities of many different companies. Unlike the Asian crisis countries, most foreign investment in Israel is direct investment.

The real threat to a country's financial stability generally does not come from the liquidation of investments. When foreigners "pull their money" out of a country, they do so chiefly by calling in foreign-currency loans that they have made to that country's firms and banks, because of sudden doubts about the country's economic stability, and consequently about companies' ability to pay the loans back. Many countries, including Israel, are highly dependent on such loans, which often amount to much more than foreign investment proper. The best defense against the sudden liquidation of a country's foreign debt is, again, sound economic policy, which convinces investors of the government's commitment to economic stability.

The high degree of direct investment in Israeli companies also explains why foreigners are investing in Israel: Because they can't afford not to. A large part of the investment is in Israel's high-technology firms. Partial or total ownership of an innovative Israeli company can give a foreign firm an important advantage in global markets. Some firms invest in Israel to gain a presence in the Israeli market; thus Danone, a large French dairy-products firm, bought 25 percent of the local Strauss dairy company in 1996. The Israeli market is as big and wealthy as Nice and Marseilles put together, and Danone, which is expanding outside France, saw an important opportunity. Danone joins a host of other international corporations which have come to the same conclusion in the last few years: That among the world's leading emerging economies, Israel is simply an investment too promising to pass up.

Even before the elections in May, Israel's successful economic policies were under constant assault. The Histadrut and the emerging social lobby in the Knesset agitated for increased government spending. The business establishment repeatedly attacked the Bank of Israel's interest-rate policy. Real estate developers complained that the Bank of Israel's regulations were "killing off" their sector. It was only with difficulty that the previous government managed to avoid giving in entirely to these importunities and causing serious damage to the economy.

Those who cavil about current economic policy should count their blessings. Last year, the country got a taste of what the price of imprudent economic policy might be. In August 1998, in response to intense political pressure, the Bank of Israel lowered interest rates by a percent and a half. Immediately the shekel began to fall. Inflation started to rise; foreign exchange started to flee the country—shades of Malaysia or South Korea. In October and November, the Bank raised interest rates sharply once more. The exchange rate stabilized, inflation subsided and foreign investment to Israel continued to flow.

Budget season is in the offing, and Israel's new government will be under pressure to "correct the errors of the previous government," in order to "get the economy moving again." Self-serving advocates of irresponsible economic policy will argue that, after all, they aren't calling for very great changes: How bad can it be if the government relaxes its inflation target a little? What terrible things will happen if the budget and trade deficit are permitted to start expanding again, after years of decline? Suffice it to say that, as the experience of Thailand, Malaysia, South Korea and Brazil shows, seemingly moderate changes of this nature, particularly the shift in *direction* from declining to increasing inflation and trade and budget deficits, may be sufficient to turn Israel into a victim of the next worldwide financial panic. The "errors" of Israel's economic policies in the last three years had an excellent rationale, and conferred advantages on the Israeli economy that will become far more evident once they are squandered.

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