

Implications of the Global Economic Crisis

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The world is currently in the midst of a deep economic crisis, the first such crisis of the information age. Economic crises of this kind usually entail two components, a financial crisis and a real economic crisis developing in its wake. The financial crisis stems from a failure in the functioning of the financial system. It is manifested in tremendous monetary losses, in the crash of financial institutions, in the loss of trust in the system, and in low financial supply (a slowdown in the flow of money). The lack of financial oxygen causes increasingly more companies to cancel projects and lay off workers. At the same time, the blow to private savings on the capital market and the loss of employment security cause the public to reduce spending on goods and services. Thus the real economic crisis is created, expressed in a sharp downturn of consumption and product, a rise in business bankruptcies, a reduction in the nation's income from tax revenues, a sharp increase in unemployment, a rise in poverty, and so on.

Crises of this magnitude affect countries' ability to realize their national objectives in a wide range of areas, and may harm their ability to function effectively or even threaten internal stability. The current crisis, at least from the financial viewpoint, is considered the worst since 1929. Then the financial crisis led to the Great Depression, the deepest economic crisis of modern times, which ended only with World War II. The social and political implications of the Great Depression facilitated the rise of fascist regimes, headed by Nazi Germany, and the rise of support for Communism. Today, and unlike in the past, the leaders of the countries with the largest markets

(the G-20) are working vigorously and in coordination with one another in order to halt the economic decline, and are not waiting for the free market to revive itself.

The following essay surveys the world financial crisis and its ramifications for Israel's strategic environment.

The Economic Crisis around the World

As a result of the financial crisis that began in 2007, the American market, together with the economies of the European Union bloc and Japan, skidded into an official recession (i.e., a situation in which negative growth is recorded for two consecutive quarters) in the second half of 2008. So, for example, from the start of 2008 until April 2009 unemployment in the United States shot up from 4.9 to 8.9 percent. In May 2009 the number of those who claimed unemployment benefits reached a peak of 6.66 million. In March 2009, 130,831 bankruptcies were declared in the United States – a rise of 46 percent compared with March 2008 and of 81 percent compared with March 2007. From the beginning of 2009 until the middle of April, 25 banks failed in the United States, compared with 25 for all of 2008, and three for 2007. As a result of the crisis in the large economic sectors, the situation of other countries has worsened as well, and some have required assistance from the International Monetary Fund. In the first quarter of 2009 GDP in the US dropped 1.6 percent (compared with the previous quarter).

Other developed countries are experiencing a dramatic economic low. In Germany, for example, in the first quarter of 2009 the GDP dropped 3.8 percent (compared with the previous quarter); in Italy, 2.4 percent; in Britain, 1.9 percent; and in France, 1.2 percent. The OECD forecast of May 2009 envisions a 4.3 percent decline in the product of member states for 2009, and a drop of 0.1 percent for 2010. OECD predicts that the US will experience an economy recovery before Europe, due to the package of economic incentives offered by the administration and because the financial crisis in the US is at a more advanced stage. Because of the crisis in the large economic groups there has also been a definite worsening of the status of the developing countries, and several have required assistance from the International Monetary Fund. For China the situation is different.

Although it has not escaped an economic slowdown, it is considered one of the few large countries that will enjoy relatively large growth this year – about 6 percent.

The strategy for the various countries trying to cope with the crisis is based mainly on plans for rebuilding the financial systems and stimulating market activity. At the G-20 conference on April 2, 2009, British prime minister Gordon Brown said that the sum total of economic stimuli on the part of various countries around the globe for the next two years is expected to reach \$5 trillion. Another important factor in coping with the crisis is reducing the cost of money (i.e., interest). The largest central banks in the West have lowered their monetary interest almost to zero. This is an aggressive treatment approach whose scale has never before been attempted in the history of economics. This treatment demonstrates the depth of the problem as well as the desire to achieve quick solutions, before the damages due to the crisis deepen. Nevertheless, there are also severe side effects, such as a steep rise in government debt and budget deficits, as well as the danger of a future outbreak of inflation.

The end of the first quarter of 2009 shows some positive indicators in the financial system, such as steady rises in the worldwide shares market, the renewed issue of bonds, a decline in the inter-bank interest rate, and an improvement in the financial reports of a number of large banks in the United States in the first quarter of 2009, compared with the 2008 fourth quarter reports. These indicators are attributed in part to the massive influx of funds to the banks and the low interest rates.

Against this backdrop, on April 14, 2009 Federal Reserve Chairman Ben Bernanke stated: “Recently we have seen tentative signs that the sharp decline in economic activity may be slowing, for example, in data on home sales, homebuilding, and consumer spending, including sales of new motor vehicles. A leveling out of economic activity is the first step toward recovery.”¹ A similar sentiment was voiced on May 11 by his colleague Jean-Claude Trichet, president of the European Central Bank, who said that the world economy is near a turning point.

Not all experts share this optimism. Prominent among the less sanguine is the economist Nouriel Roubini, who was one of the few to foresee the crisis. On April 8, 2009, Roubini estimated that we cannot yet see the light

at the end of the tunnel, and that the Wall Street bear market is not yet over. In mid April he said that the rate of global shrinking of economic activity had indeed slowed down in recent months, but the decline in activity continued. The problems of the financial sector in the United States have not yet emerged fully, and the total sector losses are expected to grow to \$3.6 trillion, compared to the \$1 trillion loss to date. He estimated that in 2010, the rate of unemployment in the United States is liable to exceed 11 percent and the rate of growth will be only about 0.5 percent.

Strategic implications

Despite the fact that the crisis started in the United States, its standing as a world power has not been affected. Indeed, what stands out is the administration's ability to put strong measures in place, so that the American economy is likely to be the first to emerge from the crisis. On the other hand, the crisis has sharpened the problematic status of the EU (i.e., a uniform economic policy does not suit every country), and has emphasized the weakness of nations suffering from shaky economic mechanisms (such as Russia).

China is maintaining its strength. Although the economic slowdown has not passed it by, China is considered one of the few large countries that in 2009 will enjoy a relatively high growth rate in comparison with the rest of the world. At the same time, the crisis has emphasized the economic interdependence between the United States and China. For China, the United States represents a major export market and a source of new technologies, and thus is an important factor in Chinese growth. On the other hand, for the United States, China is a source for cheap goods, investments, and financing of the American national debt (China is America's biggest creditor, holding Treasury bonds valued at over \$740 billion). At the same time, there are those who view China and other developing nations in East Asia as a danger to employment and growth in the United States, because the United States is incapable of competing with those countries' cheap manufacturing capabilities. This phenomenon causes a tremendous trade imbalance between the US and China.

Maintaining economic and social stability in the US is a primary objective of Obama's administration, but the administration is not

neglecting its foreign policy, including efforts in the Middle East. Moreover, despite American budget constraints, it would be reasonable to assume that American military aid to Israel and other countries in the region will not be affected, in light of America's foreign policy needs and the desire of the administration to help the American arms industry at this time.

Trends in the Global Oil Market

Oil is one of the factors connecting the Middle East with the global market, as it boasts some 60 percent of the world's proven oil reserves. Over the last decade, until July 2008, there was a long, steady rise in oil prices. The average cost of OPEC oil in July 2008 stood at \$131 per barrel – an all-time high, even in real terms. The main reason for this was the rapid growth of the global market, which caused a significant increase in demand by East Asian countries, but other factors were at play as well: oil price speculations, fears regarding a possible confrontation between the United States and Iran and the subsequent supply shock, and more. At the same time, there was a dramatic increase in the costs of other raw materials and in the cost of agricultural produce, which increased inflation in different countries around the world.

After the high of July 2008, the trend reversed itself – a result of decreasing demand and expectations of negative growth for the global market. In December 2008, the average cost of OPEC oil for the month dropped to \$38.6 per barrel.

Based on forecasts published by the International Energy Agency on May 14, 2009, world demand for oil in 2009 will average 83.2 million barrels a day, 3 percent less than in 2008. At that time, the cost of oil stood at about \$58 per barrel. The price of oil is projected to climb when the global economy rallies, but in the meantime there are companies that have already decided to suspend or cancel projects to discover new oil fields and to improve production.

Strategic implications

The extreme swings in the cost of oil make even clearer the need for developing alternative fuel sources, both for economic reasons and for political ones, especially since most of the world's oil reserves are located

in unstable regions or in the hands of regimes in conflict with the West. Therefore, the oil consumers, including Israel, would be wise to invest in developing alternatives to oil despite the fact that the current plummeting of its cost renders such moves economically less worthwhile in the short run.

The drop in oil prices reduces the economic profitability of building infrastructures for atomic energy, thereby undermining arguments put forth by states seeking to develop nuclear capabilities, primarily Iran. In addition, the drop in oil prices does not reduce the importance of the Persian Gulf as the chief source for energy in the world because it still contains most of the world's proven oil reserves. Therefore, the US will find it difficult to withdraw fully from Iraq without solutions that will ensure the stability of the region.

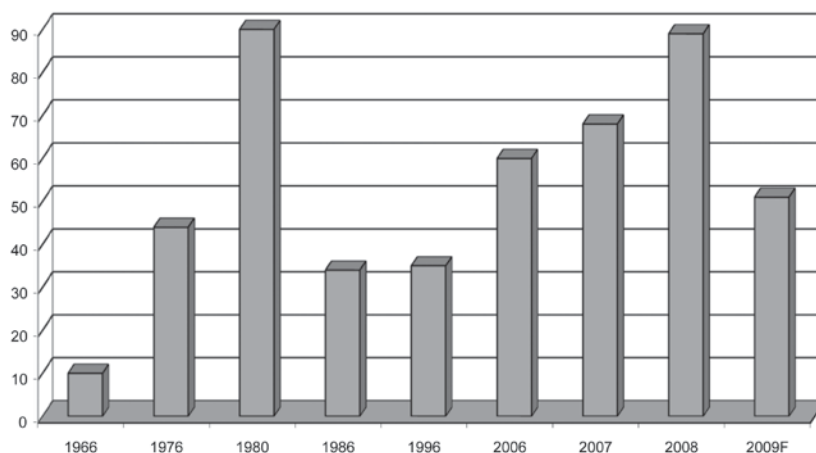


Figure 1. Annual Average OPEC Oil Prices
(in \$, per barrel, in fixed prices, 2009)

Source: OPEC data until 2008;² 2009 – authors' projections

The Effect of the Crisis on Regional Markets

Saudi Arabia and the Gulf States (GCC member nations) have been affected by the crisis in two areas: a decrease in their revenues from oil exports and a decrease in the value of their assets invested abroad. Based on estimates by the International Monetary Fund, the growth in their economies in 2009

will reach approximately 1.5 percent. These estimates assume that the average price of a barrel of oil will not go below \$50, but, even if it drops lower, GCC members have the tools to temper the impact of the decline. The rise in the cost of oil until the middle of 2008 increased these states' revenues from oil exports, bringing them to a total of \$2.2 trillion since 2003. The aggregate surplus of the last five years in the current accounts of the GCC members is over \$900 billion. Large slices of these surpluses were used to purchase various assets all over the world and also to reduce the government debts. This activity was undertaken primarily by sovereign wealth funds. Because these funds are run without transparency, it is only possible to estimate the extent of the wealth they represent and the damage they have absorbed in recent months. Based on the most conservative estimates, the extent of foreign assets belonging to GCC member states stood at some \$1.2 trillion at the end of 2008. Despite the erosion in the total value of foreign assets, since September 2008 estimated at between 15 and 25 percent, the wealth in these funds helps the Gulf states take stabilizing steps. In fact, in early 2009 the governments have instructed some of the funds to infuse capital into the local stock markets and central banks. All of these allow Saudi Arabia and the Gulf states a significant amount of room for maneuvering.

The manner in which the Gulf states choose to use their assets also depends on their desire to leverage their wealth in order to advance political interests. Many times in the past, the purchase of company stocks in the West by Arab oil states was met with suspicion, lest a foothold in the large financial institutions and conglomerates serve as a means for achieving their political objectives. Today it seems that the global financial system's thirst for liquidity has increased the attractiveness of the capital in the Gulf states' wealth funds, and the need for credit has muted the voices objecting to the phenomenon. Evidence for this may be found in Prime Minister Brown's November 2008 visit to the Gulf, when he invited the capital funds to expand their activities in the British market. Similarly, some figures in the International Monetary Fund and the World Bank have in recent months implored the Gulf governments to join forces in the efforts to rescue the international financial system by injecting capital from their

funds and increasing their quotas in the International Monetary Fund's reserves.

The Gulf governments, which in 2008 made a number of investments in large American banks³ and other large companies, are for many reasons in no hurry to inject a lot of money into strategic purchases, not least of which because of the economic risks inherent in such investments. The decrease in oil prices and the losses they accrued because of the financial crisis also increased their need for risk management. Nonetheless, the appetite of the Gulf states for investing in the West has not been sated. So, for example, in March 2009, the Aabar Fund, an Abu Dhabi investment fund, bought 9.1 percent of the stock of the German automotive giant Daimler. Such purchases, along with various statements issued by the managers of some of the large funds, suggest that the funds will take advantage of the opportunities embedded in the crisis in order to buy large chunks of other companies in the West at bargain prices.

Table 1. Revenue from Oil Exports by the Large Arab Producers⁴
(in \$billions, in current prices)

	2002	2003	2004	2005	2006	2007	2008 (est.)	2009 (forecast)
Saudi Arabia	63.8	82.2	110.8	161.7	188.4	206.4	292	148
Iran	19.2	26.1	34.2	53.2	59.1	64.9	91	46
Iraq	12.5	7.5	17.7	19.0	27.5	37.3	52	27
UAE	21.7	25.1	38.0	49.9	69.8	74.5	105	53
Kuwait	14.0	19.0	26.6	42.4	53.1	60.0	85	43
Qatar	6.8	8.8	11.6	17.5	24.2	27.8	39	20
Libya	9.4	13.5	16.8	28.3	36.9	39.8	56	28
Algeria	12.3	16.4	23.0	32.8	38.3	44.2	62	32
Total OPEC	211.9	258.1	364.7	535.6	650.2	731.1	1034	522

Source: OPEC data until 2007, and authors' estimates

The shifts in the income and wealth of the oil states indirectly affect the oil-less states in the Middle East (e.g., Jordan and Lebanon) and the smaller oil producers (Egypt and Syria) that rely on remittances transfers from workers in the Gulf states to their home countries, international trade, and

project financing. The economic crisis somewhat lessens the contribution of the oil producers to the economy of the other states.

The *Iranian* economy largely depends on the global energy market. Iran exports some 2.5 million barrels of oil per day and its oil export revenues represent about 80 percent of total exports earning. The surge in the global energy market allowed Iran's economy to grow in the last five years at an annual average rate of over 5 percent, but Ahmadinejad's promise to distribute the oil profits to all Iranian citizens was not fulfilled. The unemployment rate remains high (12.5 percent, according to official data), and in 2008 the rate of inflation hit more than 25 percent mid-year. In addition to the increases in the cost of goods on the global market, one may attribute some of the inflation in Iran to its monetary policy (interest rates significantly lower than inflation) and to international sanctions. The financial campaign headed by the United States reduces the ability of Iranian financial institutions to make international transactions and contributes to rising prices because it has raised the country's import costs. The drop in the prices of goods globally has had the opposite effect on Iran. On the one hand, the drop in prices on the world market directly contributes to a drop in Iran's cost of importing food and raw materials. On the other hand, the drop in oil revenues has forced the government to cut back significantly on the extensive subsidies it has been providing. Ahmadinejad, who in November announced that Iran will continue to flourish even if the cost of a barrel of oil drops to a mere \$5, later admitted that the decrease in oil prices will force a drastic reduction of Iranian subsidies and cause an increase of taxes.

The drop of oil prices has indeed had a negative impact on Iran's economy. However, it still has foreign currency reserves that may allow it to blunt the effect of international pressures. Total Iranian foreign currency reserves at the beginning of 2009 stood at \$96 billion. This sum can fund Iran's imports for a long time, even without any income from exports (in 2008, Iranian imports were estimated at \$67 billion). Nonetheless, the economic crisis is making the loss of revenue resulting from the economic sanctions more painful than before.

The global economic crisis has changed the challenges faced by the *Egyptian* and *Jordanian* economies. If in the middle of 2008 inflation

appeared to be the central threat to their economic stability, their greatest challenge in mid 2009 is to cope with the slowing growth. The crisis has some contradictory effects: on the one hand, rapid inflation may be expected to become more moderate in light of the drop in the cost of goods and real estate, but on the other, a decrease in investments and economic activity is liable to damage growth and increase unemployment. The level of integration between the financial systems of Egypt and Jordan and the global financial system is not high, and therefore one may assume that the local banks are not exposed to toxic assets.

In the energy field, Jordan is an absolute oil importer whereas Egypt is a net oil importer (consuming more oil than it produces), so that in terms of trade balances both countries are benefiting from the decrease of oil prices. Nevertheless, there is a correlation between the situation of the oil states in the Gulf and the ability of the other countries in the region to grow, and therefore the expected economic slowdown of the Gulf states, because of the drop in energy costs, will affect Egypt and Jordan as well.

As a result of the crisis, there is a flight of the capital (some of it speculative) that in recent years fueled the Egyptian and Jordanian real estate sector. This phenomenon probably stems from the drop in the flow of investments coming from the Gulf states to the countries in the region. Similarly, the crisis, also affecting global and Arab tourism, will reduce the foreign currency incomes of the two countries. Their revenues are also liable to be negatively affected by the decrease in trade passing through them (the Suez Canal in Egypt and the Aqaba Port in Jordan).

The combined effect of these phenomena may be lessened because of the decrease of food and oil prices, which will cut costs on imports of consumer goods and production inputs. The global decrease in the cost of goods has already eased the rate of inflation in the region (according to the IMF's April 2009 outlook, this year it is expected to reach 12 percent in Egypt and 4 percent in Jordan).

The Egyptian government comes to the crisis in a relatively good state because in recent years it managed to maintain reasonable deficits of 6 percent in its GDP. The Jordanian government also succeeded in the last year in cutting fiscal spending and reducing its public debt. The relatively reasonable fiscal state gives the two governments ample room for maneuver

in the course of the coming year. At the same time, the measure of their ability to blunt the economic-political pressures created by the global crisis depends on the depth and duration of the crisis. In any case, at this stage it does not seem that the economic crisis is endangering the internal stability of the two countries. However, its ramifications are liable to arouse successive waves of criticism aimed at the economic liberalization steps announced by both governments.

The financial crisis has only limited direct effect on *Syria's* economy, as its financial system is small and centralized. In 2008, the Syrian market grew relatively rapidly – 5 percent – but this year growth is expected to be much lower. The Syrian market's major problem is not necessarily connected to the global crisis, rather stems from the thinning out of its oil reserves and the decrease in oil production and exports. In 1996, the rate of production stood at 600,000 barrels per day; today it is less than 380,000, and this number is expected to drop more. If one considers the payments by foreign oil companies, Syria, possibly as early as 2007, turned into a net oil importer. The thinning out of its oil reserves will enlarge the deficit in the current accounts of the balance of payments, and therefore also Syria's dependence on external sources of capital. At this stage, the effect of the drop in oil prices on Syria is negative but limited. As long as the economic depression continues, Syria benefits from the drop in prices of raw materials and imported goods.

Syria's ability to make essential changes in its economy is affected by its international standing. In recent years Syria has tried to interest companies in investing in the country, but only a few Western companies have been convinced and the primary growth in foreign investments in Syria has come from GCC members, Iran, and Turkey. The economic depression may decrease the flow of investments from these countries. This is one of the central reasons that the possible thaw in the strained relations with the United States is so essential to Syria's economy, especially at this time. Similarly, an improvement in relations between the countries may pave Syria's way to membership in the World Trade Organization. In 2001 Syria applied for membership in the organization but was rejected, in part because of American opposition.

The improvement noted in the last year in Syria's relations with the EU is a positive development for Syria's economy. On December 14, 2008, the sides initialed an updated version of the 2004 trade agreement, whose implementation was frozen after the murder of Rafiq al-Hariri. The updated agreement states that the sides will strengthen their cooperation in a range of areas and will establish a free trade area within twelve years. The EU is Syria's main trade partner, and therefore the removal of tariffs on a string of agricultural products is vital to Syrian interests. The implementation of the agreement is planned for this year, but depends on the approval of all 27 EU member states. Though most are tending towards supporting the ratification of the agreement, there are certain internal issues that may deter some states. Therefore, they are expected to present Syria with various demands; for example, Britain is demanding that Syria prevent the infiltration of terrorists from its territory into Iraq.

The *Lebanese* economy, unlike Syria's, is open and maintains extensive contact with countries abroad. This enlarges Lebanon's negative exposure to the crisis on the global market in the fields of banking, foreign investments, the national debt cycle, and tourism, which is an important source of revenue. In 2009, the growth of the Lebanese economy will be significantly lower than the rapid growth it experienced in recent years (8 percent in 2008, 7.5 percent in 2007). In 2006 Lebanon suffered from an economic freeze (zero growth) because of the Second Lebanon War. Nevertheless, the decrease in oil prices and other import goods contributes to the economy and it seems that Lebanon is weathering the crisis well.

The *Palestinian Authority*: Since Hamas' takeover of the Gaza Strip, Israel and the international community have been working with the Palestinian economy on two contradictory efforts. On the one hand, they have strengthened Abu Mazen's camp, through the infusion of money by the international community to this camp, the removal of roadblocks, and the provision of employment for Palestinians from the West Bank in Israel. On the other hand, Israel and Egypt work against Hamas in the Gaza Strip by the imposition of an economic embargo, with the international community withholding the infusion of cash to the Gaza Strip. As a result, the gap between the economic status of the West Bank and the Gaza Strip has grown wider.

Since the outbreak of the al-Aqsa Intifada, the basic condition of the Palestinian economy has been difficult and the current crisis is contributing its share. The drop in the price of food and fuel is helpful for the Palestinian economy, but the PA is expected to be negatively affected by the economic situations of the Persian Gulf, Jordan, and Israel. This also goes for the income of Palestinians supported by these economies. The scope of aid in 2008 was estimated at \$1.5 billion, a large sum when compared to the Palestinian GNP, estimated at only \$5 billion, demonstrating the Palestinians' dependence on external aid. Based on estimates by the World Bank, external aid is preventing the majority of the population of the Gaza Strip from falling into dire poverty (i.e., difficulty in attaining a basket of basic goods).

Table 2. Arab States and Iran: Government Debt as a Percentage of Product

	2004	2005	2006	2007	2008 (estimate)
Kuwait	27.9	11.8	8.5	7	5
Saudi Arabia	65	38.9	27.3	18.7	10.7
UAE	8.5	9.2	10	10	9.6
Iran	26.3	23.7	19.7	17.2	13.4
Jordan	91.8	84.2	81.5	79.7	65.3
Egypt	112.9	112.8	98.8	88.7	81.9
Syria	73.2	23.3	19.4	17.2	–

Source: IMF⁵

Strategic implications

Overall, the global market crisis is harming all the economies of the Middle East at some level or other. At this stage, various countries are coping successfully with the crisis and no threats against their stability have surfaced. Nevertheless, the challenges these regimes face are significant, and their ability to cope with them successfully depends in part on the following factors: the duration of the crisis and its intensity, the success of the financial policies of each of the countries, the statistics base (e.g., a high rate of unemployment in some states even before the start of the

crisis), the attitude and behavior of the oppositions to the crisis, and the power of the regimes.

Iran: The economic crisis makes no significant difference with regard to the nuclear issue. At first glance Western countries may find it easier to toughen the sanctions against Iran because of the oil market situation. However, they would likely be less motivated to do so because of their own economic crisis. Similarly, the concern about an outbreak of inflation becoming more potent a threat because of the stabilizing steps taken by governments around the world may reduce the incentive to take preemptive steps that are liable to cause a renewed increase in energy costs. Tehran has the economic capability to withstand sanctions much more severe than those currently in place, at least in the next few years. Nevertheless, increasing the economic pressures on Iran may serve as (another) consideration in its deliberations in favor of a resolution to the issue.

Syria: The effects of the crisis on Syria in the coming year will be limited, but Syria's economic situation has elements supporting a change in policy towards the West, including a negative economic horizon (primarily because its oil sources are drying up), and the difficulty in seeking assistance from nations that in the past supported it, given its poor relations with the Arab Gulf states and Russia's economic situation.

Lebanon: The susceptibility of the Lebanese economy to the crisis and the harsh criticism leveled at Hizbollah because of the damage done to the country during the Second Lebanon War support the avoidance of military confrontations. Nonetheless, this is not its exclusive consideration.

Egypt and Jordan: The economic situation is one of the important parameters affecting their long term stability given their statistics bases (e.g., Egypt's relatively low standard of living and Jordan's demography). At present, there are no signs of the influence of the crisis on their internal stability, though waves of criticism are liable to be leveled at the government by the public and the opposition.

GCC members have sustained large fiscal losses due to the crisis but their situation is relatively good, considering the rise in oil prices over the last five years and in light of the tremendous foreign currency surpluses they have amassed. Even today, oil revenue represents a source of potential inter-Arab assistance that may be used in political settlements should these

states so desire. It is precisely the economic depression that may make the assistance more attractive to the Palestinians, Syria, and Lebanon. These funds could finance solutions such as rehabilitating refugee camps in Arab countries and the territories, constructing an underground or aboveground passageway between the Gaza Strip and the West Bank, a water desalination plant in the Gaza Strip and the means for moving the water to the West Bank, and more. At first glance, the probability of realizing such assistance seems low in the foreseeable future, but it may be applicable in the long term, because it serves the interests of the Arab oil states also striving for stability in the Middle East and is in line with the Saudi Arabian inclination to advance political processes. It may be possible to see the \$2 billion assistance pledged by GCC member states for the reconstruction of the Gaza Strip as a sign of things to come in this direction.

The Palestinian economy: The situation is greatly affected by the political split in the Palestinian arena and by policies towards Israel, Egypt, and the international community. The political boycott of Hamas and the economic embargo on the Gaza Strip, compared with increasing support for the PA in the West Bank, have widened the economic gap between the Gaza Strip and the West Bank. The damage incurred by the military confrontation with Israel, along with the ongoing economic distress, has worsened the crisis in the Gaza Strip. This trend is expected to continue as long as the political situation in the Palestinian arena itself and the Israeli-Palestinian arena remains unchanged. Moreover, the gap between the West Bank and the Gaza Strip will continue to grow if the policy of “economic peace” is applied to the West Bank.

The Effect of the Crisis on the Israeli Economy

The most immediate manifestation of the crisis on the Israeli economy is an end to the period of rapid growth. The Israeli economy tends towards exports and is highly dependent on the global economy. After five years of rapid growth, the second half of 2008 saw a sharp slowdown in the Israeli economy. The overall growth rate for 2008 reached 4 percent; however, in the last quarter of 2008, the economy froze, compared with growth rates of 5.4 percent for 2007 and 5.2 percent for 2006.

In 2008 GDP totaled 714 NIS. The forecast by the Bank of Israel regarding product growth in 2009 (from January 25) stands at -0.2 percent. That is, per capita growth in 2009 will be near minus 2 percent, compared with 2.8 percent in 2008. The slowdown is the result first and foremost of the situation of the global economy but there are additional factors, such as the lack of structural changes and additional growth engines that would support continuing rapid growth. It seems that even without the current crisis, the 2009 growth rate would have been lower than in recent years and reach only about 3.5 percent (the growth prediction for the 2009 Israeli economy according to the draft of the budget prepared in mid-2008). The Bank of Israel's forecast for growth in 2010 stands at 1 percent.

Expressions of the economic crisis in Israel

Worse macro statistics: Based on reports by the Central Bureau of Statistics, in the first quarter of 2009 there was a drop in annual terms of 3.6 percent in GDP, 4.2 percent in business product, and 4.3 percent (6 percent in per capita consumption). In addition, the exports of goods and services dropped by 14.4 percent in the first quarter of 2009 over the previous quarter (a 46.3 percent reduction if calculated annually); and the imports of goods and services (except for defense imports, airplanes, and diamonds) dropped by 21.4 percent (61.9 percent in annual terms).

A wave of employee layoffs: In March 2009, 20,072 employees lost their jobs, compared with 11,856 in March 2008. This represents a record number of layoffs for a single month. The growth in the scope of layoffs reflects the hi-tech sector, traditional industries, various trade branches, real estate, and finance.

The public's savings have been significantly affected as a result of the losses on the capital markets. In the course of 2008, the pension funds lost close to one fifth of the value of the assets deposited in them. The improvement on the capital market in the first quarter of 2009 has offset some of these losses.

A sharp decrease in profits in many Israeli companies: The freeze in raising capital on the Israeli stock exchange and abroad and the growing difficulty in getting bank credit have limited their ability to operate and

recycle debt. Many companies, especially in real estate, are hard pressed to repay loans, and some have been forced to regulate their debts.

A decrease in national tax revenue and a sharp rise in the government spending deficit: In March 2009 the Finance Ministry estimated that the state's revenue from direct and indirect taxes would total about 160 billion NIS in 2009, some 40 billion NIS less than government estimates of August 2008.

Table 3. Growth in Israel

% of real change in product in relation to the previous year (growth)	
2003	1.8
2004	5.0
2005	5.1
2006	5.2
2007	5.4
2008	4.0
Forecast 2009	-1.5

Source: Central Bureau of Statistics and Bank of Israel Forecast⁶

Israel began dealing with the crisis relatively late compared with countries abroad. In November 2008, the Olmert government formulated a response to the crisis, which included making guarantees available to banks in order to facilitate loans to mid-sized and small businesses, establishing leverage funds to assist Israeli businesses to recycle debt, rolling out a financial safety net for people age 57 and up who meet certain criteria, and more. In addition, the government planned to enlarge spending on infrastructures through budgetary projects (principally transportation) and extra-budgetary projects (principally water desalination and energy).

On May 13, the Netanyahu government approved a two year budget for 2009-2010. The 2009 budget is 316.6 billion NIS, and the budget deficit will be limited to 6 percent of the product. The 2010 budget is 321.5 NIS, and the budget deficit will be limited to 5.5 percent of the product. The defense budget for 2009 was reduced by some 1.5 billion NIS (about 3.1 percent). The budget reflects the tension between three principal needs: the

need to realize various national objectives; the need to preserve financial stability; and the need to maintain the political coalition.

For its part, the Bank of Israel is making full use of the tools at its disposal. In April 2009 it reduced the annual interest rate to an unprecedented low of 0.5 percent, compared with 1.75 percent in January 2009 and 4.25 percent in January 2008. At the same time, the bank is purchasing long term government bonds in order to reduce interest rates for the long term.

On the positive side is the discovery of natural gas in Israel. Occurring simultaneously with the crisis and unrelated to it, the beginning of 2009 saw an historic development in Israel's energy market as the result of the discovery of a large reserve of natural gas at the Tamar 1 drilling site (90 km west of the Haifa coastline) in January, and an additional, smaller reserve at the Dalit 1 drilling site (60 km west of the Hadera coastline) in March 2009. These discoveries come on the heels of previous gas finds in the Mediterranean off Israel's coasts, starting with the first discovery of a large gas reserve in 1999, west of Ashkelon's coastline. According to estimates by the discovery teams, the amount of gas at Tamar 1 is at least three times the amount discovered in the past off Ashkelon and Ashdod (the Yam Thetis site), and the value of the gas is estimated at some \$15 billion. On January 18, 2009, after the companies reported on the discovery of gas at Tamar 1, Minister of Infrastructures Binyamin Ben Eliezer announced: "If drilling at the Tamar site actually produces the estimated amounts, then Israel's dependence on other supplies will decrease, though not disappear altogether."

Implications for Israel

To date, the Israeli economy is showing much stability, relatively speaking, and the stability of Israel's financial system does not seem to be in question. Nevertheless, Israel's economy in the coming year will be affected first and foremost by the state of the global economy. Until the global economic crisis has passed, Israel must focus its efforts on minimizing damages and preventing effects of the crisis. In addition, Israel would do well to preserve the startup industry and continue to develop the human capital technology, which is a financial and strategic asset for Israel, and develop the energy industry, since energy prices are expected to rise again.

Table 4. Defense Burden in Israel

	local defense spending (% of product)
2003	6.8
2004	6.2
2005	6.0
2006	6.0
2007	5.8
2008	6.0
2009 forecast	5.9

Source: Central Bureau of Statistics⁷ and authors' prediction

Conclusion

At the point in time where the world is now, it is difficult to forecast the political and social implications of the current economic processes. Even if the present crisis has already peaked, it is doubtful if the real economic crisis has peaked, and thus certain parameters such as unemployment may yet worsen.

The state of Israel's economy will be affected primarily by the state of the global economy. The end of the world economic crisis depends on several factors, first and foremost the success of the Obama administration. The recovery of the global market depends primarily on the recovery of the American market; recovery of the American market depends primarily on restoring the faith of the American public in the country's economic mechanism; and restoring the American public's faith in the economy depends primarily on President Obama's leadership and his professional team. Thus far President Obama has displayed determination and the ability to take difficult decisions quickly. In recent months he has conveyed guarded optimism. In a speech given on April 14, 2009, he defined the situation as follows: "There is no doubt that times are still tough. By no means are we out of the woods just yet. But from where we stand, for the very first time, we are beginning to see glimmers of hope."⁸

Notes

- 1 <http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm>.
- 2 Organization of the Petroleum Exporting Countries, *OPEC Annual Report 2007* (Vienna, 2008); Organization of the Petroleum Exporting Countries, *World Economic Outlook 2008* (Vienna, 2008).
- 3 For example, an investment fund in Abu Dhabi injected \$7.5 billion into the financial giant Citigroup in the form of debentures for conversion, giving it the right to exchange the loan for 4.9 percent of the capital of the bank stock.
- 4 The data include income from the export of crude oil, oil products, and natural gas liquids.
- 5 International Monetary Fund, *Regional Economic Outlook: Middle East and Central Asia* (Washington, DC, May 2009).
- 6 Central Bureau of Statistics, *Macroeconomics Statistics Quarterly* (Jerusalem: October-December 2008); Bank of Israel, *Economic Developments in Recent Months 124: January-April 2009* (Jerusalem: June, 2009).
- 7 Central Bureau of Statistics, *National Accounts 1995-2007* (Jerusalem: January 2009).
- 8 http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-the-Economy-at-Georgetown-University/.