# In the Shadow of Delegitimization: Israel's Sensitivity to Economic Sanctions

Nizan Feldman

Memorandum 163

המכון למחקרי ביטחון לאומי
THE INSTITUTE FOR NATIONAL SECURITY STUDIES
INCORPORATING THE JAFFEE CENTER FOR STRATEGIC STUDIES
TEL AVIV UNIVERSITY
אוניברסיטת תל-אביב

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# בצלה של מתקפת דה־לגיטימציה:
# רגישותה של כלכלת ישראל לסנקציות

ניצן פלדמן

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# Executive Summary

Over the last year, several attempts have been made by the Israeli media and a number of government ministries to assess the level of economic damage attributable to the delegitimization campaign being led by the BDS (Boycott, Divestment, and Sanctions) coalition against Israel. While these attempts have led to several important publications, there is as yet no comprehensive study which combines the wealth of available theoretical and empirical knowledge about sanctions with a political-economic analysis of the Israeli economy. This memorandum hopes to fill this gap by examining how sensitive the Israeli economy is to economic pressures deriving from political motives.

Chapter 1 presents a general review of the academic literature on sanctions. A consideration of this literature and of past instances demonstrates the complexity of the drive to implement economic sanctions whose effectiveness depends on the behavior of different players and their varying interests. Understanding this complexity is integral to my analysis. While most attention is currently directed at the activities of the BDS movement, it must not be forgotten that their undertakings do not take place in a political-economic vacuum, but rather in an arena involving a variety of players who are not, in most cases, interested in harming economic ties with Israel.

The BDS movement will only manage to cause significant economic harm to the Israeli economy if it finds a sympathetic ear in governments and commercial enterprises. I have therefore invested great efforts in identifying the variables that can be expected to influence the decisions of governments and relevant commercial bodies whether to either adopt or block the punitive measures that unofficial players are attempting to promote. Thus, in Chapter 2, I analyze the political-economic arenas of Israel's major trading partners and examine how important trade and investment in Israel is for each of them. I have identified a number of factors that limit the implementation of most of the punitive economic measures that the BDS movement aims to advance. Among these, the following three issues stand out:

1. The majority of Israeli exports comprise production inputs and intermediate components for a range of products and are therefore not sensitive to campaigns calling for a consumer boycott of Israeli merchandise. It is only by convincing governments to change their trade agreements with Israel or by leading a boycott of companies whose products are based on Israeli inputs that the BDS movement will cause a noticeable drop in demand. The memorandum will show the improbability of unofficial organizations managing to lead such pervasive processes.
2. While it may be true that Israel's major trading partners will not face a strategic macroeconomic threat if economic ties with Israel are significantly downgraded, the interests of many companies and the activities of specific sectors are likely to be harmed. European industry and other industries will manage to find replacements for most of the Israeli products, but this will entail significant costs for many industrialists, who also wield political power. Therefore, governments that chose to place sanctions on Israel will not only incur economic losses, but will also pay a political price. These economic and political costs are only two of the various factors that support the assessment that the EU is unlikely to initiate any significant change in its trade agreements with Israel.
3. Many components of the merchandise exported from Israel are manufactured by multinational companies—foreign corporations that have established manufacturing operations in Israel or acquired controlling interests in Israeli companies. Any government decisions that harm Israel's capability to export or to attract foreign investment will also damage the interests of these powerful multinationals, and they are thus likely to try and influence their home countries to block such measures.

Beyond these three important issues, the memorandum raises a long series of additional economic, political, institutional, legal, and technical constraints that are likely to hinder attempts by the BDS movement to cause strategic macroeconomic harm to Israel. Nevertheless, one cannot discount the possibility that the movement may create a dynamic inspiring punitive measures that will inconvenience many Israeli companies and raise their business costs. The negative public atmosphere and the application of effective pressure on governments already dissatisfied with Israel's policies and conduct on the Palestinian issue may spawn measures that will ultimately harm Israel's interests. Even without the implementation of extreme punitive measures at their own economic and political costs—e.g., the alteration of trade agreements or the official adoption of broad sanctions against Israel—these governments can express their disapproval of Israel's policies toward the Palestinians in many ways. For example, the desire to avoid public criticism may lead certain governments to discriminate against Israeli companies in government tenders; likewise, sanctions against merchandise manufactured in settlements may lend greater prestige to the unofficial campaign against Israel and even affect the export of merchandise manufactured within the Green Line. The analysis also indicates that any official punitive measures—even those with negligible direct economic impact—will be considered a success for the BDS movement and will increase its momentum.

Chapter 3 develops an econometric model that provides, for the first time, empirical evidence for the claim that Israel's economic ties with EU countries are, in fact, sensitive to deterioration in the Israeli-Palestinian conflict; for example, increased numbers of Palestinians harmed in the conflict result in reduced Israeli exports to EU countries but not to other trading partners. By neutralizing the effects of important economic variables, the model allows for the assumption that unique political processes occurring in EU countries do, in fact, make it somewhat more difficult for Israeli companies to operate in the EU when the conflict flares up.

The findings show that the conflict's negative political consequences for Israeli trade with Europe have not, thus far, been significant in macroeconomic terms. However, further expansion of the delegitimization campaign against Israel is liable to strengthen the link between trade and the conflict. It seems that the most important variable determining the extent of damage caused by the unofficial campaign being waged against Israel by groups such as the BDS movement is the level of antagonism among the general public and within EU governments toward Israel's actions against the Palestinians.

# Introduction

Throughout its history, the Israeli-Palestinian conflict has impacted a broad array of processes within the Israeli economy. Beyond its direct and basic influence on budgetary issues and patterns of production and consumption, the perceptions of different governments at various points in time have shaped their official economic policies toward Israel. Government attitudes toward the conflict have also regulated the enthusiasm of foreign companies and other economic agents to operate in Israel. Although there is nothing new about the connection between the conflict and the international environment within which Israel's economy operates, new paths are being forged which have the potential to strengthen the link between the conflict and Israel's economic performance.

For over a decade now, NGOs, with the BDS (Boycott, Divestment, and Sanctions) coalition at their helm, have been attempting to foment a discourse which aims to pressure Israel through boycotts, sanctions, and divestment. The activities of these organizations do not stop at shaping a new discourse that turns Israel into a pariah state; they also take active steps to isolate Israel academically, culturally, and, especially, economically. Their efforts in the economic realm have three main focuses: (1) attempts to lead a comprehensive consumer boycott of Israeli goods; (2) pressure on commercial enterprises to divest from Israel and reduce trade activities with Israeli companies; (3) traditional political activities aimed at convincing governments to take official punitive measures against Israel.

While it is true that in the past Israel has withstood various economic pressures—including even direct and indirect boycotts—the involvement of mainly unofficial actors in the current campaign presents new, less familiar

I would like to thank Prof. Eran Yashiv for the help and close guidance he provided at all stages of writing. I would also like to thank Brig. Gen. (ret.) Meir Elran for his important comments and support.

challenges. It would be foolish, however, to analyze these new challenges through an exclusive focus on the activities of these NGOs. The efforts of these unofficial bodies do not take place within a vacuum, but rather in an arena featuring various players whose interests are determined by a broad spectrum of economic and political processes. While attention is currently focused on the economic campaign led by the BDS coalition, the positions of governments and institutional interest groups remain equally important elements in determining the sensitivity of the Israeli economy to the pressures applied in reaction to its conduct vis-à-vis the Palestinians.

In order to fully understand the Israeli economy's sensitivity to possible pressure during future fluctuations in the Israeli-Palestinian conflict, we must first map out all of the relevant players capable of affecting Israel's commercial activities. Second, we must attempt to understand which variables determine the level of enthusiasm of these players to cooperate with measures intended to harm the Israeli economy. Only after achieving an in-depth understanding of these issues will it be possible to attempt a serious and relevant assessment of the extent of economic damage that may be caused by both these new and the more traditional endeavors.

This memorandum describes the complex weave of processes and interests that determine Israel's economic sensitivity to external political pressures. It includes three chapters of analysis and a concluding chapter. Chapter 1 presents a thorough examination of the academic literature on sanctions and describes past cases relevant to Israel's situation. It identifies the variables that have previously affected the motivation of governments and other economic actors to initiate or cooperate with various kinds of sanctions. Chapter 2 analyzes the political-economic relations of Israel and its major trading partners. I first categorize Israel's trading partners according to their sensitivity to fluctuations in the Israeli-Palestinian conflict, and then, using the theoretical analysis presented in Chapter 1, I identify the political processes that are likely to moderate or intensify efforts to harm Israel's economy. Chapter 3 employs an econometric model to estimate the damage caused so far by efforts to pressure Israel, taking into account those factors connected to fluctuations in the Israeli-Palestinian conflict.

The analysis presented in the first two chapters pinpoints a long line of economic, political, institutional, and technical constraints that may hamper attempts by unofficial actors to deliver a significant blow to Israel's economy. These constraints stem mainly from the composition of Israeli exports and the identity of the corporations driving trade and investment activity in Israel. Most Israeli merchandise exported to the EU and other important markets are production inputs and are therefore not consumed as final goods by the general public. Campaigns calling on consumers to boycott Israeli products are perhaps capable of harming the export of agricultural and food products, which represent less than 10% of Israel's total exports to the EU, but they will find it harder to impact the export of chemical, rubber, IT, machinery, and optical products. Such goods, which represent more than 45% of Israel's total exports to the EU, are embedded in various stages of production in many different industries throughout Europe and other countries.

Industry in Europe and elsewhere could find replacements for most Israeli products, but this would incur costs for many politically powerful industrialists who never willingly make unnecessary adjustments to production processes. Commercial firms will only reduce their dealings with Israeli companies if the unofficial campaign succeeds in leading an effective secondary boycott against companies that use Israeli inputs. As I explain below, implementation of an effective boycott of this sort is no easy task, but may be possible with certain companies under specific conditions.

The identity of the companies that import from Israel represents another political challenge to those seeking significant punitive steps against Israel. A large percentage of Israeli exports consists of merchandise manufactured by multinational companies with manufacturing operations in Israel or by Israeli companies with subsidiaries in Europe and other markets. Any official restrictions on trade or investment in Israel may end up impacting the interests of these multinational firms, perhaps even harming their manufacturing operations in other countries.

Unfortunately, neither the potential economic damage to the various interest groups nor the political and economic costs to governments whose economic ties with Israel may be harmed are high enough to discount the possibility of a dynamic that leads to the emergence of unofficial and official punitive measures against Israel. Past cases and extensive empirical literature have shown that one of the most crucial variables affecting the likelihood of sanctions is a government's political motivation to effect change in the policies of another country. When there is a clear state interest in leading sanctions against another country, a government is more willing to confront interest groups and to bear certain macroeconomic costs. In other words, alongside the variables that increase the economic and political costs of sanctions, there are also those that increase the political benefit of sanctions. When the benefits outweigh the costs, the imposition of sanctions becomes more likely.

Another significant variable that determines the damage caused to Israel by the BDS coalition is the level of antagonism caused by Israel's actions against the Palestinians among the public and, in particular, among the governments of EU countries. Their unofficial initiatives and measures are likely to gain momentum and cause significant damage provided they find sympathetic governments, which is far more likely among European countries than other important trading partners. This claim is based not only on European Commission statements and the recent decision to approve the labeling of products from the settlements, but also on the econometric model applied in Chapter 3, which proves that trade with EU countries is more sensitive to increased levels of violence in Israeli-Palestinian conflict. According to this analysis, a rise in the number of Palestinian casualties harms Israeli exports to EU countries but not to other major trading partners. Since the model neutralizes the effects of violence on pure economic processes, it provides new empirical evidence that unique political processes taking place in EU countries do, in fact, injure Israeli trade. Nevertheless, it should be noted that the direct negative impact identified by the study is not significant and actually disappears when the violence subsides. Furthermore, it is likely that only a percentage of this negative impact is a direct result of the unofficial campaign being waged by the BDS movement.

The fact that the official and unofficial initiatives intended to put economic pressure on Israel have not, as yet, managed to cause significant economic damage does not necessarily mean the same for the future. As mentioned above, the capability of the unofficial campaign to cause real economic damage to Israel depends mainly on the cooperation of the European governments. Various scenarios can be imagined in which the formulation of negative discourse against Israel combined with increased hostility toward Israel's policies by official bodies will trigger a chain of events that increases the economic pressure on Israel in various ways. Even without official statements, there are many steps governments can take in support of the unofficial campaign against Israel, thereby reinforcing their influence.

However, the analysis must not ignore those aforementioned factors and processes that can be expected to moderate processes designed to harm economic ties with Israel. I therefore see no reason to scrutinize extreme scenarios which involve EU governments instituting significant comprehensive sanctions against Israel's economy and companies immediately terminating their connections to Israel. As I make clear throughout, even without such extreme scenarios, any rise in the level of antagonism toward Israel's policies against the Palestinians is likely to lead to measures that might hurt the Israeli economy.

Chapter 1

# What Do Academic Literature and Past Instances Teach Us?

## Introduction

Most articles looking to estimate the consequences of a potential economic boycott of Israel have referred to the many academic studies dealing with economic sanctions. In most cases, however, the use of such studies and the attempts to draw conclusions from past instances have been imprecise. The more precise articles related only to fragments of data and failed to pay broader attention to all of the proposed models and empirical evidence. Partial and imprecise use of the research literature and of past examples may lead to erroneous deductions and conclusions that are irrelevant to the specific case of Israel. In order to understand how the academic literature can help us, I present a survey of the major articles in the field and attempt to derive relevant insights and identify the features and variables that should be considered when analyzing Israel's sensitivity to economic sanctions.

Controversy over the effectiveness of economic sanctions has occupied scholars and foreign policy makers since the 1920 formation of the League of Nations, whose founders hoped that the imposition of economic sanctions would enable the organization to maintain world peace. The traditional academic discourse can be roughly divided into two camps. The first claims that economic sanctions, as well as economic carrots, are effective tools that can bring about significant change in the conduct of states. The second attributes negligible influence to economic sanctions, highlighting the paradox inherent in a policy tool that exacts high costs from states choosing to implement it (hereafter: "sender states") while having no effect on the conduct of the states on which the sanctions are imposed (hereafter: "target states").

The belief in the effectiveness of sanctions rests on the assumption that decision makers are sensitive to unnecessary changes in the division of resources within their country's economy and determined to maximize its aggregate benefit. It therefore follows that it is possible to influence the decision makers to change policy through the imposition of sanctions that will lead to higher aggregate costs for their economy. This optimistic outlook has been criticized by a wide range of scholars who have questioned the fundamental assumption that a tradeoff exists between economic costs and the waiving of core strategic goals; loss of economic welfare does not motivate changes when important national interests are at stake. While there are states that changed their policies as a result of demands by sender states, these changes stemmed from other causes with the sanctions having only minimal impact on the decision and apparent response to these demands. There are, for example, studies that have argued that even the economic sanctions imposed on South Africa—often cited as an example of successful economic sanctions—were not a significant factor in the decision to end the apartheid regime.[1]

This theoretical debate generated empirical studies examining the connection between sanctions and policy changes. The broadest and best-known empirical infrastructure is based on a series of studies that began in the 1980s at the Peterson Institute for International Economics.[2] In their latest (2007) study, it was found that in 34% of 174 cases target states changed their policies to some degree due to economic sanctions. This finding has recently been cited in many opinion pieces published in the Israeli press and in the few studies that have dealt with the possibility of sanctions being imposed on Israel.

However, many scholars are of the opinion that these studies have an upward bias and that the rate of success for sanctions is, in fact, much lower at approximately 5%.[3] These skeptical researchers often use statistical analyses to demonstrate the poor achievements of sanctions. By controlling for alternative explanations—mainly the threat of force that sometimes accompanies sanctions—they have shown that sanctions do not affect the likelihood of states to change their policies.[4]

It is important to note that even those who doubt the effectiveness of economic sanctions as a foreign policy tool do not belittle the economic damage that sanctions can cause to the target state's economy. In other words, despite the dispute regarding the impact of sanctions on the target state's conduct, there is a broad consensus that sanctions can, under certain conditions, cause significant economic damage to the target state. Those who analyze Israel's sensitivity to sanctions and derive encouragement from the many studies that have proved the ineffectiveness of sanctions are, therefore, missing the main point: the fact that sanctions have, in most cases, failed to change policy does not mean that they failed to cause serious damage to the economy of the target state.

This, therefore, raises the questions: what are the conditions that increase the prospect of sanctions to cause significant macroeconomic damage? Which factors increase the likelihood of states to impose meaningful sanctions on states with which they are not in direct conflict? In order to understand the level of Israel's sensitivity to sanctions, one must first understand what might affect the motivation of states to apply economic pressure on political grounds.

Following is a brief summary of the academic discussion on these issues, specifying the factors that have been identified as affecting the success of sanctions and, more importantly, the damage caused to the target states. The list of variables that have received scholarly attention is long, and I therefore relate only to those relevant to the case of sanctions being imposed on Israel. After a brief presentation of these variables, I present in the following chapters a deeper analysis of each as they relate to the Israeli example.

## The Power of Unofficial Protest Movements and the Domestic Political-Economic Arena

The major focus of the traditional theoretical discussion on economic sanctions is the clear-cut case of State A taking punitive economic measures against State B. Any discussion of the Israeli context must determine which countries are most likely to exert economic pressure and examine the nature of Israel's economic and political ties with these countries.

Beyond a focus on official government actions, it is also important to analyze the conduct of non-state actors, such as unofficial protest movements, interest groups, and multinational companies. The attempts to harm Israel have thus far mostly been led by non-state actors, so I begin the survey with the small body of literature which examines the capability of the latter to wage significant economic campaigns.

The increased power and activity of NGOs, unofficial protest movements, and multinationals have highlighted the possibility of countries to suffer from punitive economic measures even without any official state policies. Most of the research on the impact of unofficial punitive economic measures has focused on the campaign waged by non-state actors against the apartheid regime in South Africa. As I explain below, these studies do not always present a clear picture, and it is thus difficult to draw any direct and definitive conclusions regarding the effects and consequences of an unofficial sanctions regime against Israel.

There are a number of moves that non-state actors can make to harm a country's economic welfare. These include consumer boycotts, which generate fear within commercial companies that their economic connections with the target state will draw political protest and thus affect profitability, and the creation of bureaucratic and operational obstacles to disrupt the flow of trade and investment. For example, labor unions have often expressed their displeasure with the conduct of foreign governments by delaying the unloading of merchandise at seaports and airports.[5] There have also been cases of labor unions, universities, and other institutions pressuring their pension funds and the banks to cut off financing to companies operating in certain countries (as will be discussed below).

Any discussion about Israel's sensitivity to unofficial campaigns generally focuses on the latter's success in leading effective consumer boycotts that discourage consumers from purchasing Israeli products. While this is an important issue, the effectiveness of an unofficial campaign depends on its influence over the considerations and motivations of not only private consumers, but also governments, commercial companies, and financial investors. Bilateral trade between countries comprises the movement of both consumer goods and production inputs. Significantly greater political efforts are needed to convince companies to boycott important inputs from certain countries than to convince consumers to boycott consumer goods; the costs facing an industrialist who is required to find alternatives is considerably higher than those facing the consumer. Furthermore, while individual consumers do not, as a rule, consider the broader consequences of their economic conduct, commercial companies are likely to fear any countermeasures that may result from their boycott of imports from a certain country, which, in turn, could damage their own exports and investments.

Commercial companies thus need to find very good reasons for moves that might harm their production, exports, and investments in profitable markets. Protest movements can provide these reasons by casting doubt on the ongoing profitability of these markets. In other words, companies will consider reducing operations with a certain country when they fear that these may lead to a significant consumer boycott of their own products, a boycott whose damage outweighs the benefits of any continued ties with that country. Another measure capable of arousing the concern of executives and shareholders is pressure on investors to divest their holdings in companies that violate ethical codes. This move could lead to higher financing costs and thus provide companies with sufficient justification for cutting their ties with profitable markets.

The constant hurling of accusations regarding unethical commercial conduct, which succeed in winning public and media support, may cause long-term damage to companies even if this is not evident in the short term. In recent years, there has been growing awareness of corporate social responsibility (CSR), and many companies allocate significant resources to maintaining a clean image. Many multinational corporations profess to being more sensitive to the rights of their workers throughout the world and more respectful of their cultures and environments. When corporations show a degree of sensitivity to how they are perceived by consumers and investors around the world, then the formation of a discourse and narrative which portray countries in a negative ethical light is likely to affect their dealings with these countries. A significant proportion of the multinational corporations that have ties with Israel are certainly sensitive to the issue of CSR, a trend which the BDS movement has identified and is striving to exploit.

The shaping of a negative discourse around a specific country is liable to harm its exports and the operations of multinational corporations based therein. Even in the absence of official punitive measures, the intensification of a negative discourse may prevent companies that are identified with a country accused of unethical policies from winning government tenders, since foreign governments may prefer to avoid any attendant public and political criticism. When ethical aspersions are cast against a host country, associated companies struggle to brand themselves and may be forced to conceal their connection to the country. This point is particularly important in the Israeli context, as security and other products enjoy a good reputation precisely because of their association with Israel. Several researchers have pointed out a clear and affirmative link between a country's positive image and branding and their exports and ability to attract direct foreign investments.[6] However, since it is difficult to accurately assess damage caused by injury to reputation and by attempts to obscure ties with a company's home country, no studies have directly and quantitatively examined how the need to obfuscate the home country relationship affects the trade and operations of multinational corporations.

There are already statements by Israeli companies who admit that fears of a boycott have caused them to hide their Israeli identity and their achievements in many areas. This is especially apparent among Israeli security firms that attempt to maintain a low profile when operating in various countries. For example, the CEO of Israel Aerospace Industries confessed that, due to the threat of a boycott, he does not highlight the company's good relations with Airbus.[7] International subsidiaries of Israeli companies sometimes adopt names designed to obscure their ties with the Israeli parent company. As already mentioned, it is very difficult to assess whether the need to hide their connections to Israel does, in fact, harm the potential exports and operations of Israeli companies throughout the world. But harm to the total of exports notwithstanding, the need for obscurity does raise the business costs of Israeli exports and the international operations of Israeli companies. The intensification of the negative discourse about Israel will further increase such costs.

As mentioned above, the vast majority of the studies that examined all these possible phenomena focused on the campaign led by unofficial parties against South Africa and on the role they played in the decisions of more than 200 foreign companies to freeze relations with South Africa from 1985 to 1990. The suspension of trade and divestment by American and European countries happened in tandem with the unofficial campaign; popular discourse even credited the campaign with the companies' withdrawal. The link between the two variables remains controversial.

There are, however, testimonies of CEOs who state explicitly that it was the fear of pressure from unofficial protest movements that caused them to cut their ties with South Africa. Companies that produce consumer goods, such as the cosmetics company Revlon, openly declared their concerns regarding damage that could be caused by the consumer boycott turning against them. Countries that focus on the export of inputs and the building of infrastructure became more disturbed after official bodies in the US, such as municipalities, conformed with the spirit of the campaign and announced their decision to sever economic ties with companies supplying the apartheid regime with infrastructure services. Other CEOs expressed concerns about the rise in financing costs, after pension funds divested from companies that operated in South Africa.[8]

Studies showed that the stock prices of most of the companies that left South Africa declined after they announced their intention to leave South Africa.[9] This proves that companies were willing to take a step that would hurt them in the short term in order to avoid measures that would jeopardize their future profitability. There are, however, other studies that demonstrated a rise in stock prices following a company's decision to leave South Africa. (This disparity stems from differing controls of alternative variables and disagreements on the method of estimation that enables the isolation of the unique effect of the announcement on stock prices.[10]) These findings prove that the financial markets possibly evaluated the potential economic damage of continued operation in South Africa. Either way, this group of studies suggest that an unofficial economic campaign is capable of impacting companies and other economic agents throughout the world.

In addition to these testimonies and studies, there are also studies that attest to the indifference of capital markets to political pressure wielded against companies. Even the decision by pension funds to sell their holdings in companies operating in South Africa failed to harm the stock prices of those companies, and their ability to raise capital was likewise uninjured.[11] Researchers who have cast doubt on the effectiveness of the economic campaign against South Africa attribute the companies' withdrawal to the internal instability throughout South Africa. If true, then the statements by CEOs regarding their fear of sanctions and their desire to act according to ethical codes were no more than lip service intended to conceal the drop in profitability and to express regret for their past operations in South Africa.

Since the unofficial campaign against the apartheid regime took place at a time of great political instability within South Africa and was also accompanied by official government sanctions, it is difficult to isolate its impact and to accurately assess how the symbiotic relationships between these three processes affected the South African economy. However, whether it was the lack of political-economic stability or the unofficial pressure and official sanctions that drove the companies' decisions, their withdrawal from South Africa attests to an important phenomenon: political variables can cause rapid change in the considerations of multinational corporations and lead them to discontinue business activities in markets to which they have long been committed. Approximately six months before IBM exited South

Africa, its president expressed his commitment to continuing operations, stating that IBM operated not to promote ethical activities, but rather to run profitable business activities.[12] This declaration did not, however, stop the company from quickly leaving South Africa together with other giant corporations whose leaders had made similar statements. If there is one important lesson to be learned from the case of South Africa, it is that the declarations of commercial firms expressing their commitment to continue operations in Israel regardless of political processes should be viewed with skepticism. Such declarations should not be seen as an insurance policy against companies reconsidering their operations in Israel in light of political-economic fluctuations that may harm their profits.

Another issue that emerges in the literature and was extensively researched in the South African case is the ability of unofficial organizations to convince governments to take official punitive steps. As with most government decisions relating to the shaping of economic policy, the decision to apply economic pressure to another country is influenced by the domestic political-economic arena in which both official and unofficial interest groups operate. It is, of course, possible that political pressure, which begins with the informal activism of interest groups and NGOs, will eventually become official government sanctions.[13]

It has been proved that the imposition of sanctions perceived as just by the public grant the government credit that can be cashed in for electoral votes. The need of governments to satisfy domestic public opinion is presented in a number of important studies as one of the reasons why countries impose sanctions even when they doubt their effectiveness. According to the formal analysis that typifies much of the literature on sanctions, the benefit derived from domestic political considerations is likely to offset the economic costs entailed by the imposition of sanctions. When the domestic political benefit is particularly high, countries tend to impose sanctions even when they know that the sanctions may harm their own economy and contribute very little to any policy changes in the target state.[14] Therefore, according to the logic of this model, the prospect of an unofficial campaign leading to official punitive measures against Israel rises as public opinion grows more negative.

As with most of the variables that emerge from the academic discourse about sanctions, the ability of non-state organizations to apply significant economic pressure remains a matter of dispute. While it is difficult to accurately gauge the economic damage previously caused by non-state actors, there is no doubt that this is one of the key questions to consider when analyzing Israel's sensitivity to economic pressure. Although it is possible to pinpoint certain official government declarations and actions that link the Israeli-Palestinian conflict to economic involvement with Israel, it is the unofficial organizations that dominate the discourse calling for divestment from Israel. The BDS coalition derives great inspiration from the campaign to end the apartheid regime, and BDS activists focus their efforts and activities on driving processes that encourage individuals and companies to boycott Israel. They also use various channels to apply political pressure with the ultimate aim of making governments adopt official punitive economic measures against Israel.

The success of the pro-Palestinian movements, as with any interest group, depends to a certain extent on their political power and their integration in the institutional establishment of the countries in which they operate. It should not be forgotten, however, that interest groups do not operate in a political-economic domestic vacuum. Effective activities calling for the severing of economic ties with Israel can be expected to meet negative responses from entities that benefit from these economic ties. Just as nongovernmental actors can drive a process that ends with the imposition of official sanctions, there are also many examples of states interested in launching sanctions being reined in by commercial firms and unofficial organizations who emphasize the broader consequences of severing economic ties with an important trading partner. For instance, various groups in Germany are currently running a campaign to dilute EU sanctions against Russia. These groups emphasize the damage that the sanctions have caused Germany's economy thus far and present professional economic analyses of the prospective damage if sanctions are intensified.[15]

To summarize, the literature and past cases have demonstrated that there is a need to map out the various interest groups and to understand the extent to which the political-economic scene in their home countries might impact economic ties with Israel. The focus should thus be on examining the power of the organizations calling for a boycott of Israel and assessing their potential influence on the considerations of corporations and governments while simultaneously trying to identify which sectors, corporations, or other players can be relied upon to circumvent an economic campaign against Israel.

## The Nature of Economic Interdependence

Despite increasing academic interest in the role of unofficial groups in the application of effective economic pressure against countries, most of the literature still has concentrated on decisions by governments to impose sanctions on target states. This is, as previously mentioned, the most common pattern, with most significant sanctions regimes being formulated by states and not by unofficial organizations. Among the host of variables examined in the discourse surrounding official sanctions, the economic ties between the sender and target states have received most of the attention. The nature of the economic interdependence purportedly affects the decision to launch a sanctions regime, the intensity of the sanctions, the scale of damage caused by the sanctions, and their prospect for effecting change in the target state's policy.

On the most basic level, economic pressure is clearly more problematic for the target state when wielded by an important trading partner rather than a marginal trading partner. It is thus not surprising that studies have shown a clear and positive relationship between the target state's dependence on the sender state and the sanctions' chances of success.[16] In other words, the greater the dependence of State A on economic ties with State B, the more likely State B is to impact policy change in State A through economic pressure.

It should not be forgotten, however, that governments are not quick to adopt measures that may cause aggregate damage to their economy. It is thus important to consider the extent of economic dependence between the target and sender states. In addition to examining Israel's sensitivity to certain sanctions, attention must also be paid to the potential damage caused to the sender states.

The economic relationships between two states are often characterized by asymmetric dependence with one state more vulnerable to disruption; accordingly, one of the sides will struggle to find alternatives that will offset the damage should the economic ties be terminated, while the other side will quickly find suitable replacements. On a macroeconomic level, asymmetry in economic dependence reduces the less vulnerable party's concern regarding the consequences of sanctions, while, of course, it increases the fear of the more vulnerable party and thus facilitates the imposition of sanctions by the former on the latter.

The oldest, simplest, and most common way to express the nature of the dependency created by economic ties between a pair of countries is to divide total bilateral trade by the GDP of each country. In other words, the dependency of State A on trade with State B equals $Trade_{AB}/GDP_{A}$. Another popular method is to divide total bilateral trade by the total trade of each of the states. According to these two veteran metrics, Israel's trade relations with most of its important trading partners show asymmetry to Israel's detriment: the total bilateral trade with Israel's major trading partners represents a higher proportion of Israel's GDP than of most of these partners.

One should not, however, race to the conclusion that this macroeconomic reality reduces the concerns of Israel's trading partners regarding the economic and political consequences of adopting official sanctions against Israel. There are times when microeconomic issues, which are not expressed in the aggregate data, can temper the enthusiasm of governments for imposing sanctions. For example, even when the total bilateral trade with State A is not a significant component of State B's GDP, it may be significant for the production activities of a certain sector or certain companies, which would have difficulty finding alternatives to the inputs coming from State A. Likewise, economic activity with State B may be responsible for a large share of revenues for a single important company with political influence in State A. As previously stated, governments are reluctant to enter into conflict with strong corporations and are thus unlikely to rush to adopt sanctions that may harm such corporations, even if they will not impact the aggregate macroeconomic data.

When a multinational company from State B founds a plant in State A, it may suffer from the very sanctions that were intended to harm State A's exports. Furthermore, sanctions that limit investments in certain countries may damage multinational corporations which already operate in those countries. The growing number of multinational corporations and the expansion of their operations amplify their sensitivity to political positions taken by their home countries. In a world where many multinational corporations operate in the same industries, governments suffering from political-economic pressure can easily find replacements. Therefore, the temporary suspension of business activities due to political pressure on a state may cause the multinational corporations operating there to lose profitable markets.

Even punitive measures not explicitly designed to limit the operations of multinational corporations in a certain state may, nonetheless, cause them harm, as the target state may decide to harass foreign companies or respond with a counter-boycott against imports from the sender state. For example, the US sanctions on Russia (in the wake of the Ukraine crisis in 2014) did not initially relate to the operations of companies such as McDonald's, nor did it include measures affecting their ability to operate in Russia. However, this did not prevent the Russian authorities, several weeks after the United States announced its sanctions, from enforcing health regulations on McDonald's that previously had not been required.[17]

Sometimes the import of specific technologies or a unique product may have no significant impact on the nominal value of total trade, but is nevertheless responsible for a rise in productivity in certain sectors—a rise that is subsequently expressed in an increased GDP. The restriction of such imports will cause damage whose costs are higher than the nominal value of their trade. The internationalization of the production process—one of the developments that most characterizes globalization—has a significant impact on the leeway of countries thinking of imposing sanctions. The more the production process is dispersed internationally, the more likely that sanctions imposed by State B on State A will damage the production and exports of State B. Sender states may find immediate replacements for consumer products, but they are likely to be more hesitant to restrict the import of inputs vital for production in their country.

Clear proof of this argument was provided in the 2012 crisis between China and Japan regarding disputed islands in the East China Sea. The wrath of the Chinese public at Japan's conduct led, over the course of summer 2012, to a consumer boycott of Japanese cars, which was encouraged by several state media outlets. While supporting the boycott of Japanese consumer goods, the Chinese government still made sure to continue nurturing investment and trade ties for non-consumer goods, which serve as crucial production inputs for Chinese export goods. China's official belligerence, which encouraged the boycott of Japanese consumer goods, quickly died down once concern was raised that restrictions on the import of consumer goods would ultimately lead to a reduction in the import of production inputs and electronic components from Japan. Since Japanese inputs are integrated in the production processes of Chinese assembly plants, the administration feared that a boycott of Japan would hurt the export of many products such as iPhones and iPads.[18] While Israel does not export inputs of such scale to any country, there are certainly factories throughout the world that would be forced to make production adjustments if significant restrictions were imposed on Israeli exports.

It is thus evident that to properly study the economic considerations that accompany the decision to impose sanctions, a broad macro view is simply not enough; attention must also be paid to microeconomic processes. In order to assess the extent to which economic considerations may deter countries from imposing sanctions on Israel, an examination must be made of their alternatives and of how sensitive they are on a macroeconomic level to disruptions in their economic ties with Israel. The proportion of merchandise imported from Israel that is manufactured by multinational corporations or that serves as important inputs and investment products in the production process of companies and sectors with political clout must also be considered. First, the destinations and points of origin for Israeli exports and imports should be mapped in an attempt to gauge the political sensitivity of the merchandise traded to the various destinations. Second, there must be a thorough examination of the composition of exports to destinations whose economic ties with Israel are vulnerable to political pressure; this has received scant consideration in past studies and is perhaps one of the most important points when considering Israel's sensitivity to economic pressure. A vigorous boycott campaign can reduce demand for consumer goods, such as food products imported from Israel, but, as explained above, it would be difficult—though not impossible—to affect the demand of corporations for inputs and intermediate products arriving from Israel.

A careful examination of the contents of Israeli trade is also relevant to the question of Israel's ability to cope with punitive economic measures by diverting trade to alternative markets in countries whose trade ties are less sensitive to political fluctuations. This depends not only on political capabilities and the friction costs of changing trading partners, but also on the demand for Israeli merchandise in alternative markets and the availability of alternatives.

## Political Relations as a Factor in the Effectiveness of Sanctions

Economic considerations alone are insufficient means to assess the motivation of countries to choose sanctions as a bargaining tool. The political motivation to influence policy is capable of suppressing or dampening economic considerations and, thus, of designing sanctions that are certain to cause damage to the sender state as well. In fact, the willingness to adopt sanctions that will economically damage the sender state signals determination and makes it clear that the expressions of dissatisfaction with the target state's policies are not just lip service. This logic provides the basis for studies that have argued that only sanctions causing damage to the sender states can broadcast a credible message capable of influencing a target state's policies.[19] Nonetheless, it is clear that if a change of policy offers them some kind of benefit, countries will consider imposing sanctions that hurt their own economies, despite any domestic political struggles that may accompany this decision.

Just as there may be asymmetry in the economic dependence of two countries, so too in the importance they attribute to the disputed issues. The more important an issue is for the sender country (and less for the target country), the more likely it is to impose significant sanctions, which are, in turn, more likely to change the target state's policy. Of course, this logic works in the opposite direction as well; namely, the prospect of sanctions influencing policy diminish as the target state attributes greater importance to the issue of dispute than the sender state.[20]

Unfortunately, it is difficult to present a clear and precise typology that ranks issues according to their importance and predicts which issues increase motivation to adopt significant sanctions. For example, while the US administration of George H.W. Bush chose to express its dissatisfaction with Chinese human rights violations through measures that did not really hurt the US or China, the Carter administration of the 1970s imposed significant sanctions on several countries to protest their human rights violations. These sanctions also hurt the US economy and thus signaled the depth of American intent.[21]

Empirical studies have proved that countries are willing to adopt sanctions and absorb economic costs even for objectives that do not affect them directly. Databases of detailed descriptions of sanctions show that countries often impose sanctions in order to influence issues that are generally categorized as "low-salience politics." A further examination of these databases, however, also indicates that direct conflicts between countries, which had the potential of becoming military confrontations, produced more severe sanctions than other cases.[22]

There have been many instances of countries using sanctions in an attempt to change policies that did not present them with any direct threats. The possibility that countries will impose sanctions on Israel in order to express their disapproval of Israeli policy toward the Palestinians cannot, therefore, be discounted. It is not unusual for countries to make economic sacrifices in order to protest policies they perceive as violations of human rights and international law. Nevertheless, great care must be taken not to draw direct inferences from the less relevant cases of countries that have imposed severe sanctions in an attempt to affect policy that posed a threat to their own national interests: for example, the EU sanctions on Russia, which aimed to obstruct policy that impinged on the security of EU countries.

Another crucial political variable, which has traditionally garnered attention in sanctions literature, is the nature of the direct political ties between sender and target states. Studies have shown that the odds of success for sanctions improve when the sender and target states are allies; when the two states are rivals, however, the odds are reduced, since both parties expect future conflict and concentrate on achieving relative profit and building a reputation.[23]

Unconnected to the success of sanctions, there are also examples of countries imposing sanctions on their allies when the latter have harmed their interests. A survey of one of the most well-known databases—which serves as the basis for many studies on sanctions and contains 183 cases of sanctions applied between 1903 and 2002—reveals 47 cases in which the sender and target states were allies.[24] One cannot, therefore, negate the possibility of Israel finding itself under economic pressure from so-called friendly countries. A wide overlap of political interests between Israel and its trading partners cannot provide Israel with immunity from their possible imposition of sanctions.

## The Impact of the Institutional Framework on the Effectiveness of Sanctions

The institutional processes that took place in the post-Cold War international system highlighted the need to examine the roles of different institutions in shaping sanctions regimes. The end of the inter-bloc struggle facilitated the ability to pass sanctions resolutions in the UN Security Council without the absolute veto of one of the permanent members, although this has changed recently due to the renewed conflict between the US and Russia. While only two sanctions resolutions had been passed in the UN Security Council prior to 1990, dozens have since been passed against various countries. Most of the significant official sanctions, however, are not within the framework of the UN Security Council, but are unilateral initiatives of individual countries or multilateral initiatives of international governmental organizations.[25]

The rise in the number and power of governmental economic organizations has raised the question of which are more effective: sanctions formed in official multilateral frameworks or sanctions formed as unilateral initiatives of individual countries.[26] Both these scenarios are plausible in the case of Israel; independent sanctions initiatives are already taking shape in individual countries as are processes that may end in sanctions by multilateral organizations. The damage of a sanctions resolution passed by official international frameworks is likely to be greater than the direct damage caused by the measures decided upon. A sanctions resolution adopted by an important international forum lends political legitimacy to individual countries looking to take more severe steps against the target state and signals to commercial companies that the target state can be expected to face greater international pressure in the future and thus advises them to reduce all business dealings. Such processes were evident following the rounds of sanctions imposed on Iran by the UN Security Council. The US veto presumably protects Israel from the imposition of sanctions by the Security Council, but even official sanctions resolutions passed by other frameworks—in particular the EU—are capable of causing more damage than the sanctions themselves. As will be explained below, such resolutions are likely to indicate an increased political risk of doing business with Israel.

Due to the greater institutionalization of intergovernmental organizations, such as the World Trade Organization or the EU, there is a growing need to study the dos and don'ts of their various charters regarding the imposition of economic sanctions against member and nonmember states. Any discussion of Israel's sensitivity to economic pressure must examine the identity of the frameworks through which trade and investment relations are formalized via the countries that can be expected to apply economic pressure. Israel is a member of the World Trade Organization and has bilateral trade agreements with many of its major trading partners. This raises two central questions: how do these institutional frameworks affect the ability of Israel's trading partners to harm Israel, and is it possible that countries signed to bilateral economic agreements with Israel will violate them, request renegotiating and implementing changes, or even consider canceling them? Both these questions will be discussed below.

## Smart Sanctions

In the mid-1990s, both scholars and policymakers began to look for ways to increase the effectiveness of economic sanctions while avoiding collective punishment of the target state's population. Several studies highlighted the counterproductive results of sanctions that cause aggregate damage to the target state's GDP and harm to various populations. Hardship perceived by citizens of the country, they asserted, does not pressurize the leadership, and it may even encourage rallying around the flag and greater support for the government.[27] These claims were supported by analysis of the economic and political results of the sanctions imposed on Iraq, which failed to persuade Iraq to comply with the UN Security Council's demand to increase supervision over weapons of mass destruction. The example of Iraq was seen by many as proof that even exacting a tremendous price from the aggregate economy of a country does not make it change its ways. The failure of the economic sanctions stood out against the humanitarian cost paid by the Iraqi populace, and leaders and opinion makers began to introduce ethical questions into the discourse on economic sanctions.

The solution subsequently proposed by scholars and think tanks was termed "smart sanctions."[28] Smart sanctions are defined as a focused economic attack against the ruling elite, specific personalities, and commercial bodies that are close to the regime and are responsible for actions that the sender state is attempting to stop. Measures that limit the financial leeway of commercial companies and banks are also sometimes categorized as smart sanctions. Policymakers eagerly adopted this new concept, and it has achieved great popularity in Security Council discussions and other forums.

Smart sanctions reduce potential friction with interest groups who are not looking for sweeping trade and investment sanctions against the target state and, at the same time, take ethical questions and public criticism out of the equation.[29] There are many cases of economic campaigns against a state beginning with smart sanctions and later progressing to comprehensive sanctions, such as the formation of US and EU sanctions on Iran. Similarly, the first sanctions imposed by the US and the EU on Russia during the Ukraine crisis focused on an asset freeze and travel restrictions on Russian business people.

Smart sanctions must also be taken into consideration when assessing Israel's sensitivity to economic pressure. We must examine which companies—due to either the nature of their operations or the composition of their executive leadership—might be subject to smart sanctions and which organizations could lead a smart sanctions campaign. The expansion of sovereign wealth funds (SWF) should also be recalled in this context. Government management of investment portfolios is likely to boost the political component in the decisions of SWF managers. It could be interesting to examine the extent to which shares in Israeli companies are exposed to political decisions that affect the SWFs' investment policies.

## Summary

The scholarly discussion of sanctions continues to attract great attention, with the effectiveness of sanctions still being debated. The most recent studies have focused on conditions that increase the chances of sanctions influencing the target state's policy. However, this is possibly not the most central or interesting question when discussing the potential repercussions of sanctions on Israel. There is much speculation regarding the way in which economic sanctions might affect Israeli policy due to a long line of political processes, both internal and external, that are difficult to assess. An analysis of the Israeli economy's sensitivity to sanctions is, on the other hand, a more manageable undertaking, requiring reliance on some uncertain assumptions, but mostly on the examination of objective data.

Even though the damage caused by economic sanctions is presented in the literature as an explanatory (independent) variable or a control variable and not as a central response variable, the examination of past cases helps to highlight the most important aspects of the discussion: the nature of the economic relations between Israel and its trading partners on a macro level; the influence of microeconomic issues on the political-economic environment of potential sender states; analysis of the relevant interest groups in the countries of the major trading partners; the nature of the political relations with the trading partners; and the institutional framework that secures Israel's trade relationships. Each of these aspects will be addressed below.

Chapter 2

# The Political-Economic Sensitivity of Israeli Trade

This chapter opens with a classification of Israel's export destinations according to their sensitivity to fluctuations in the Israeli-Palestinian conflict. First, I assess which of Israel's major trading partners are likely to take official or unofficial steps against Israel. I then examine the composition of the exports to each of Israel's major trading blocs in order to assess the sensitivity of various types of merchandise to political activity aimed at blocking their entry to markets. Finally, I explore whether the institutional frameworks that secure Israeli trade with its major trading partners provide Israel with a certain amount of protection from sanctions.

## Sensitivity of Israeli Trade with the European Union

Over the last twenty years, many important changes have taken place in Israel's trading trends, which have led to some diversification in trade destinations. Despite seasonal and annual fluctuations, a clear trend can be discerned that indicates a decrease in the relative weight of the EU as a destination for Israeli exports. While in 1995 exports to the EU represented 41% of total Israeli exports, in 2014 it was down to less than 32%.[30] There was, at the same time, a sharp and consistent rise in Israeli exports to other destinations, predominantly Asia. In 1995 exports to Asia represented 13% of total exports; by 2014 they represented more than 20% of total exports. The US has remained a fairly stable export destination over the last twenty years, standing at approximately 20% of total exports. The EU remains, however, Israel's largest trading partner, and over the last decade there have been no real fluctuations in the relative weight of EU trade within Israel's overall trade.[31]

Public and media discourse about Israel's vulnerability to sanctions tends to focus on potential sanctions instigated by EU bodies. This discourse intensified after the European Commission approved on November 11, 2015 a document calling for EU countries to label products made in Israeli settlements.

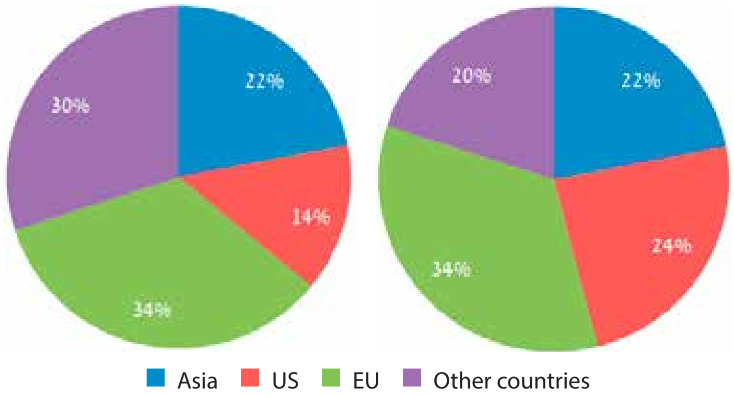


**Figure 1:** Distribution of Israeli Trade by Country Groupings[32]

The decision to label products is just one of many proofs attesting to the political sensitivity of Israeli trade with EU countries; there is a long list of variables and examples demonstrating that Israel's trade with the EU is impacted more acutely by fluctuations in the Palestinian issue than its trade with other major trading partners. There are several explanations for this, in addition to econometric proofs discussed below.

First, according to official EU policy, the depth of the EU's economic ties is generally associated with progress in other issues that are central to the EU. A historical analysis of the institutionalization of Israel's economic ties with the EU reveals a clear and explicit connection between EU willingness to upgrade economic agreements with Israel and progress in the peace process. Even before the decision to label products, during periods of heightened Israeli-Palestinian tension, the EU would issue guidelines clarifying that the frameworks for economic cooperation did not include any economic activity that originated in Judea, Samaria, or the Golan Heights. It should be noted that Israel's trade agreements with the EU do not grant customs exemptions for goods manufactured beyond the Green Line. The decision to label products was, therefore, a direct continuation of the policy that the Israel-EU Trade Agreement had signed in 1995, which does not apply to territories captured by Israel in 1967.

Nevertheless, during times of tension, the EU has tended to hone the distinction between goods produced in Israel proper and those produced beyond the Green Line, sometimes even creating non-tariff barriers to block entry of settlement products to Europe. A prime example of this occurred during Operation Protective Edge, when the EU reinforced an entire list of veterinary regulations making it harder to export agricultural produce from the territories as well as products with raw materials from the territories.

Second, upsurges in violence between Israel and the Palestinians has led to unprecedented calls to stop European exports to Israel of military and civilian products that may have military uses (dual use products). Such measures can be implemented as an independent initiative by any country within the EU. Since the Second Intifada, several EU countries have taken steps to restrict the export of military products during periods of tension. A rise in violence or stagnation in the peace process increases the pressure to suspend the Israel-EU Trade Agreement that codifies their trade relations.[33] Although EU officials have often stated that the EU has, at present, no intention of changing their trade agreements with Israel and any such step would clash with economic and political interests, the link between intensification of the Israeli-Palestinian conflict and European public discourse cannot be ignored. The trade agreement is unlikely to be canceled, but the very discussion of its possibility may reduce the desire of European agents to strengthen commercial ties with Israel.

Third, the campaigns by unofficial parties for a boycott of Israel are stronger and more institutionalized in EU countries. The percentage of affiliation and the power of professional associations in EU countries, in addition to the power of universities, student groups, and other institutions that have previously succeeded in promoting unofficial punitive economic measures against other countries, is greater than in most of Israel's other trading countries, as is the percentage of Muslims. This can be assumed to contribute to the prevalence of unofficial initiatives against Israel and to improve their chances of success. It is also plausible that due to political and electoral considerations, governments in some EU countries must pay more attention to the feelings of their Muslim electorate. As stated in the previous chapter, electoral considerations have often served as motivating factors for sanctions, despite the economic damage they are likely to cause the sender state and their unlikelihood of affecting the target state's policy.

The fact that Israel's economic ties with the EU are considered more politically sensitive to the dynamics of the conflict does not, however, mean that ongoing stagnation in the peace process or an escalation in violence will necessarily lead to actions causing Israel significant aggregate damage. Israel is an important trading partner for the EU, and there are many factors that would undermine—although unfortunately not discount—any attempts to harm their economic relations.

Trade relations between Israel and the EU are blatantly asymmetrical in their interdependence. While the EU is Israel's largest trading partner, Israel is the EU's twenty-eighth largest trading partner. In 2014 EU imports from Israel represented a mere 0.7% of total imports and their exports to Israel approximately 1%.[34] As previously mentioned, many studies have argued that this kind of asymmetry increases the likelihood of the stronger country using effective economic leverage over their smaller, more dependent partner. But, sometimes, the asymmetry actually provides the stronger player with political and economic advantages that are not easy to relinquish. The EU enjoys a trade surplus with Israel (Israeli deficit) in goods and services.[35] While not significant in macroeconomic terms, countries are never in a hurry to cripple trade ties that improve their trade balance.

A focus on aggregate data in an attempt to determine sensitivity and vulnerability to measures that disturb economic ties may, however, provide a distorted picture, particularly in the case of the EU with its twenty-eight countries of varying commercial and political interests. The opposition of EU governments, led by Germany, to the enforcement of labels on products from Israeli settlements highlights the difficulty of regarding the EU as a club whose members all attribute the same importance to economic and, especially, political ties with Israel. It should also be reiterated that even when the aggregate data attest to asymmetry between the parties, the deterioration of trade relations with a small country can cause significant damage to different sectors in a number of countries, as well as to domestic political-economic struggles. In the case of the EU, damage to trade relations with a small partner might also lead to political-economic conflict among its member states.

This last point is substantiated by evidence from the 2008 EU sanctions against Iran, a trading partner whose nominal trade value with the EU was not so different from Israel's in the same year. The formulation of this sanctions package led to a political-economic conflict within and among the EU countries. The Iranian case is, of course, very different from Israel, as Iran supplied several EU countries with a significant proportion of their oil; Israel might not export oil to the EU, but it does export important raw materials and inputs.

An examination of the composition of Israeli exports to the EU shows different products according to the country. Israeli exports to Germany, for example, are diverse, with no single company or sector responsible for a significant share of the exports, while the majority of exports to France consist of metal products, chemicals, and agricultural products. There is also much variety in the activities of Israeli multinational corporations in EU countries. In Holland, there are Israeli companies with local subsidiaries; in Germany, on the other hand, there are no significant Israeli companies with a multinational character. There are also differences in the level of public and official interest in the Israeli-Palestinian conflict, which should serve as a warning to anyone looking to present overall conclusions regarding the sensitivity of Israeli exports to political pressure in the EU.

Nevertheless, several prominent features can be highlighted in the composition of Israeli exports to the EU. As can be seen in Table 1 below, a considerable proportion of Israeli exports to the EU are production inputs for various phases of production and for industries with different technological power. These exports are not consumer goods and are thus less vulnerable to public boycott campaigns. They can only be impacted if an unofficial campaign succeeds in influencing commercial companies, but they are not immune to official sanctions that ban the entry of all Israeli goods into the EU nor to changes in Israel's trade agreements with the EU. However, calls for a sweeping and official boycott of such goods can be expected to encounter blocking efforts—of either high or low intensity—by industrialists who rely on Israeli inputs for their production processes, which could lead to internal political struggles.

Any examination of the EU's overall trade policy and of the possibility of the imposition of sanctions against Israel cannot ignore the dominance of the various interest groups in EU countries. The power of the various interest groups around the EU can perhaps explain why recent EU restrictions on the sale of goods from Judea and Samaria have related specifically to food and agricultural products. This measure, which has negligible impact on the individual European consumer, is consistent with the interests of European farmers who are always looking to block import competition and who traditionally exert great influence over EU trade policy. In other words, any restrictions on the import of agricultural products are embraced by this strong interest group, without impacting the interests of any other official interest group. On the other hand, restrictions on the import of inputs will clash with the interests of industrialists who will be forced to find alternatives, without perhaps benefiting any other interest groups. The macroeconomic situation in many EU countries has yet to stabilize, which is likely to discourage companies from making unnecessary changes to production processes and looking for alternatives.

**Table 1:** Makeup of Exports from Israel to EU Countries, 2013

| Industry | US dollars (millions) | Percentage of total exports to EU | Level of sensitivity to boycott | Explanation |
|---|---|---|---|---|
| Agriculture, fishing, forestry | 882.0 | 4.8 | High | Support of interest groups; Sensitivity to consumer boycott |
| Food products | 447.1 | 2.4 | High | Support of interest groups; Sensitivity to consumer boycott |
| Clothing | 27.8 | 0.2 | High | Support of interest groups; Sensitivity to consumer boycott |
| Textiles | 183.1 | 1 | High | Sensitivity to consumer boycott |
| Pharmaceuticals | 2765.3 | 15.1 | Medium | Reliance on elasticity of demands |
| Chemicals and derivative products | 4469 | 24.4 | Low | Inputs are less sensitive to consumer boycott; Interest groups oppose restrictions |
| Rubber and plastic products | 908.5 | 5 | Low | Inputs are less sensitive to consumer boycott; Interest groups oppose restrictions |
| Computers, optics, electronic equipment | 1769.1 | 9.7 | Low | Inputs are less sensitive to consumer boycott; Interest groups oppose restrictions |

| Industry | US dollars (millions) | Percentage of total exports to EU | Level of sensitivity to boycott | Explanation |
|---|---|---|---|---|
| Electrical equipment | 381.4 | 2.1 | Low | Inputs are less sensitive to consumer boycott; Interest groups oppose restrictions |
| Machinery | 1270.2 | 6.9 | Low | Inputs are less sensitive to consumer boycott; Interest groups oppose restrictions |
| Diamond processing[36] | 1867.3 | 10.2 | Low | Niche industry not exposed to consumer boycott; Product does not indicate country of origin |

As can be seen in Table 1, agricultural and food exports represent less than 7% of total Israeli exports to the EU.[37] As mentioned earlier, these exports are sensitive to sanctions because they largely consist of consumer goods that are easily identifiable as Israeli and receive no protection from interest groups; rather, there are strong interest groups who are happy to block them. Clothing and textile exports, also theoretically vulnerable to an effective consumer boycott, do not represent a significant share of total exports to the EU, and thus a boycott, while damaging the relevant sectors in Israel, would not cause significant macroeconomic damage.

The export of chemical goods, nearly all production inputs for European industry, represents 24.4% of total exports to EU countries. Rubber products and machinery used in European industry together represent approximately 12% of total exports to the EU, and approximately 10% of Israeli exports to the EU consist of computer products and electronic and optical equipment. Most of these products are incorporated as important components of end products produced in various industries in Europe, including the security industry. Finding alternatives for some of these exports would be no easy task. The export of pharmaceuticals represents over 15% of all exports to the EU. Even though these are typically generic drugs, the unyielding demand for drugs from Israel should not be underestimated. Health facilities and large pharmacies are generally not happy about changes in the supply of drugs that are recognizable to their staff and customers.

Another important point regards the identities of the companies that export to the EU. A significant percentage of Israeli exports comprises goods produced not by companies with an exclusively Israeli identity, but by multinational corporations; a major proportion of Israeli exports are, therefore, products of multinational corporations based in countries other than Israel. These are foreign companies that have acquired holdings in previously Israeli-owned companies, such as food giant Nestle which, as of April 2016, bought out the Israeli company Osem. In addition, a sizable share of Israeli exports involve goods from companies such as Intel, which have established production operations in Israel, or from Israeli companies which have manufacturing operations overseas via acquired companies or factories they have built (see Table 2).

**Table 2:** Exports from Israel Distributed Among Local and Multinational Companies[38]

| | OUT (Israeli companies that own foreign companies) | IN (Israeli companies owned by foreign companies) | Israeli | Total |
|---|---|---|---|---|
| Total companies | 115 | 61 | 95 | 271 |
| Total product exports (in billions of US dollars) | 12.3 | 8.7 | 9.6 | 30.6 |
| Total workers (in thousands) | 66.2 | 28.7 | 23.9 | 118.8 |

*Source:* Economics Research Administration of the Israeli Ministry of Economy.

This reality may present an additional stumbling block to any attempts to restrict Israeli exports. Official restrictions on exports may end up harming the direct interests of multinational corporations with production operations in Israel. When the interests of such companies are threatened, there are usually diplomatic and political repercussions involving their home countries. For example, official measures against Israel that harm the interests of a company like Intel are likely to motivate official US parties to block an economic campaign targeting Israel. Likewise, any attempts to restrict the exports of Israeli companies with holdings in European subsidiaries, like Teva, may affect overall operations, including production operations in Europe.

As some of the goods manufactured in Israel by multinational companies—such as chips manufactured at the Israel Intel plant—are less identified with Israel, they are less sensitive to a direct consumer boycott. Except for Teva, there are no well-known Israeli companies that are identified with Israel and export sizable quantities of consumer goods to Europe. While the dominance of multinational corporations might hinder attempts to conduct a direct boycott of Israeli exports, it can also provide some leverage in pressurizing companies connected with Israel. In other words, the engagements of multinational corporations with Israel provide boycotters with known addresses for directing their demands. It is easier to target large, prominent companies and corporations than to compile a long list of all Israeli companies operating in Europe.

As previously mentioned, many of the multinational corporations connected to Israel have in recent years become more sensitive to issues of corporate social responsibility (CSR). The BDS movement, recognizing this trend, is working to provide evidence of Israel's failure to comply with the CSR code. Ongoing accusations of unethical business conduct that succeed in achieve media and public attention are capable of damaging companies, even if they do not directly affect their bottom lines in the short term.

In 2015 there were reports of various attempts to apply pressure and consumer boycotts against large, well-known corporations "suspected" of supporting and conducting business with Israel.[39] A particularly notable example was the declaration by the CEO of Orange upon his visit to Egypt regarding the company's intention to terminate business activities in Israel. As I make clear below, institutional constraints raise great doubts about the ability of governments to recreate the days of the Arab boycott and to conduct official sanctions regimes intended to distance multinational corporations from Israel. While these constraints do not apply to unofficial organizations, the imposition of a significant, long-term consumer boycott against strong corporations is challenging for non-state actors. The natural tendency of corporations is to maintain and protect profitable operations, and as the CEO of Orange noted, there are also contractual obligations that restrict the flexibility of companies to terminate ties with a given country overnight. It is debatable whether the global demand for shares in strong global companies can really be affected through pressure applied by NGOs; even if, for example, informal pressure prompts a pension fund to reduce its holdings in a corporation due to its activities in Israel, there are likely to be other institutions that are more than happy to buy up the shares of this profitable corporation. Nevertheless, it remains feasible that the constant harassment of international companies by informal bodies may have a long-term impact on their decisions regarding investments in Israel.

From a macroeconomic perspective, most of Israel's significant EU trading partners enjoy a trade surplus with Israel. While, theoretically, restrictions on imports from Israel—without corresponding restrictions on exports to Israel—would be likely to improve the trade balance with Israel, the EU would struggle to avoid restricting exports to Israel if it were to harm imports. First of all, judging by past measures, the unilateral steps taken by European governments have been, in fact, restrictions on exports from Europe of security-related products. Countries would find it hard to justify sanctions on Israeli imports while simultaneously allowing such exports. Second, official statements have tried to encourage European countries to reduce their operations in Judea and Samaria, which may signal future official restrictions that would make it harder for European countries to export inputs to factories operating beyond the Green Line. Third, restrictions on the entry of Israeli products could, at least theoretically, reduce Israeli demand for European inputs; just as Israel exports inputs to Europe, a considerable proportion of European imports to Israel are also various types of inputs. Any damage to the global demand for Israeli products will reduce Israel's need for inputs and capital goods. This does not apply only to the export of Israeli consumer goods; even goods imported from Israel and used as inputs in Europe are usually produced through use of other inputs and capital goods sourced in Europe.

Just as the composition of Israeli exports to Europe limits the EU, so do European exports to Israel. The asymmetry of their economic interdependence is significant here and prevents Israel from convincingly countering calls for sanctions on European imports in response to the restrictions on Israeli exports to Europe. Approximately 34% of all Israeli imports in 2014 came from the EU. Even if these imports were based on consumer goods alone, it would be impossible to impose significant restrictions on imports from such a dominant source without paying a heavy macroeconomic price. However, in the same year, imports of consumer goods represented only 18% of total imports from Europe, with the greater part consisting of production inputs (approximately 49%) and capital goods (20%). Imports from the EU provided more than 28% of Israel's total imports of manufacturing inputs and more than 52% of the imports of machinery and equipment.

Both Israel and the EU are likely to be hurt in an economic crossfire. EU sanctions on Israeli imports may drag EU governments into unpleasant conflicts with interest groups and reduce production for a certain period of time; Israeli sanctions on European imports, however, could totally paralyze Israeli production. While easier to find replacements in today's globalized world, finding immediate replacements for such a large proportion of inputs and capital goods would be quite a challenge. Fears in Israel usually concentrate on the imposition of sanctions on Israeli exports, but restrictions on Israel's imports from Europe would be no less painful. Israel should thus hope that the EU does not consider imposing significant restrictions on EU exports to Israel and should certainly not be initiating any of its own moves in that direction.

While the asymmetry of their interdependence makes Israel much more sensitive to processes that disturb economic relations, a number of economic and political factors complicate any EU decisions to impose real economic sanctions on Israel. As previously mentioned, due to the nature of Israel's exports to EU countries, most exports are not particularly vulnerable to a direct consumer boycott, and the strong interest groups that benefit from Israeli exports are likely to resist any official policies restricting these exports. Nonetheless, it must be remembered that one of the important—if not the most important— variables in the discussion of the likelihood of sanctions is a country's political motivation to change the policy of another country. When there is obvious governmental interest in imposing sanctions on another country, there is more willingness to confront interest groups and to suffer the macroeconomic costs. Both the formation of the EU sanctions packages against Iran and the EU's dealings with Russia prove that these decisions are always motivated by political maneuverings between and within EU countries. Nevertheless, as both cases show, when highly motivated to block a certain policy, the EU is capable of making decisions that counter its own macroeconomic interests and, in such cases, governments prove willing to confront strong interest groups.

Comparisons must be made very carefully, of course, and the EU is far more interested in influencing Russian rather than Israeli policy; the potential cost of imposing sanctions on Russia is also much higher. The price that the EU is willing to pay for sanctions against Israel depends on the extent of antagonism caused by Israeli policy among the member states. In accordance with the model presented in Chapter 1, heightened government and public antagonism toward Israel is likely to increase the benefit of sanctions such that they outweigh the economic costs.

Israel is not, at present, supplying the EU with reasons to impose comprehensive official restrictions on the movement of goods either to or from Israel. In light of EU interests, and for various legal and institutional reasons, the EU seems unlikely to terminate its trade agreement with Israel. However, it is certainly feasible that it will take official steps that, while not perceived as radical, would give the unofficial anti-Israel campaign momentum and thus impact Israel negatively. For example, the actual decision to label products from the settlements has negligible macroeconomic consequences—the Israeli Ministry of Economy estimated that the new provisions are applicable to $50 million worth of exports of an overall annual total of around $200 million worth of products manufactured in Judea, Samaria, and the Golan Heights—but the move, as well as any official overall boycott of goods from the territories, signals a readiness to take further steps and could deter companies from strengthening their economic ties with Israel.

There are those who believe that the labeling of products from the settlements could, paradoxically, take the edge off Israeli isolation and could, therefore, be seen as a cost worth paying. They have claimed that this labeling may not only increase demand for these products among consumers who want to support Israel, but it may also put an ethical stamp of approval on Israeli goods made outside of the territories and protect them from a boycott. Although there is some logic in this approach, it does not take into account the boost such official measures give to the BDS movement and their possible snowball effect. While the BDS movement cannot be credited with the European decision to enforce product labeling on goods manufactured in the settlements—this discussion predated their formation—an official decision to boycott goods manufactured in the territories could certainly be perceived as a BDS victory whose momentum might have significant repercussions, first and foremost, for Israeli companies operating both within the Green Line and in Judea and Samaria. In other words, an official decision to boycott products from settlements is likely to encourage a secondary, unofficial—and even official—boycott of Israeli companies somehow connected to operations in Judea and Samaria. Such measures could, in turn, intensify the pressure on sectors and companies with extensive, easily identifiable activities in the settlements. Most worryingly, Israeli banks, which are obviously tied to the financing of projects in the settlements and also provide financial services to their residents, would be targets for punitive measures implemented by European financial institutions and governments (see details below).

As mentioned above, a direct consumer boycott is unlikely to cause significant damage to the export of Israeli inputs; however, if European companies estimate that their ties with Israel are causing self- harm, they may gradually seek alternatives in other markets. Effective unofficial activists calling for a boycott of Israel are capable of extending their campaign and of influencing the considerations of companies that purchase raw materials and components from Israel. Such a campaign is more complicated than a regular consumer boycott, both logistically and politically, and requires more time. Its success depends, to a large extent, on the level of antagonism inspired by Israel's policies among the public and the business community and on any official decisions, not necessarily explicit sanctions, made by European governments.

## Sensitivity of Israeli Trade with Asia

The last twenty years have seen a continual rise in Israeli exports to Asian countries. In 2013, Israeli exports to Asia totaled $10 billion (not including diamonds)—approximately 20% of all Israeli exports.[40] Unlike trade relations with the EU, these are not governed by a uniform bloc whose members are committed to some kind of united framework (other than to the rules of the World Trade Organization). If in the case of the EU, I avoided looking only at aggregate data and relating to the EU as a monolithic bloc, this is all the more relevant in the case of Asia. Nonetheless, several economic and political similarities can be highlighted in the trade relations between Israel and most of its Asian trading partners.

It is fair to state that trade with most of Israel's trading partners in Asia is currently not sensitive to fluctuations in the Israeli-Palestinian conflict. Prior to the 1990s, trade with most Asian countries was affected by their fear of the Arab boycott of Israel and did not, in fact, take place until the renewal of diplomatic ties in the early 1990s. But, from the moment trade relations commenced, there have been barely any explicit declarations by Asian governments connecting the flow of trade with Israel to the Israeli-Palestinian conflict; they may express criticism of Israeli policies in the territories, but they do not, on the whole, see these policies as harming business ties.[41] In fact, even during some particularly low points in Israeli-Palestinian relations, several economic agreements were signed between Israel and Asian trading partners; for example, Israel and India signed cooperation agreements in the fields of health and environmental protection in 2003, one of the most violent years of the Second Intifada. A recent demand by the Chinese government that Chinese workers in Israel should not be employed in construction projects over the Green Line is an exception to this rule. However, this declaration should not be seen as a harbinger of significant change in China's approach; China has a considerable interest in blocking any international punitive measures that might hinder Israeli exports and thus harm the profits of the Chinese state companies that have acquired Israeli companies over the last two years.

Although several trade blocs in Asia, which are anchored in an institutional framework, are gaining momentum, these institutions do not seem at all concerned with the Israeli-Palestinian conflict. Likewise, the level of interest in the Israeli-Palestinian conflict among the general public in most of Israel's Asian trading countries is significantly lower than in European countries, as is the intensity of organizations calling for a boycott of Israel; with the exception of India and Malaysia, most have no significant Muslim population with either political power or interest in the Israeli-Palestinian conflict.

Another important point is the high level of involvement of most Asian governments in their countries' economies. The greater the state involvement in the economy, the closer the connection between trade and government policy. While in pure market economies, governments have the power to influence trade relations with other countries in many ways, in market economies, the interests and decisions of companies and consumers can have significant impact on trade with certain countries. This is less relevant in economies where the state owns the large companies, such as China, or where the political-economic structure is typified by a close-knit dialogue between corporations and state institutions, such as Japan. It is, as yet, hard to see any official motivation in Asian countries to suspend or restrict trade with Israel, and, other than possible symbolic measures, most Asian governments are unlikely to restrict trade while it serves their aggregate welfare.

An analysis of Asia demands a distinction between the effects of the conflict on both existing and potential trade flow. With regards to the latter, progress in Israeli-Palestinian relations could provide some Asian countries with an incentive to strengthen trade ties through the signing of a free trade zone agreement. Israel does not yet have a free trade zone agreement with any of the key Asian countries, but is currently in negotiations with China, South Korea, and India. Progress in Israeli-Palestinian relations could be expected to improve trade conditions with Muslim countries, such as Indonesia and Malaysia. While these countries allow trade relations with Israel, they impose certain restrictions, which are likely to relax somewhat with the easing of the political climate surrounding Israel.

Israel's major trading partners in Asia are China, South Korea, India, and Japan. India has the highest political sensitivity to the Israeli-Palestinian conflict due, perhaps, to higher percentages of Muslims in certain trade zones, although the large Muslim minority in India is generally not militant. During both Operation Protective Edge and Operation Cast Lead,[42] calls for boycotts of international companies that operate in Israel, such as McDonald's and Nestlé, were reported in these regions.[43] However, these calls did not seem to gather momentum and failed to have any impact. Likewise, they did not stop the Indian government from approving a weapons deal with Israel after years of refusal. The signing of the weapons deal strengthens the claim that unofficial protests against Israel are unlikely to influence governments' security and economic considerations.

Exports to India in 2014 totaled $1 billion (double if diamond exports are included), and in recent years, India has been ranked among Israel's top ten export destinations. Most of these exports consist of minerals and chemical products used by local industry, which are, thus, less sensitive to a consumer boycott. Israel also exports to India important components for the country's security industry, such as measuring equipment, navigation devices, and optical and electronic equipment. There is, in addition, a fair export of finite security products. Security exports are not susceptible to consumer boycotts, depending mainly on the broader strategic interests of the importing country, which sometimes deviate from the quality of diplomatic relations with the exporting country. In short, any discomfort felt by the Indian government regarding Israeli policy is unlikely to be central to their decisions regarding the import of Israeli security products.

As previously stated, Israel's other major Asian trading partners (Malaysia aside) are less sensitive to fluctuations in the Israeli-Palestinian conflict than Europe and the type of exports not particularly susceptible to a consumer boycott. The hope that increased exports to Asia might compensate for damage caused by the conflict to exports to Europe has been expressed by many, including Prime Minister Benjamin Netanyahu during Japanese Prime Minister Shinzō Abe's visit to Israel in January 2015.[44] But, regardless of the issue of political pressure on Israel, a diversification of trade destinations and a deepening of economic ties with Asia are the right moves. It is possible that they will, in the long term, reduce Israel's sensitivity to politically motivated economic pressure, but in the short term, it is hard to see how Israel can quickly redirect large exports of inputs from Europe to Asia. It is the very same circumstances that protect Israel from a direct consumer boycott in Europe that hinder the redirection of exports to Asia. It is generally easier to find alternative markets for consumer goods than to find industries and factories that need to make adjustments for the integration of new inputs in their production process. Some Israeli inputs are used in factories with very specific needs, and thus the global demand is very limited. Furthermore, the redirection of trade for products with a broader appeal, such as chemicals and minerals, still relies on the demands of industry in the alternative target markets; there must be a significant rise in demand in order to swiftly redirect the export of inputs from Europe to Asia. Trade agreements that reduce duties on such goods may increase demand for them in Asia, but current discussions about free trade agreements with Asian countries are yet to fully mature, and there is usually a time lapse between the signing of such agreements and actual implementation. Other than by lowering prices, Israel cannot, therefore, take immediate and significant steps to speed up the Asian demand for Israeli inputs.

## The Likelihood of American Pressure

While the EU is Israel's main trading partner, when trade is divided by individual countries rather than trade blocs, the US heads the list of Israel's export and import destinations. It is fair to assume that the US government will avoid any major steps that could harm Israeli trade. While there remains a possibility that the US will express its displeasure with Israel's policies by adopting symbolic punitive measures or restrictions on the export of certain security products, these are unlikely to impact trade relations between the countries or to cause macroeconomic harm to Israel.

As presented in the literature survey above, it is not uncommon for differences of opinion between friendly countries to lead to punitive economic measures, and the US and Israel are no exception here. The US has several times used economic pressure or other types of leverage with economic repercussions to punish or pressure Israel; most prominently in 1992, when the George H.W. Bush administration rejected the request of the Shamir government for $10 billion in loan guarantees to help finance the giant wave of immigration from the Former Soviet Union. It was recently revealed that the US State Department has been considering revisiting the issue of loan guarantees and tightening the connection between the guarantees and investment in the territories, with the guarantees being reduced as Israeli investment in Judea and Samaria grows. These loan guarantees are the $3.8 billion remaining from the $9 billion provided by the George W. Bush administration in 2003 to help Israel deal with the global economic crisis and the Second Intifada. This was not, it should be emphasized, a direct grant, but a way of helping Israel to procure loan financing with the US as a guarantor if Israel was to default on the loans. Israel last used these loan guarantees to raise financing in 2004 and has no apparent intention of using them in the near future. Rather, Israel prefers to save the option of the guarantees as an insurance policy for extreme emergency circumstances that might entail a dramatic rise in financing costs. The ability to rely on US guarantees presumably broadcasts a positive message regarding Israeli bonds even during normal times. Even if Israel does not use them, an announcement that these guarantees, which are due to expire in 2016, will not be extended may lead to higher financing costs.

The guarantees were clearly far more significant at the time of the famous confrontation between the George H.W. Bush administration and the Shamir government than today when returns on Israeli government bonds are not so different from US bonds. A decision to discontinue the guarantees might be perceived in US political discourse as a blow to Israel's ability to finance debt during times of security crises and thus to Israel's security and would, therefore, involve a political confrontation with both chambers of Congress, something that no administration relishes. It would therefore be more politically expedient for any administration to refuse Israeli requests for new support than to roll back existing economic assistance.

It is, as previously stated, difficult to imagine a scenario in which the US government would take official steps to damage the ongoing trade between the two countries. Even when the George H.W. Bush administration expressed strong opinions about the loan guarantees affair, no one seriously suggested restricting or suspending the trade agreement with Israel. It should be noted that in 1992, Israel was the only country in the world to have a free trade zone agreement with the US. The US is currently conducting talks on trade agreements with many countries, and it is hard to see how an American administration could justify harming the trade agreement with Israel while at the same time conduct trade negotiations with countries considered far less friendly.

Over the last few months, pro-Israel legislators in the US have been trying to push initiatives to impose sanctions against companies or countries that cooperate with the boycott of Israel. Several states have already adopted laws that aim to reduce the incentive to boycott Israel. South Carolina passed a law prohibiting the state from signing contracts with companies that boycott countries that have ties with South Carolina, and similar proposals are being promoted in Illinois and other states.[45] Those encouraging this legislation have emphasized that a boycott of Israel would damage the US economy and American corporations that operate in Israel and possibly even cost US citizens their jobs.[46] Regardless of their validity, these arguments support my earlier claim that attempts to harm Israeli exports of products of multinational corporations present the boycotters with some complex challenges.

Efforts by pro-Israel players to block attempts to isolate Israel can be seen in the wider political-economic arena governing overall US trade policy. Israel supporters succeeded in adding an amendment to the trade law requiring US delegates in negotiations for the creation of trade agreements with Europe and Asia to declare US opposition to any support by its trading partners for the BDS movement or for initiatives to boycott Israel or companies operating in Israel or in "territories under Israel's control."[47] The use of the phrase "territories under Israel's control" forced the State Department spokesperson to make a clarification that the US administration had no intention of ordering its representatives to express US reservations regarding a boycott of the territories. After many years of US opposition to Israeli building in the territories, the Obama administration could not publicly declare its intention to protect economic activities in the settlements. The highlighting of the settlements by pro-Israel players can thus be seen as a tactical error, as it forces the administration to make declarations implying that the US does not oppose a secondary boycott of Israeli companies whose operations are mainly based within the Green Line, but who also operate in Judea and Samaria. Pro-Israel organizations are therefore advised to focus their efforts on enlisting the administration in a comprehensive struggle against the economic campaign to isolate Israel.

## Do the Multilateral Institutional Frameworks Protect Israel?

The frameworks that formalize trade relations between Israel and its major trading partners place legal constraints on the countries seeking to harm Israeli exports for political reasons. Israel is a member of the World Trade Organization (WTO), the world's most important multilateral framework for the regulation and advancement of liberalization in international trade. Unlike other international organizations, the WTO has an effective mechanism for settling disputes between member states. The organization's guiding principle, to which all 160 member states are committed, is nondiscrimination: a member state that grants a trade benefit to another state must apply the same benefit to any other members of the organization (known as the most-favored-nation [MFN] principle); states are also not permitted to discriminate between local production and imports (known as the national treatment principle).

There are well-known cases of countries facing an external economic campaign who have threatened to turn to WTO's Dispute Settlement Body (DSB) on the grounds that this violates WTO rules. For example, Russia—which joined the WTO in 2012—recently claimed that the US sanctions package is illegal because it contravenes WTO rules. The US ambassador to the WTO counteracted that all legal aspects of the sanctions had been thoroughly examined and that the US was not in breach of WTO rules.[48] The seriousness of the response of those countries accused of violating WTO rules shows that countries are neither indifferent toward the organization nor interested in violating its rules (despite, of course, varying levels of commitment to the spirit and rules of the organization).

There are, however, some recognized exceptions to the MFN principle. For example, Section 21B of the General Agreement on Tariffs and Trade (GATT) allows nonconformity in cases where countries must protect their national security. However, in the case of Israel's trading partners, who do not find themselves in a potentially military conflict with Israel, security considerations cannot be used to excuse a raise in tariffs or nontariff barriers on Israeli exports.[49] In other words, Israel can file a suit with the DSB against countries that discriminate against Israeli exports for political reasons.

There have, in fact, been recent suggestions that Israel should file a suit with the DSB against the EU in the wake of the decision to label settlement products. For example, in 2015, law professors Avi Bell and Eugene Kontorovich published a detailed article explaining that the European resolution violates the MFN principle and recommended Israel to appeal to the DSB against the EU.[50] Regardless of the legal controversies raised by this article and the inherent risk that the DSB would rule against Israel in such a suit, it would be a mistake to appeal to the DSB and place the product labeling issue on the international trade agenda. At this point, Israel needs to avoid inflating the effectiveness of this issue lest it contribute to a snowball effect. Moreover, it is not at all clear that a ruling in favor of Israel against the EU—which would allow it to take punitive countermeasures against the EU—would actually serve Israeli interests. The EU is obviously not interested in the WTO ruling that product labeling is illegal and is unlikely to be concerned by the negligible economic impact of any Israeli countermeasures.

Israel must save the option of turning to the DSB for cases of countries imposing sanctions that could cause grave harm to its trade and represent clear violations of WTO rules. According to the organization's rules, a ruling in favor of Israel would allow the raising of tariffs on imports from the offending country at a rate that would compensate for the damage caused to Israeli exports.[51] Of course, any such ruling would not inconvenience countries that had made the decision to terminate all exports to Israel. It is, nevertheless, hard to find examples of major trading partners terminating exports to a country with which they are not in direct conflict.[52]

Israel's membership in the WTO can serve as a consideration in the cost-benefit calculations of countries that want to raise tariffs and institute non-tariff barriers on Israeli goods. However, it is feasible that the cost-benefit considerations of countries highly motivated to harm Israel would encourage them to risk the costs involved in a WTO suit. High-state motivation to restrict Israeli exports may generate unofficial bureaucratic practices that represent de facto non-tariff barriers, but it would be difficult to prove that such measures violate WTO rules.

The membership of Arab states in the WTO is one of several factors discouraging the recreation of the Arab boycott. It is difficult to see how in today's globalized world with countries committed to the WTO's rules governments could declare official threats of secondary and tertiary boycotts of companies connected with Israel. However, the relative immunity afforded Israel by the institutionalized framework of international trade—which depends, as previously mentioned, on a country's motivation to restrict trade ties with Israel—is irrelevant to many economic areas. Many sectors and domains are not included in the binding framework of the WTO. For example, the WTO Agreement on Government Procurement (AGP) is a voluntary and complex agreement to which most WTO members have not committed. Unlike the case of goods trading, this agreement fails to create a binding framework that would deter governments from unofficially discriminating against Israeli companies or merchandise in governmental tenders. Furthermore, neither the WTO nor any other multilateral organization has an institutionalized mechanism capable of preventing discrimination in either incoming or outgoing direct foreign investments.

Although the WTO also relates to trade in services, there is not the same broad commitment among countries to the MFN principle.[53] Likewise, the bilateral trade agreements that Israel has signed tend to present less stringent commitments regarding trade in services. In other words, there are no institutional frameworks that present real legal restrictions on the politically-motivated damage to the movement of services to and from Israel; this is a crucial point considering the ongoing rise in service exports over recent years, which reached (excluding startup companies) $34 billion in 2014, representing 35% of all Israeli exports (goods and services).

As with trade in goods, the majority of service exports comprise economic activities linked to production processes and incorporated as interim components for end products. For example, computer and software services and research and development services represent 42% of Israel's total service exports.[54] The export of such services is not particularly sensitive to a direct consumer boycott, and it can therefore be assumed that governments seeking to harm Israel will first go after other services.

Restrictions on the free movement of business people through the imposition of bureaucratic obstacles, such as a backlog in issuing entry visas and work permits, is one of the common ways of beginning smart sanctions regimes. Although such decisions are liable to harm all service exports, they are most likely to impact the export of professional services such as the undertakings of Israeli lawyers, accountants, engineers, and architects, which totaled approximately $3.4 billion in 2014.[55] Banking and financial services are also usually in the cross hairs of countries attempting to form a smart sanctions package against other countries. In 2014, the export of Israeli banking and financial services totaled $650 million.

Israeli banks are a relatively easy target for those looking not only to harm Israeli financial activities overseas, but also to encourage divestment from shares in Israeli companies. Israeli banks provide banking services for Israeli citizens living over the Green Line and extend credit to companies operating there. It is thus fairly easy for boycotters to depict the banks as deeply involved in the financing of business activities in Judea and Samaria. Over the last two years, several EU banks and pension funds have announced their divestment from Israeli banks. In January 2014, PGGM, the largest pension fund in the Netherlands, announced its divestment from Israel's five largest banks. In February 2014, Dansk Bank, the largest bank in Denmark, announced that it had blacklisted Bank Hapoalim due to its financing of the construction of illegal settlements in the West Bank.[56] Similar steps have been taken by other banks in Scandinavia. These institutions did not, however, hold so many shares in Israeli banks, and therefore their declarations did not impact the share prices or fundraising efforts of Israeli banks. Previous declarations made by government pension funds or private financial entities similarly had no impact on Israeli share prices.

It is difficult to assess the likelihood of such measures causing damage in the future. It could be argued that global demand for shares in successful Israeli companies, some of which are traded on the US stock exchange, depends ultimately on their performance. There is, however, no doubt that Israeli companies would suffer a dramatic decline in their share prices should there be a worldwide campaign in which many financial institutions declare a unanimous halt on investment in Israeli companies or official sanctions are imposed by governments on Israeli financial institutions. The more tangible damage would be caused by pressure exerted on pension funds and banks to divest from companies that are associated with Israel. It is, however, very difficult to implement boycott campaigns of this type; even if such initiatives were launched, they would not necessarily deliver a significant blow to the demand for shares in these companies. Nonetheless, such steps could strengthen the companies' fears and their desire to avoid the trouble and negative image associated with operations in Israel.

Chapter 3

# Estimating the Effect of Politics on the Movement of Israeli Trade

This chapter aims to provide empirical support for some of the claims presented in the previous chapters via an econometric model, which examines how fluctuations in the Israeli-Palestinian conflict affect the movement of Israeli trade. My analysis proves that trade with the EU is more sensitive to deterioration in Israeli-Palestinian relations than with any other Israeli trading partner.

Although the BDS movement has been active for more than a decade and the potential consequences of sanctions have occupied the press, academia, and state institutions for some time, there have as yet not been any studies exploring whether the campaigns against Israel have actually damaged its economy. There have been studies highlighting the damage caused by calls to boycott Israeli products based on interviews with representatives of Israeli companies; but this research approach is anecdotal. In order to get a real idea of the boycott's impact, a series of interviews must be conducted over time and relate to a cross-section of companies from all sectors of Israeli exports.

Those who support the claim that the boycott movements do not significantly damage Israel's economy have suggested focusing on trade data. A quick analysis of the trade data shows that Israeli trade with Europe has actually increased consistently since the start of the BDS movement; likewise Israeli trade with other countries that might be expected to be sensitive to heightened tensions in the Israeli-Palestinian conflict. As can be seen in Figures 2 and 3 (below), even in years when Israel embarked on operations that drew significant recriminations, trade with European countries—where the BDS movement has extensive activities—was not significantly harmed. But this sort of research strategy is also far from precise. The fact that Israel's trade with a particular country actually rose in a year which saw a military operation does not prove that the potential trade flow was unharmed.

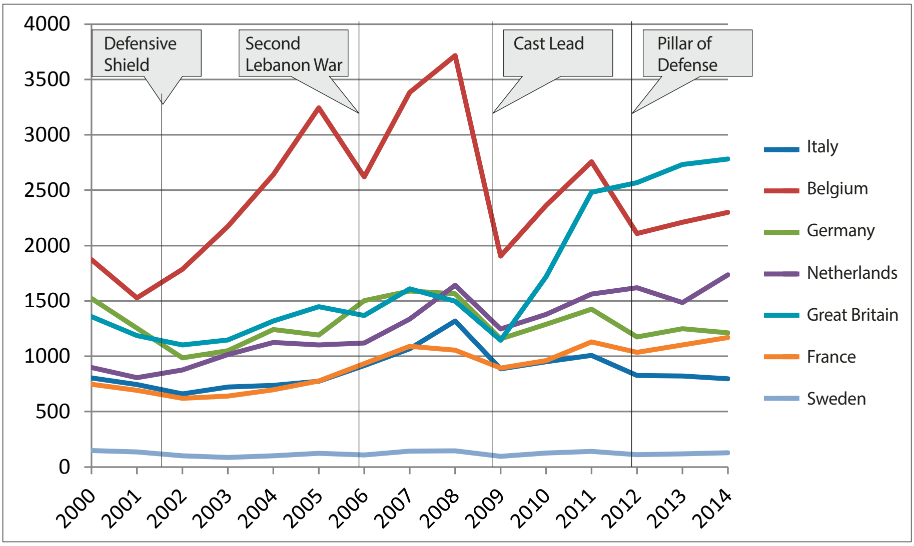


**Figure 2:** Exports to EU Countries with High Political Sensitivity (Real US Dollars in Millions)

Conversion of trade data to real data was done with the year 2000 as the base year.

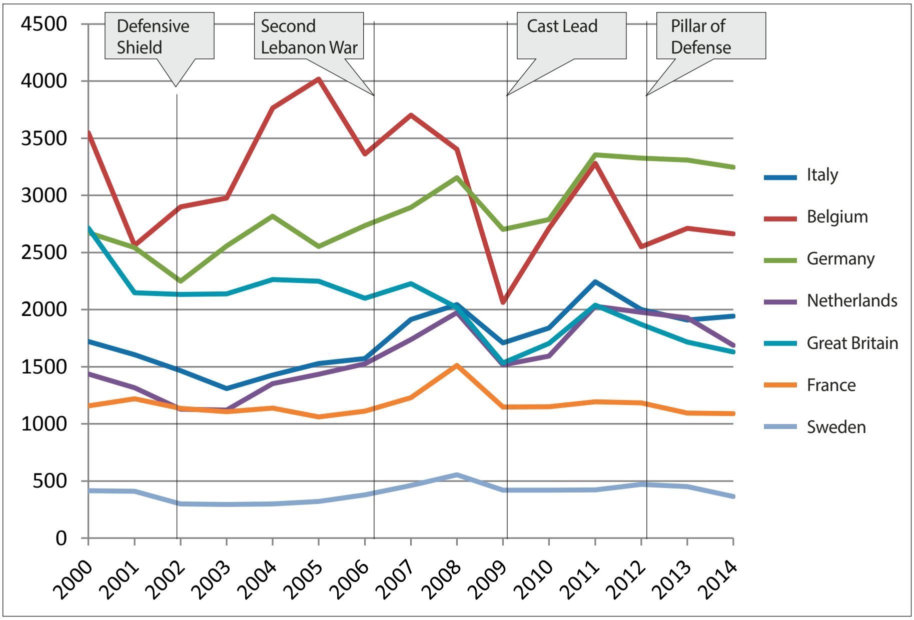


**Figure 3:** Imports from EU Countries with High Political Sensitivity (Real US Dollars in Millions)

It is, of course, possible that a certain trading partner enjoyed economic growth during the year of a particular military operation, thus leading to a rise in the demand for Israeli products and offsetting the harm caused to Israeli trade by the military operation. For example, the fact that trade in goods between Israel and Turkey rose in 2011 does not prove that the Marmara Crisis of 2010 left trade relations unharmed: rather, there was growth in Turkey in 2011 that apparently increased the demand for Israeli goods and thus neutralized the negative effect of the crisis. In other words, without the crisis, it is possible that the total trade between the countries would have been even higher. This example should clarify that, without controlling for changes in GDP and other variables, it is difficult to isolate the impact of a particular event on trade between countries. Thus, the simple observation of trade data is insufficient for disqualifying the claim that campaigns against Israel damage its economy.

In order to avoid such imprecise inferences, I present a more sophisticated analysis of Israeli trade trends. This analysis is based on a model that allows for the control of important variables and thus enables a full understanding of the effect of flare-ups in the Israeli-Palestinian conflict on Israel's trade trends.

It is important to note that the analysis presented here does not relate directly to the impact of the BDS movement or other processes through which the Israeli-Palestinian conflict may hurt Israeli trade. There are many methodological pitfalls in attempting a successful estimation of the latter, which may explain why there have not yet been any serious attempts. However, my analysis provides a much clearer picture of the relationship between political trends and Israeli trade. It should also be noted in advance that it is not always possible to draw conclusions about the future from past trends; the fact that certain findings indicate that the campaigns against Israel have not caused significant damage thus far does not necessarily mean that they will not do so in the future.

## The Model

Isolating the effect of the Israeli-Palestinian conflict on the movement of Israeli goods demands a methodology that controls for the effects of other variables impacting Israeli trade. The most accepted method in studies of this kind is the gravity model of trade, which connects the movement of goods between two countries with three groups of explanations: 1) factors that express potential supply; 2) factors that express potential demand; 3) friction factors that are likely to increase or decrease the flow of goods between the countries. The basic model describes the trade flows as dependent on three key variables: GDP, population as proxy variables of demand and supply of goods, and the distance between the countries as a variable of shipping costs.

The simplicity of the gravity model is, paradoxically, a drawback when trying to explain complex trade phenomena, because the model fails to take into account consumer preferences, the structure and costs of production, exchange rates, and other important economic variables. However, as a framework for controlling interfering variables, the simplicity of the model is its strong suit. The gravity model is most useful for providing a statistical explanation, and it has been used extensively in studies examining the effect of political variables on trade. Over the last few years, the model has been greatly developed with improvements in its methods of estimation that deal with some of the aforementioned deficiencies.

For this study, I conducted several tests based on the gravity model. I considered many complex methodological issues which, in order to avoid an extremely technical discussion involving concepts from the world of econometrics, I have chosen not to specify in this paper. (A small selection of these technical issues appear in the notes).

The first stage comprised building a database of all Israeli foreign trade from 2000 to 2014. In 2000, the Israel-EU Trade Agreement took full effect, and I thus chose this year as the starting point.[57] Each observation of the sample included information about Israel's real trade with a trading partner in a specific year.[58] Since the diamond trade represents a significant share of Israeli trade with countries where there is extensive BDS activity, I chose to base the analysis on trade data that includes diamonds.[59]

In order to indicate the fluctuations in the Israeli-Palestinian conflict, each of the observations included the number of Palestinians killed in conflict with IDF forces in the West Bank and Gaza Strip in that year.[60] This is essentially a proxy variable of the intensity of the Israeli-Palestinian conflict.[61] The expectation was that a rise in violence due to the conflict would reinforce the calls for a boycott of Israel. Regardless of the political impact of the violence, there are, of course, pure economic processes that are likely to cause a negative relationship between security events and Israel's trade. There are many ways in which security events can harm trade; for example, influence on production patterns, a change in tastes, a drop in private consumption, a risk that deters economic agents, temporary disruption of sea and air routes, and so forth. The control that the model presents for Israel's GDP captures these influences to some extent, but cannot completely isolate all economic processes which stem from security events. Therefore, the results of the study relate to many ways in which exacerbation of the conflict affects the patterns of Israeli trade and do not present an exclusive analysis of the potential impact of efforts to boycott Israel.

Nonetheless in order to get some idea of the possible repercussions of political reactions to the Israeli-Palestinian conflict, procedures were carried out examining whether trade with the EU is, in fact, more sensitive than trade with Israel's other trading partners. An interaction variable was therefore added which multiplies the conflict variable by a dummy variable of membership in the EU. Significant negative coefficients of the interaction variable showed that a rise in the intensity of the conflict causes a sharper drop in Israel's trade with the EU than with other trade blocs.[62]

Because the negative effect of some of these processes does not happen overnight, the conflict variable and interaction variable have been presented in real time and with a year delay. In addition to the trade variable (the dependent variable), the conflict variable, and interaction variables (the major independent variables), the following control variables were included in the equation (all variables are expressed in natural logarithms unless otherwise noted):

1. Israel's GDP and the GDP of its trading partners in millions of real dollars in that year. Based on the gravity model, the coefficients of these variables are expected to return positive values.
2. Israel's population and the population of its trading partner in millions in that year.[63] Based on the gravity model, the coefficients of these variables are expected to return negative values.[64]
3. The distance in kilometers between Tel Aviv and the economic center of each of Israel's trading partners. Based on the model, Israeli trade is expected to move in inverse proportion to the distance.[65]
4. The trading partner's territory in thousands of square kilometers.[66]
5. The existence of a free trade agreement between Israel and the trading partner.[67]
6. The trading partner's membership in the WTO.

All estimations related to the overall sample as well as to a smaller sample comprising Israel's thirty major trading partners.[68] In addition, each of the tests performed related separately to Israel's imports, exports, and total trade. I employed several methods of estimation in order to determine the trade equation.[69] The different methods did not fundamentally change the findings relating to the relationship between the conflict and trade.

## Results and Interpretation

Test results are summarized in Tables 3, 4, and 5: Table 3 relates to total trade, Table 4 to exports, and Table 5 to imports. Columns 1 and 2 in each table relate to estimations performed on the full sample comprising all of Israel's trading partners. Columns 3 and 4 relate to estimations performed on the sample containing Israel's thirty largest trading partners. For the sake of simplicity, the tables do not present the control variables, but it is important to note that in nearly all instances the basic gravity variables received their expected values.[70]

As can be seen in Table 3, the tests showed that a higher level of violence in the conflict does not affect Israel's flow of trade in that year. In contrast, the conflict variable with a one year lag was found to be negative and significant in all the models except Model 1. This means that a rise of 1% in the number of Palestinians killed in a particular year reduced Israeli trade by an average of 0.039% the following year (in most of the models the effect was lower). At first glance, this is a very small amount; it should be remembered, however, that when a quiet period transitions into a tense period the number of casualties can jump by tens of percentage points.

The interaction variables, intended to express whether trade with the EU is indeed more sensitive to the conflict, are negative and significant in all the models except Model 2. As can be seen, this is a relatively low level of effect. The simple interpretation of the worst model is that a rise of 1% in the number of Palestinians killed led to a drop of 0.05% in trade with EU countries that year, while having no effect on trade with Israel's other trading partners. Nevertheless, this unique effect on trade with the EU disappears or diminishes to negligible levels the following year.[71]

A distinction between the effects of the conflict on exports versus imports raises a number of interesting points. First of all, the negative effect of the conflict on the ability of Israeli companies to export to the EU is higher than the effect on imports from the EU. None of the models showed a negative and significant relationship between the intensity of the conflict and worldwide Israeli exports either in real time or the following year (Table 4—Models

1 and 2). In contrast, the interaction variables relating to the effects of the conflict on exports to EU countries are negative and significant in all of the models. This effect is a little stronger than the effect found in tests relating to total trade. This finding fits with most of the tests presented in Table 5 and attests to the fact that the conflict does not have a unique negative effect on imports from the EU. In other words, the conflict has a unique negative effect on the ability of Israeli companies to export to EU countries, but not on the flow of goods coming into Israel from the EU.[72]

These findings demonstrate that European calls during times of tension for restrictions on the export of security products and dual-use products never turned into a process that truly affected the movement of imports from Europe to Israel on an aggregate level. A unique negative effect was, however, found on the export of Israeli goods to EU countries. Nonetheless, this effect is not very high and disappears the following year.

As mentioned, it is difficult to determine with certainty what proportion of the unique negative effect of the conflict on exports to the EU stems from the official and unofficial efforts to apply economic pressure against Israel. It is reasonable to assume that the rate of the unique harm caused by the conflict to exports to the EU—0.07% in the worst tests for each rise of 1% in the number of casualties—also captures the effects of other processes and "noise," which I did not manage to control for and which are not directly connected to political efforts in Europe to damage Israeli trade. In other words, it can be assumed that the effect of official and unofficial calls in the EU for economic pressure against Israel caused less damage than the amount reported in the tables.

The discovery of a significant negative relationship between the conflict and Israeli exports to Europe provides empirical proof for the first time that political processes may have a negative effect on Israeli exports to the EU. While the effect appears to be negligible for now, the same cannot be assumed for the future. As presented in the first two chapters, the extent of future damage depends on a number of factors, most significantly, the motivation of companies and, particularly, of European governments to harm Israel. A rise in the level of antagonism caused by Israeli policies will, it seems, increase the rate of damage to its exports due to attempts to apply economic pressure.

There is much concern that the anti-Israeli discourse will become entrenched and will constitute a turning point that will cause significant damage to

Israeli trade in Europe. This scenario was presented in a paper published by the Ministry of Finance in 2013 and recently cleared for publication in the media.[73] However, any extreme scenario must take into account all of the counterbalances presented in the first two chapters of this study, which showed the unlikelihood of the termination of trade relations with the EU. In order for EU states to consider dissolving the Israel-EU Trade Agreement, which benefits many parties in Europe, there would need to be an extremely serious deterioration in political relations.[74] Even without extreme scenarios, any future intensification of negative anti-Israel discourse is likely to strengthen the connection between the conflict and the ability of Israeli companies to export to Europe.

**Table 3:** Effects of the Conflict on Total Trade

| | (1) | | (2) | | (3) | | (4) |
|---|---|---|---|---|---|---|---|
| Dependent variable and sample | Total trade | | Total trade | | Trade – 30 major partners | | Trade – 30 major partners |
| Method of estimation | Random Effects GLS with regression with AR(1) | | Fixed-Effects GLS with regression with AR(1) | | Random-Effects GLS with regression with AR(1) | | Fixed-Effects GLS with regression with AR(1) |
| Violence_t Number of Palestinians killed in given year | -0.002 | | -0.015 | | 0.0046 | | -0.007 |
| | (0.015) | | (0.015) | | (0.01) | | (0.01) |
| Violence_t-1 Number of Palestinians killed in previous year | -0.02 | | -0.039** | | -0.02** | | -0.037 |
| | (0.016) | | (0.017) | | (0.01) | | (0.01) |
| EU – dummy variable for membership in EU | 0.8 | ** | 0.36 | | 0.6 | ** | 0.19 |
| | (0.315) | | (0.35) | | (0.191) | | (0.2) |
| Violence_t* EU- Interaction between violence variable and EU variable | -0.05 | ** | -0.028 | | -0.04 | ** | -0.02** |
| | (0.029) | | (0.03) | | (0.016) | | (0.015) |
| Violence_t-1* EU- Interaction between violence previous year variable and EU variable | -0.03 | | -0.018 | ** | -0.03 | ** | -0.014 |
| | (0.033) | | (0.034) | | (0.018) | | (0.017) |

| | (1) | | (2) | | (3) | | (4) |
|---|---|---|---|---|---|---|---|
| FTA – Dummy variable for free trade agreement | 0.33** | | 0.147 | | -0.1 | | 0.018 |
| | (0.153) | | (0.197) | | (0.138) | | (0.14) |
| $R^2$ | 0.83 | | 0.1 | | 0.82 | | 0.82 |
| Observations | 1333 | | 1226 | | 374 | | 345 |

05 < $p$. **

**Table 4:** Effects of the Conflict on Israeli Exports

| | (1) | | (2) | | (3) | | (4) | |
|---|---|---|---|---|---|---|---|---|
| Dependent variable and sample | Exports | | Exports | | Exports – 30 major trading partners | | Trade – 30 major trading partners | |
| Method of estimation | Random-Effects GLS with regression with AR(1) | | Fixed-Effects GLS with regression with AR(1) | | Random-Effects GLS with regression with AR(1) | | Fixed-Effects GLS with regression with AR(1) | |
| Violence_t Number of Palestinians killed in given year | 0.006 | | -0.001 | | 0.009 | | -0.001 | |
| | (0.016) | | (0.017) | | (0.013) | | (0.012) | |
| Violence_t-1 Number of Palestinians killed in previous year | -0.022 | | -0.029 | | -0.01 | | -0.031 | ** |
| | (0.018) | | (0.019) | | (0.014) | | (0.01) | |
| EU – dummy variable for membership in EU | 0.7 | ** | 0.28 | | 0.64 | ** | 0.38 | ** |
| | (0.339) | | (0.379) | | (0.235) | | (0.25) | |
| Violence_t* EU- Interaction between violence variable and EU variable | -0.07 | ** | -0.06** | | -0.06 | *** | -0.05** | |
| | (0.03) | | (0.03) | | (0.02) | | (0.019) | |
| Violence_t-1* EU- Interaction between violence previous year variable and EU variable | -0.02 | | -0.02 | | -0.024 | | -0.005 | ** |
| | (0.02) | | (0.038) | | (0.022) | | (0.021) | |
| FTA – Dummy variable for free trade agreement | -0.041 | | 0.147 | | -0.16 | | 0.018 | |
| | (0.16) | | (0.197) | | (0.96) | | (0.178) | |
| $R^2$ | 0.7 | | 0.1 | | 0.43 | | 0.27 | |
| Observations | 1333 | | 1226 | | 374 | | 345 | |

.05 < $p$**

**Table 5:** Effects of the Conflict on Israeli Imports

| | (1) | | (2) | | (3) | | (4) | |
|---|---|---|---|---|---|---|---|---|
| Dependent variable and sample | Imports | | Imports | | Imports – 30 major trading partners | | Imports – 30 major trading partners | |
| Method of estimation | Random-Effects GLS with regression with AR(1) | | Fixed-Effects GLS with regression with AR(1) | | Random-Effects GLS with regression with AR(1) | | Fixed-Effects GLS with regression with AR(1) | |
| Violence_t Number of Palestinians killed in given year | 0.0006 | | -0.022 | | -0.01 | | -0.029** | |
| | (0.02) | | (0.02) | | (0.017) | | (0.017) | |
| Violence_t-1 Number of Palestinians killed in previous year | -0.016 | | -0.04** | | -0.02 | | -0.048 | ** |
| | (0.02) | | (0.02) | | (0.019) | | (0.048) | |
| EU – dummy variable for membership in EU | 1.15 | ** | 0.07 | | 0.56 | ** | -0.133 | |
| | (0.43) | | (0.45) | | (0.299) | | (0.334) | |
| Violence_t* EU-Interaction between violence variable and EU variable | -0.05 | ** | 0.01 | | -0.017 | | 0.005** | |
| | (0.04) | | (0.027) | | (0.025) | | (0.02) | |
| Violence_t-1* EU-Interaction between violence previous year variable and EU variable | -0.057 | | -0.005 | | -0.04 | | -0.018 | |
| | (0.04) | | (0.044) | | (0.028) | | (0.028) | |
| FTA – Dummy variable for free trade agreement | 0.87** | | 0.28 | | -0.155 | | -0.105 | |
| | (0.215) | | (0.265) | | (0.203) | | (0.24) | |
| $R^2$ | 0.8 | | 0.14 | | 0.635 | | 0.12 | |
| Observations | 1333 | | 1226 | | 374 | | 345 | |

.05 < *p***

# Summary and Policy Recommendations

The unofficial campaign to economically isolate Israel has so far caused negligible direct damage, but this does not mean that possible future consequences can be discounted. Although mechanisms exist that provide Israel's economy with some immunity from extreme scenarios that would lead to a severe and direct blow to the ability to conduct business with international markets, the intensification of negative anti-Israel discourse and the disapproval of Israel's policies by various governments may harm the Israeli economy in various ways. This memorandum provides for the first time empirical evidence for the claim that economic activity with Europe is indeed more sensitive than with other trading partners to fluctuations in the Israeli-Palestinian conflict. This empirical evidence, together with all the other specified factors, shows that any possible damage to the Israeli economy depends mainly on steps that could be taken by EU countries.

As I have attempted to clarify, decisions regarding the imposition of official sanctions and cooperation with unofficial punitive measures are analogous to a cost-benefit game in which many players with conflicting interests pull in different directions. Since the taking of significant punitive steps against Israel depends on the conduct of various players whose interests do not overlap, it is extremely difficult to precisely predict the feasibility of every process that is on the agenda of those seeking to isolate the Israeli economy. Nevertheless, a number of clear trends and factors can be identified that increase the likelihood that the economic campaigns against Israel will cause damage.

Since the export of consumer goods does not hold significant weight within the total of Israeli exports, the implementation of a direct consumer boycott on Israeli goods does not present a strategic macroeconomic challenge to Israel. Nonetheless, such a step may worry many Israeli companies, raise their business costs, and even deliver a significant blow to several corporations and sectors. The entrenchment of negative discourse certainly increases the chances that an unofficial campaign will cause greater damage through a consumer boycott of Israeli consumer goods. Some products, such as food products, can have their Israeli identity concealed and thus reduce the damage of a boycott, but such steps increase business costs and may, conversely, lead to a drop in demand from consumers looking for familiar Israeli products.

In my opinion, a change in only the discourse causes no threat to Israel's core exports of inputs and non-consumer goods. In other words, the unofficial campaign will only present a strategic threat to the Israeli economy if it succeeds in either implementing a secondary boycott of companies that incorporate Israeli goods in their production processes or invest in Israel or in pressurizing governments to significantly change the frameworks that institutionalize their economic ties with Israel. These two threats are unlikely to be realized, but it is possible to imagine a scenario in which such measures gather certain momentum.

The implementation of a secondary boycott—not to mention a tertiary boycott involving companies that do business with companies that do business with Israel—would be a difficult task. Unlike with consumer goods, it would be difficult for the boycotters to compile a list of products containing Israeli components or of all companies that incorporate Israeli inputs in their production processes. The boycotters could direct their efforts toward a number of major, well-known flagship companies operating in Israel in the hope that such pressure would create momentum and deter other companies. But in order for such pressure to have an effect, the companies that rely on Israeli inputs and invest in Israel must be convinced of the economic damage of continued business dealings with Israel.

Most Israeli exports are produced by companies with a multinational dimension that have significant economic and political power, likewise for the companies responsible for most of the direct investment in Israel. This fact does not completely immunize the flow of investments into Israel and of exports out of Israel, but it does reinforce the assessment that some of the strong companies operating in Israel will attempt certain blocking maneuvers before abandoning Israel and harming their own economic interests. This was demonstrated recently when politicians and lobbyists in the US, seeking to promote legislation against parties attempting to boycott Israel, highlighted the expected damage to US multinationals and general employment if sanctions are imposed on Israel.

At present, neither European nor any other governments seem to be responding affirmatively to calls for official, comprehensive economic sanctions on Israel or the dissolution of trade agreements. In light of the entire continuum of interests and processes described in this memorandum, the future acquiescence of the EU or other major trading partners to such calls appears unlikely. However, various official measures, not considered extreme, are certainly feasible. Such measures may include the intensification of focused processes intended to harm the export of goods from the settlements and may cause a considerable amount of damage. As presented in the first two chapters, any decision by governments or strong organizations to implement official measures may lead to costs that exceed the resulting direct damage.

A major concern regarding official measures, highlighting the lack of legitimacy attributed by governments to commercial activity in the territories, is the momentum they create for sanctions against all Israeli companies. These official measures may increase the official and unofficial pressure on sectors and companies whose extensive activities in the settlements are easily identified, such as banks and infrastructure and construction companies. A negative public atmosphere regarding Israel and the application of effective pressure may also discourage government tenders from engaging Israeli companies in an attempt to avoid public censure. This may be true even without any explicit government declarations. As I have emphasized throughout this memorandum, we must address any possible measures as a two-way process, with official actions providing a tailwind for the unofficial campaign and unofficial actions increasing the likelihood of governments taking official steps.

## Policy Recommendations

There is no one variable that can exclusively determine how anti-Israel discourse will affect Israel's economy. However, the level of antagonism engendered among the public and governments in Europe by Israeli policies toward the Palestinians can be considered the most significant variable for determining the amount of damage that might be caused to the Israeli economy. The BDS movement needs no excuses for harming Israel and will continue its struggle regardless of fluctuations in the conflict. Their campaign will only cause serious damage if it wins the attention and cooperation of the public, of companies, and, in particular, of governments in the various countries. The motivation to cooperate with BDS and even to impose official sanctions on Israel will be influenced primarily by Israel's conduct toward the Palestinians.

Since most of the potential damage lies in official measures taken by EU governments, Israel should engage in diplomatic maneuvers that will reduce the motivation of EU governments to use economic leverage to impact the peace process. It is difficult, however, to suggest a wide range of relevant steps while there are no changes in the policies toward the Palestinians and construction in the settlements. As mentioned, there have been many cases where states have imposed sanctions on allies; even if Israel cooperates with EU governments on a range of issues unrelated to the conflict, it is not at all certain that this will moderate the trends supporting punitive economic measures among those leading the criticism toward Israel. This implies that the major key to anesthetizing the potential threats stemming from the BDS movement and official sanctions lies not in specific and focused measures directed at companies or states considering a boycott of Israel, but in much broader measures concerning Israeli policy toward the Palestinians.

Policy on the Palestinian question should not, of course, be analyzed only from an economic perspective; this issue involves a long series of political, strategic, security, and diplomatic considerations. If, however, we focus on the economic aspect, it can definitively be stated that Israeli initiatives to renew negotiations or a change in Israel's settlement policy are the most effective ways of dealing with the multifold attempts to isolate the Israeli economy. While it is unclear whether such steps would diminish the efforts of the BDS movement to harm Israel, it can be assumed that some kind of progress on the Palestinian issue would significantly reduce the willingness of European governments to cooperate with nongovernmental initiatives and curb any official measures.

Beyond this broad statement are certain moves and modes of conduct that are likely to reduce Israel's costs, even without any significant changes in the peace process. On the diplomatic front, Israel should avoid direct conflict with Europe against the backdrop of labeling products from the settlements. This does not mean that Israel should avoid criticizing potential European punitive measures. On the contrary, both official and unofficial Israeli elements must use aggressive rhetoric to highlight the absurdity of sanctions against Israel when there is no talk of suspending economic ties with the many other countries whose conduct runs counter to EU values and/or involves severe human rights violations. However, it would be a mistake to belittle the importance of the EU or to hint that Israel would consider punitive countermeasures in response to European moves. As explained in

Chapter 2, threats of Israeli countermeasures are not credible and may even inflame passions and increase motivation to implement measures against Israel.

Likewise, declarations about Israel's need to develop new markets should not sound like defiance of the EU. The deepening of economic ties with Asian countries is correct policy in its own right, and there is no need to declare a connection between this policy and the boycotting of Israel. As was shown empirically in the previous chapter, economic ties with Asian countries are, in fact, less sensitive than relations with Europe to fluctuations in the Israeli-Palestinian conflict. The faster quotas of trade with Europe are diverted to Asia, the more likely ties with Asia are to reduce fears regarding the political-economic consequences of the Israeli-Palestinian conflict. Such rapid redirection of trade is not, however, possible for many reasons.

The only effective way to significantly increase demand for Israeli goods in Europe is to complete negotiations for free trade zone agreements with major Asian countries. It could be that in the mid-term, the improvement of ties with Asia will somewhat moderate the potential damage of a political boycott. For now, however, Israel must not pin its hopes on the diversion of exports to Asia as an effective and immediate remedy for an anti-Israel campaign in Europe.

The legislation being promoted in the US, which has already been passed in a number of states and is designed to punish companies that impose a boycott on Israel, provides commercial corporations with another reason not to cooperate with the isolation of Israel. Official state backing of steps intended to hurt those promoting and cooperating with the boycott movement is likely to moderate their impact. The American administration is unlikely to be enlisted in attempts to pressurize governments promoting a boycott on settlement goods, and such attempts are not recommended. Pro-Israel groups that raise the issue of the settlements in the context of the fight against Israel's economic isolation will force the administration to once again express its opposition to Israeli construction in the territories. When heard as part of the discourse on boycotts of Israel, such declarations may be erroneously interpreted as the administration's tacit approval of broader action against Israeli companies with some kind of connection to the territories. It is therefore recommended that the Israeli government and supporters of Israel do not focus on the issue of settlements, but rather attempt to enlist the US in a comprehensive, broad-based struggle against the boycott movement.

This is, of course, only one of many reasons why the Israeli government should try to restore its relationship with the US.

A course of aggressive action in the legal, public relations, and economic spheres may increase the costs for companies and economic agents who cooperate with calls to boycott Israel. Israeli legal experts must examine the validity of official boycott measures against Israel. As evident in the statement by the CEO of Orange, legal and contractual considerations place certain restrictions even on those seeking to rapidly terminate activities in Israel. Similarly, legal considerations connected with the commitments of WTO members and with bilateral frameworks that institutionalize economic relations with major trading partners place certain restrictions on punitive measures against Israel.

However, as explained in Chapter 2, Israel must save the option of using the WTO's Dispute Settlement Body for cases involving official sanctions that can be easily proven violations of WTO rules and that may cause significant damage to the Israeli economy. Uncontrolled use of WTO institutions may lead to accusations of Israel-led politicization of the organization. Israel is, thus, advised not to turn to such institutions in response to measures with negligible direct impact and certainly not when chances of victory are low, such as would be the case with the European labeling of settlement products.

Any step to improve Israel's image is, of course, recommended, as it may help to dampen the enthusiasm of consumers and various economic agents for a boycott. Public relations efforts, using both traditional channels and social networks, must expose the overall motives and stances of the BDS movement and try to undermine its legitimacy. There is also a need for aggressive public relations activity focusing on companies that are likely to cooperate with anti-Israel campaigns.

Just as the BDS movement prepares lists of Israeli companies involved with the territories, Israel should familiarize itself with the activities of various companies throughout the world. Companies considering boycotting Israel must be made aware that this will draw attention to their operations in other locations, and they will be forced to explain why they decided to suspend business with Israel while continuing to work with different countries with blatant daily violations of human rights. A recommendation of this type was presented in a paper published by the Israeli Ministry of Finance.[75] This approach demands ongoing research monitoring of the activities of companies that may boycott Israel.

As mentioned, there is no credibility to the threat of an Israeli counter-boycott against European governments. But this does not mean that it is impossible to create a counter-boycott against commercial corporations that cooperate with the BDS movement. The cost-benefit considerations of companies considering a boycott of Israel may change if they have reason to believe that they will lose not only the Israeli market, but also demand for their products among Jewish communities and pro-Israel elements throughout the world. To create this credible counter-boycott threat, preparatory work must be done to analyze the patterns of consumption of pro-Israel bodies and to identify key pro-Israel business players who might be enlisted to impose sanctions on businesses that boycott Israel.

In conclusion, I recommend that a single body be appointed to coordinate and effectively advance all of the efforts described in this report. It is important to remember that just as it is difficult to accurately predict the potential effectiveness of punitive measures against Israel, the effectiveness of blocking measures described in the previous few paragraphs also cannot be forecast. However, I am confident that the effectiveness of each of these measures would be significantly enhanced were Israel to succeed in decreasing the motivation of governments to cooperate with the BDS coalition.

# Notes

1 Philip Levy, “Sanctions on South Africa: What did They Do?” *American Economic Review* 89, no. 2 (1999): 415-20.

2 Gary Clyde Hufbauer, Jeffrey J. Schott, Kimberly Ann Elliott, and Barbara Oegg, *Economic Sanctions Reconsidered*, 3rd edition (Washington, DC: Peterson Institute for International Economics, 2007).

3 For well-known reviews of the effectiveness of economic sanctions and of publications of the Peterson Institute, see, for example, Cooper Drury, “Economic Sanction. Reconsidered,” *Journal of Peace Research* 35, no. 4 (1998): 495-509.

4 In response to these findings, recent literature has suggested that most empirical research on the topic suffers from a fundamental methodological problem: the existing studies have focused only on the cases where countries made use of sanctions, but have paid no attention to the many instances where the very threat of sanctions caused a change in policy. The threat of sanctions has a higher chance of success than the actual use of sanctions, since countries considering a change of policy prefer to do so at an early stage and avoid the economic costs of sanctions. Therefore, the existing studies suffer from selection bias, which renders their conclusions regarding the poor achievements of sanctions invalid. See, for example, Daniel Drezner, “The Hidden Hand of Economic Coercion,” *International Organization* 57, no. 3 (2003): 643-59; Dean Lacy and Emerson M.S. Niou, “The Roles of Preferences, Information, and Threats,” *Journal of Politics* 66, no. 1 (2004): 25-42.

5 Thus, for example, during the renewed tensions in 2012 between Argentina and Britain regarding the Falkland Islands, labor unions in several Latin American countries attempted to delay the unloading of cargo from British ships. See Matt Ince, “Beyond Rhetoric: Could the Heightened Falklands Debate Threaten British Interest in Latin America?” *RUSI.org*, January 31, 2012, https://rusi.org/commentary/beyond-rhetoric-could-heightened-falklands-debate-threaten-british-strategic-interests.

6 See, for example, Philip Kolter and David Gertner, “Country as Brand, Product, and Beyond: A Place Marketing and Brand Management Perspective,” *Journal of Brand Management* 9, no. 4 (2002): 249-61; Margarita M. Kalamova and Kai A. Konrad, “Nation Brands and Foreign Direct,” *Kyklos* 63, no. 3 (2010): 400-31.

7 Zohar Blumenkrantz, “We Don’t Highlight Our Good Relationship with the European Airbus Due to the Threat of the Boycott,” *TheMarker,* June 16, 2015, http://www.themarker.com/news/aviation/1.2661043 (Hebrew).

8 For details regarding the declarations of the various CEOs and the factors that brought them to abandon South Africa, see Martin Meznar, Douglas Nigh, and Chuck C.Y. Kwok, "Effect of Announcement of Withdrawal from South Africa of Stockholders Wealth," *Academy of Management Journal* 37, no. 6 (1994): 1633-48.

9 Ibid.

10 See, for example, Kenneth A. Rodman, "Public and Private Sanctions against South Africa," *Political Science Quarterly* 109, no. 2 (1994): 313-34; Judith F. Posnikoff, "Disinvestment from South Africa: They Did Well by Doing Good," *Contemporary Economic Policy* 15, no. 1 (1997): 78-86.

11 See, for example, Siew Hong Teoh, Ivo Welch, and C. Paul Wazzan, "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott," *The Journal of Business* 72, no. 1 (1999): 35-89.

12 Posnikoff, "Disinvestment from South Africa," p. 78.

13 For example, already in early 2006, unofficial bodies attempted to pressurize pension funds in several US states to divest from companies that invested in Iran. These efforts eventually became official legislation in which governments set strict regulations requiring pension funds not to invest in companies connected with Iran. See Niv Elis, "The Pension Fund Attack On Iran, " *Forbes*, October 16, 2009, http://www.forbes.com/2009/10/16/iran-pension-divestment-business-washington-congress.html.

14 Taehee Whang, "Playing to the Home Crowd? Symbolic Use of Sanctions by the United States," *International Studies Quarterly* 55, no 3 (2011): 787-801.

15 For details regarding the political struggle that has developed in Germany in the wake of the sanctions on Russia and the lobbying on the part of industrialists, see Harriet Torry, "German Businesses Feel Chill Over Sanctions on Russia," *Wall Street Journal*, September 9, 2014, http://online.wsj.com/articles/german-businesses-feel-chill-over-sanctions-on-russia-1410277140.

16 For an extensive discussion of the effects of reciprocal economic dependence on the chances of success for sanctions, see George Shambaugh, "Dominance, Dependence, and Political Power: Tethering Technology in the 1980s and Today," *International Studies Quarterly* 40, no. 4 (1996): 559-88; Jonathan Kirshner, "The Microfoundations of Economic Sanctions," *Security Studies* 6, no. 3 (1997): 32-64.

17 Carol Matlack, "Could McDonald's Be the Latest Victim of Russian Retaliation?" *Bloomberg Businessweek*, August 20, 2014, http://www.bloomberg.com/news/articles/2014-08-20/russian-sanctions-bite-europe-mcdonalds-in-russia-suffer-too.

18 For details of the case, see Richard Katz, "Mutual Assured Production: Why Trade will Limit Conflict Between China and Japan," *Foreign Affairs* 92, no. 4 (2013):18-22.

19 David A. Baldwin, *Economic Statecraft* (Princeton: Princeton University Press, 1985); Adrian U-Jin Ang and Dursun Peksen, "When Do Economic Sanctions

Work? Asymmetric Perceptions, Issue Salience, and Outcomes," *Political Research Quarterly* 60, no. 1 (2007): 135-45.

20 For example, in the wake of the Tiananmen Square events in 1989, the US declared an arms embargo on China. The move was intended to signal US displeasure at human rights violations, but China perceived it as a blatant attempt to interfere with its sovereignty. This is a case involving a clear asymmetry in the importance attributed by the parties to the issue, and it may have been that asymmetry that led to Washington's decision to quickly withdraw the sanctions.

21 Hufbauer et al., *Economic Sanctions Reconsidered*, p. 6.

22 A detailed mapping of the sanctions based on their degree of salience to the sender state can be found in Ang and Peksen, "When Do Economic Sanctions Work?" In their study, they presented a typology of political issues based on their degree of salience, showing that in approximately 40% of cases of sanctions imposed between 1914-1990, the sender state attempted to influence a change of a policy classified as "low-salience politics."

23 Daniel Drezner, "Conflict Expectations and the Paradox of Economic Coercion," *International Studies Quarterly* 45, no. 4 (1998): 709-31.

24 The reference is to a database based mainly on Hufbauer et al., *Economic Sanctions Reconsidered*.

25 Due to the need to avoid the veto of one of the permanent Security Council members, the negotiating process for the formulation of sanctions often leads to resolutions with softened punitive measures.

26 For various arguments that arise in this debate, see Daniel Drezner, "Bargaining, Enforcement, and Multilateral Economic Sanctions," *International Organization* 54, no. 4 (2000): 73-102; Navin Bapat and T. Clifton Morgan, "Multilateral Versus Unilateral Sanctions Reconsidered," *International Studies Quarterly* 53, no. 4 (2009):1075-94.

27 For a good survey of this phenomenon and other domestic processes that accompany sanctions and can harm the populace, see David Cortright and George Lopez, *The Sanction Decade* (Boulder, CO: Lynne Reiner, 2000).

28 For a broad discussion of the impact of "smart sanctions," see Daniel Drezner, "Sanction Sometimes Smart: Targeted Sanction in Theory and Practice," *International Studies Review* 13 (2011): 96-108; David Cortright and George Lopez, eds., *Smart Sanctions* (New York: Rowman and Littlefield, 2002).

29 This last statement is not true regarding financial sanctions on a country with significant financial activities.

30 Unless otherwise noted, all trade data presented from this point on are based on publications of the Israel Central Bureau of Statistics.

31 In the final quarter of 2015, there was a drop of approximately 10% in the export of goods to EU countries. This trend is not the result of political variables, but can be explained mainly by economic processes that caused a large drop in exports to Cyprus, Bulgaria, and Finland.

32 The data relate to trade in May 2015. A cross-sectional analysis of data from 2014 presents a similar picture. The inclusion of diamond imports and exports changes the percentages of each of the trade blocs but does not affect the rankings.

33 For a detailed analysis of the initiatives taken by EU countries against Israel in the years 2000-2007, see Nizan Feldman, "Terrorizing Trade: The Impact of Terror on Israel's Trade Deficit with the EU," *Workshop on Political Events, Financial Markets, and Trade*, January 2007, Konstanz, Germany.

34 European Commission, Directorate-General for Trade, "European Union, Trade in Goods with Israel," November 11, 2016, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113402.pdf.

35 The EU comprises 28 trading partners, and there are discrepancies in the depth of Israel's relative deficit vis-à-vis the various EU trading partners. Nevertheless, Israeli has a trade deficit with every one of its major EU trading partners, except for Great Britain, with which Israel had a trade surplus for goods in 2013.

36 Because a major share of the diamond trade takes place with countries generally classified as critical of Israeli policy, I have chosen to present it in the table; the data analysis also takes the diamond trade into account.

37 The data relate to 2013, the last year for which the Central Bureau of Statistics provided data classified by country and type of goods. In this case, the data also include diamonds.

38 Table 2 presents the distribution of Israeli exports according to company type. The classification relates to the 350 largest exporting companies in Israel, which account for 87% of total exports in three categories: Israeli companies with no multinational component, Israeli companies owned by foreign companies (IN), and Israeli companies that own foreign companies (OUT). In addition to the 271 companies represented in the table, there are an additional 79 companies that meet both the IN and OUT definitions, and these involve second-order and third-order controlling interests. The table shows that the large exporters with a multinational component employ more workers than purely Israeli exporters.

39 For details regarding corporations that pro-Palestinian elements have attempted to pressure and boycott, see Ronit Domke and Michal Ramati, "The Calls to Boycott Goods from Israel Increase and Impositions of a Boycott Garner Success," *TheMarker*, August 10, 2014, http://www.themarker.com/wallstreet/1.2402212. (Hebrew).

40 When diamonds are included, trade totals $16 billion.

41 The Japanese government generally attaches great weight to economic processes in its approach to the Israeli-Palestinian conflict. This attitude does not focus specifically on direct trade and investment relations, but on finding ways to integrate the Palestinian economy in regional economic cooperation with the participation of Japan and Israel.

42 Ora Korn, "A Boycott on Israel? The Strategic Security Interest Increases," *TheMarker*, February 11, 2009, http://www.themarker.com/markets/1.529752. (Hebrew).

43 Domke and Ramati, “The Calls to Boycott Goods from Israel.”

44 Itamar Eichner, “Business Overtures: Japanese Prime Minister in Israel,” *YNET*, January 18, 2015, http://www.ynet.co.il/articles/0,7340,L-4616334,00.html. (Hebrew).

45 Ron Dagoni, “US Legislators Initiate Laws to Outlaw Those who Outlaw Israel,” *Globes*, June 7, 2015, http://www.globes.co.il/news/article.aspx?did=1001042321. (Hebrew).

46 Such an argument was explicitly raised by Peter Roskam, one of the initiators of the legislation. See Peter Roskam, “Congress Can Fight the Boycott Israel Movement,” *Wall Street Journal*, May 25, 2015, http://www.wsj.com/articles/congress-can-fight-the-boycott-israel-movement-1432591991.

47 Ron Dagoni, “The Obama Administration: We Oppose a Boycott of Israel, We Do Not Oppose a Boycott of the Settlements,” *Globes*, July 1, 2015, http://www.globes.co.il/news/article.aspx?did=1001049148. (Hebrew).

48 Tom Miles, “Russia Says U.S. Sanctions Break WTO Rules, May Cause Trade Dispute,” *Reuters*, July 24, 2014, http://www.reuters.com/article/us-ukraine-crisis-sanctions-wto-idUSKBN0FT1YI20140724.

49 Since no suit has ever forced the DSB to interpret Section 21B, it is difficult to assess what its verdict might be in a case where a country claims it boycotted Israel due to security concerns. In the age of GATT, there have been various interpretations of this section. Thus, for example, Argentina claimed in 1982 that it was impossible to use Section 21B to justify the sanctions Britain imposed on it and the participation of uninvolved countries. Deliberations on Argentina’s complaint produced no consensus due to varying interpretations of the section. Hufbauer et al., *Economic Sanction Reconsidered,* p.XXX.

50 Avi Bell and Eugene Kontorovich, “An Appeal to the WHO about the Illegal Restrictions Imposed on Israeli Products,” *Kohelet Policy Forum*, Policy Paper No. 18, October 2015. (Hebrew).

51 This is the accepted way for the DSB to sanction countries that have violated the MFN principle in their relations with another country.

52 It is, however, possible to point to cases of uninvolved countries who cut off ties with a trading partner when it was at war with the country’s allies. But the suspension of these business ties are usually short-lived. For example, at the beginning of the Falkland Islands Crisis between Great Britain and Argentina in 1982, the European Community imposed a comprehensive embargo on imports from Argentina that lasted a mere four weeks, during which many European countries expressed their opposition to the move.

53 The category of services is covered in the WTO by the General Agreement on Trade in Services (GATS). In this case too, the agreement presents the MFN as a guiding rule. However, as opposed to trade in goods, according to GATS, countries present an individual commitment to specific markets that they are opening to foreign services and in which they are applying the MFN principle.

54 Israel Export and International Cooperation Institute, *Developments and Trends in Israeli Exports* (Israel, 2015). http://www.export.gov.il/UploadFiles/03_2016/ExportMegamotMarch16.pdf?redirect=no. (Hebrew).

55 Ibid.

56 Gianluca Mezzofiore, "Israel Boycott Pressure Mounts as Denmark's Danske Bank Blacklists Israel's Hapoalim," *International Business Times*, February 3, 2014, http://www.ibtimes.co.uk/israel-boycott-pressure-mounts-denmarks-danske-bank-blacklists-israel-hapoalim-1434898.

57 A discussion of earlier periods would have also included observations of trade with the EU that occurred before the trade agreements were fully implemented and during the period of adjustment to the agreements. Since the goal here is to discuss the effect of the conflict under the current institutional framework, the year 2000 seemed a better starting point.

58 In order to express the real trade values, I referred to the inflation rate in the US (CPI data) with 2000 as the base year. Some scholars have argued that reliance on real trade data increases the chance that the gravity model will produce biased and ineffective estimations. These scholars recommended estimating gravity equations using nominal trade data. Therefore, all presented expectations were also performed on the basis of nominal trade data. These estimations produced slightly different results but not in a manner that undermines the conclusions arising from the model as presented below.

59 All models were also run on trade data excluding diamonds. No significant differences were found.

60 The source for the data are publications by B'Tselem. Though this is an organization with a clear political identity, official research institutions in Israel do not hesitate to rely on their data regarding Palestinian casualties. For example, a recent study published by the Bank of Israel examining the effect of terror on tourism was based on B'Tselem data. See Ron Shaharabany, *The Impact of Terrorism, Israel's Image, and Economic Variables on Different Types of Incoming Tourism* (Jerusalem: Bank of Israel, 2014).

61 In a different set of estimations, a dummy variable was used both in real time and with a lag of one year from the year of the military operation (including the Second Lebanon War). In an additional set, the dummy variables and the casualty variables were placed in the equations. These procedures did not change the inferences derived from the findings presented in the tables.

62 I used the same procedure with other trading partners as well. In the tests relating to other countries, no significant effect was found for the interaction variables. In order not to overburden the reader, the results presented relate only to the EU interaction variables.

63 The source for the GDP and population data is a series of publications by the World Bank. http://data.worldbank.org/indicator/NY.GDP.MKTP.CD.

64 Many recent studies have replaced the population and GDP variable with a variable relating to per capita GDP. The estimations presented in this memorandum were also run using the per capita GDP variable in place of the population variable (not presented in the tables). In none of the cases did this replacement affect the direction and significance of the conflict variables. The effect on strength of the relation was negligible.

65 The source for the data are the CEPII databases. *The CEPII Gravity Dataset* (CEPII, 2014).
http://www.cepii.fr/CEPII/en/bdd_modele/presentation.asp?id=6.

66 In this case too, the data source are the CEPII databases. Theoretically, countries with a large area are expected to trade less, since there are vast regions that are distant from the borders. The shipping costs to such regions increase the trade costs and encourage the development of local industry.

67 This is a dummy variable that receives the value 1 in the case of observations relating to trade between Israel and a country with which it has a signed free trade agreement.

68 The sample was reduced in order to remove any concern that the inclusion of trading partners with negligible levels of trade would lead to coefficients with exaggerated levels of significance.

69 Doubts concerning the method of estimation best suited for the gravity model combine pure methodological issues with theoretical issues related to the economic logic underlying the model. Regarding the former, one of the main questions stems from the fact that the samples upon which the model is usually applied include information about trade between various countries in various periods of time (cross-sectional time series data). In samples of this type, the classical assumptions of the ordinary least squares (OLS) method are violated. The challenge is to find a method that can deal with the series correlation within and between the panels and with heteroscedasticity between the panels. One of the accepted ways of doing this is to use feasible generalized least squares (GLS) models. In this study, I relied on several versions of this method of estimation. However, even when one of the versions of these models is chosen, a further doubt arises about how to relate to the degree of heterogeneity of the various units in the sample. Some scholars have argued that there is room in the model for expressing the fact that the identities of the countries have unique effects on the way the variables affect the extent of trade between each pair of countries. Any study that fails to take this issue into account will present biased estimations, because there is a correlation between the unique effect of the various units and years of the sample and the variables included in the gravity model and the random errors. In order to tackle this problem, some scholars have suggested using fixed effects estimations with others recommending random effects estimation. In this study, both of the recommendations have been adopted. Specifically, I have used the following methods of estimation: Random-Effects GLS regression with AR(1) disturbances; Fixed-Effects GLS regression

with AR(1) disturbances; Random-Effects GLS regression; Fixed-Effects GLS (within) regression.

70 In all the estimations, the coefficients of the distance variable and the area variable returned negative and significant values (these variables fall away in fixed-effects estimations). The coefficient of the GDP variable is positive and significant in all the estimations. Israel's GDP variable is positive, but in several of the estimations it is not significant. In several of the estimations the coefficients of the population variables did not return significant negative values. In all estimations, the dummy variable for WTO membership came out positive, but not significant.

71 In Model 2, in which the interaction variable in real time is not significant, the delayed variable actually turns significant. This is an effect of less than 0.02%.

72 This statement can be qualified since the interaction variable in Model 1 in Table 5 is negative and significant. However, even in this case, the coefficient is smaller in its absolute value than its corresponding coefficient value in Table 4. In other words, even according to this test, it appears that Israel's exports to the EU are more sensitive than imports.

73 Tal Schwartzman and Ben Hoffman, *The Israeli Economy in the Shadow of Delegitimization: Developments in Recent Years* (Jerusalem: Ministry of Finance: Office of the Chief Economist – Department of International Relations, 2015), http://go.calcalist.co.il/pic/GabiK/IsraeliEconomy_7.6.15.pdf. (Hebrew).

74 It is interesting to note that the free trade zone variable is significant only in Model 1 in Tables 3 and 4. The free trade zone variable is found to be positive and significant in the regression relating to import, but it is not significant in the regression relating to export. In other words, the analysis indicates that Israel's free trade zone agreements actually contribute to deepening its trade deficit.

75 Schwartzman and Hoffman, *The Israeli Economy in the Shadow of Delegitimization.*

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No. 163, February 2017, Nizan Feldman, *In the Shadow of Delegitimization: Israel's Sensitivity to Economic Sanctions*.

No. 162, November 2016, Yoel Guzansky, *Between Resilience and Revolution: The stability of the Gulf Monarchies* [Hebrew].

No.161, November 2016, Udi Dekel, Gabi Siboni, and Omer Einav, eds., *The Quiet Decade: In the Aftermath of the Second Lebanon War, 2006–2016* [Hebrew].

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