The Global Economic Crisis and its Impact on the Middle East

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The world finds itself in the midst of a major economic crisis, unprecedented in scale since the Great Depression of 1929. The financial upheaval of 2008 promptly spilled over to the real economy, generating a worldwide recession of frightening proportions. In 2009 the world economy will likely see a steep increase in unemployment, a reduction of world trade and investment, the massive shrinking of capital markets, and so on. These are the immediate manifestations of the crisis, yet we should also focus on its long term implications.

An extraordinary feature of the reaction to this crisis is the uncompromising determination of the key players to fight it to the end with all means available, including some highly non-conventional ones. The government of the United States is at the forefront, but it is not on its own. Most governments in countries that were hit by this crisis promptly applied a wide range of forceful policy tools, some of them requiring international cooperation and coordination.

These determined steps cannot hide the pressing problems that characterized the world economy prior to the outbreak of the crisis. The global issues of climate change, fossil energy, water scarcity, and trade imbalances have not disappeared and they will continue to dominate the world agenda, as well as constitute sources of tension among the major powers. However, the crisis has forcefully put a new agenda on the table, which will surely bring about significant changes in the world economic arena.

First, it is clear that key financial international bodies such as the IMF and the World Bank will have to undergo major revisions. The current crisis exposed the fact that the mode of operation of these international institutions is outdated, and in particular that they lack the capabilities to deal with large scale shocks. Moreover, it is obvious that there is an urgent need to revamp financial regulation, both at the national and at the global level.

Second, the crisis will surely lead to significant changes in the allocation of resources, since an economic upheaval of this magnitude never returns to the starting point. In particular, we can expect the rapid decline of mature industries such as automobiles (at least as currently manufactured), and the rise of new ones such as clean-tech and bio-tech. Reallocation processes occur continuously in market economies, but from time to time, mostly prompted by crises, they accelerate and jump over to a new equilibrium, causing a great deal of upheaval in the process.

It is too early to forecast how these developments will impact on the structure of the international system, and whether they will change the balance of power in the economic and political arena. In particular, we will have to track carefully whether these processes widen the gap in growth rates between East and West, between China and India vis-à-vis the United States and Europe. As we learn from history, the likelihood of confrontation between established powers and aspiring ones increases as the GDP of the latter closes in on the former.

Another interesting question relates to ideology. Up until the eve of the crisis, it seemed as if the entire world had irrevocably embraced the model of the market economy (except for a handful of mostly irrelevant outliers). However, the crisis is raising second thoughts in some intellectual quarters, questioning both the validity of the model as much as its theoretical underpinnings. The economic discipline itself is in a process of soul searching, which may lead to uncharted developments.

Although Jordan, Syria, Egypt, and Lebanon experienced significant economic growth in the last few years, their income per capita remains very low. Thus, a small economic shock might spill over and spark significant political and social turmoil. At the moment we do not see this taking place, yet worrying signs appeared when the prices of basic commodities started climbing. Thus, it is important to follow closely the implications of the crisis upon the political and social stability of those countries.

How can the crisis affect the strategic issues in the Middle East, and in particular Israel's capability to allocate resources to security? Prior to the crisis, the overall performance of the Israeli economy was overwhelmingly good, and in fact, the best registered in its 60 years of existence. A combination of steady and high growth rates, a surplus in the balance of payments, a low inflation rate, and low government deficits placed Israel at an excellent starting point to face the economic crisis.

However, the Israeli economy is wide open and hence not immune to the global commotion. Indeed, the growth rate turned negative in late 2008, unemployment rose, investment declined, and so forth. Even rapid recovery, however, will still leave serious questions about the continuous stress on the economy posed by the security burden. Israel's defense expenditure accounts for about 8 percent of GDP, a very high rate compared to the rest of the world. It is a huge challenge to keep allocating such a significant share of the budget to security, and at the same time maintain the quality of life that the population expects, given an income per capita of $28,000 a year.

Following the perceived mishaps of the Second Lebanon War, the government set up an inquiry committee to examine the defense budget (the Brodet Committee), of which I was a member. Among other recommendations, the committee envisioned a steady increase in defense expenditures, so that the defense budget will increase by 1 percent a year over the next ten years. In order to meet the defense challenges posed by multiple fronts (Iran, Hizbollah, Syria, Hamas, international terrorism, and others), Israel should stick to this path, despite the economic difficulties that it entails and that are amplified by the crisis. The implementation of the Brodet Committee's recommendations will bring about certainty and stability for the security forces, and a clear reference point for the rest of the economy.

However, we have to realize that the Palestinian front has changed dramatically in terms of what it demands, both militarily and otherwise. In fact, in the last decade there has been a dramatic escalation in the economic costs of the conflict, for both sides. This escalation may turn out to be a strategic determinant of the future of the conflict, and of the economic wellbeing of the contenders.

From 1967 to 2000, managing the Israeli-Palestinian conflict did not necessitate many resources, neither in terms of military expenditures nor in terms of other economic costs. However, things changed dramatically since the outbreak of the second intifada in late 2000, which coincided with the burst of the hi-tech bubble and the accompanying economic crisis. The combination of rising violence and the world economic turndown hurt Israel's economy badly.

With the dying out of the second intifada we did not go back to where we stood in 2000. In fact, Israel continued to allocate more and more resources to deal with the Palestinian issue. For example, building the separation fence, which is not finished yet, cost about 13 billion shekels. The disengagement from Gaza cost another 10 billion shekels, and we are not done there either. Operation Cast Lead was also very costly, as will be any similar military intervention.

The point is that for the past decade or so we have found ourselves in a race vis-à-vis the Palestinians that is increasingly asymmetrical cost-wise. It is not just that we face a sort of guerilla war (inherently asymmetrical), as opposed to facing a conventional army, as we were used to. The offensive means that the Palestinians resort to are rock-bottom cheap (materially at least), whereas the means required to neutralize them are amazingly expensive. Consider the building of the fence vis-à-vis suicide bombers; consider the expected deployment of multilayered anti-missile systems vis-à-vis Qassam rockets. This is the root of the quandary, since against a primitive rocket that costs a few hundred dollars, Israel has to develop and deploy extremely sophisticated defense systems that cost several order of magnitudes more in order to protect its civilian population.

Another cost made obvious during the Second Lebanon War is that associated with the policing work that the IDF had to do in Judea and Samaria. As a consequence of having to deploy significant forces for anti-terrorism tasks in the territories, the regular and reservist forces of the IDF did not train enough, the equipment was not properly kept, and so on. This eroded the preparedness of the army significantly and its combat skills, as became evident with the outbreak of the war in July 2006. This highly significant cost of the conflict with the Palestinians, which remained hidden for a while, hit with full force in the wake of the war. Since then the IDF has undertaken a rapid process of catching up that has been successful, but has (again) entailed high costs, this time overt and not hidden.

Thus for the first time since 1967, the conflict with the Palestinians requires us to deploy high and rapidly increasing resources to cope with it, both in terms of military expenditures and other economic costs. These demands strain our ability to tackle simultaneously the growing Iranian threat, at the same time as maintaining our qualitative edge in terms of conventional military capabilities.

The Palestinian side is also experiencing escalating economic costs, not in the means it employs to fight us (as said, those are cheap), but because of our response: the blockade of Gaza, the numerous roadblocks in Judea and Samaria, and other measures mean a dramatic decline in economic activity in Palestinian territories. This is in sharp contrast with the pre-intifada period, when the Palestinian economy was characterized by high growth rates. Unfortunately, this is the new "balance of economic terror": highly asymmetrical in nature, but nevertheless rapidly escalating economic costs for both sides.

The world economic crisis is likely to exacerbate those costs, and hence perhaps bring home to both sides the realization that the conflict may be acquiring an economic dimension that was lacking before. That is, the economic costs that both sides are increasingly bearing may become a factor in itself, in our as well as their perception of the conflict. Optimists would argue that this may turn out for the better, since such enhanced perception may hasten the search for solutions. Of course, arguments to the contrary may also be raised.

Either way, the world economic crisis is not just a passing phenomenon that interests mainly economists and businessmen, but a major storm that is likely to change the landscape all around us.