

## **Economic Relations between Israel and Europe: Selected Issues**

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Elai Rettig and Oded Eran

Economic trade between Israel and the EU countries has flourished over the past decade. Despite political disagreements, Europe is still Israel's largest and most important market, both for exports and for imports. This dominance is particularly reflected in the Israeli food market, in Israel's import of vehicles, in the pharmaceuticals market, and in technological and scientific cooperation. The immigration crisis and the terrorist threats in Europe have spurred a significant increase in defense exports from Israel to Europe, and in 2016 Europe became the second largest export destination for the Israeli arms industry, after Asia. The rift between Europe and the US may play into Israel's hands in this context, particularly in the realm of military exports to Western Europe. On the other hand, the growing political tension between the EU and the government of Israel, the boycott threats, and the strengthening of the shekel against the euro threaten other aspects of trade, and particularly Israeli exports. In any scenario, the shift of Israeli exports to the emerging markets in China and India is not expected to replace Israel's dependence on Europe any time soon.

### **Trade between Israel and Europe: The Current Situation**

Since the 1960s, Europe has been Israel's most important trading partner. This trend has only intensified since the conclusion of the Association

Agreement between Israel and the EU in 1995. Currently Europe accounts for more than one third of Israel's total foreign trade. In contrast, Israel is 24<sup>th</sup> in size among Europe's trading partners, accounting for about 2 percent of Europe's total foreign trade, and is Europe's most important trading partner in the Eastern Mediterranean.<sup>1</sup> In 2016, the value of trade between Israel and Europe stood at 34.4 billion euros (as compared to 23.8 billion euros in 2006), and since 2012 has grown by an annual average rate of 6.5 percent. In 2016-2017, the growth was reflected primarily in increased exports of goods from Europe to Israel due to the strengthening of the shekel against the dollar, while exports from Israel to Europe fell by 1.9 percent and are currently where they stood in 2011.<sup>2</sup>

Europe buys about 30 percent of Israel's exports (as of 2016), and ranks ahead of the US, which buys about 26 percent. This can be seen in particular in the processed food sector, in which about 44 percent of Israel's exports are destined for Europe.<sup>3</sup> Among European countries, the leading destination for exports is Britain, followed far behind by Holland, Belgium (mainly diamonds), Germany, and France (in descending order). The exports to these countries consist primarily of pharmaceuticals and chemicals (39.2 percent), machinery and transport equipment (21.3 percent), and computers, electronic, and electro-optic equipment and other products (15 percent). In the past year, defense exports to these countries have also grown, in particular, technology for countering infiltration, fighting terror, and border protection. In addition, exports of new cyber defense products have begun. As a result, Europe has become the second largest destination for defense exports after Asia, and is ranked ahead of North America and well ahead of Africa and South America where Israeli exports have declined substantially since 2014, primarily due to the drop in the global price of oil, which is the major source of income for many of the countries in those regions.<sup>4</sup> Despite the general trend, over the past year total Israeli exports to Europe have declined, and in particular exports to France (17 percent); on the other hand, there has been an increase in exports to Spain (14 percent), Germany (4 percent), and Italy (3 percent).<sup>5</sup> The decrease was felt mainly in the manufacturing sectors (2.7 percent) and in agriculture, forestry, and fishing (0.7 percent).<sup>6</sup> Nevertheless, the Israel Export Institute predicted that exports to Europe would recover in 2017 due to growth in the economies within Europe that constitute the main destinations for Israeli exports.

With respect to imports, over the last two years there has been a substantial annual increase of 11.6 percent in imports from Europe, primarily due to the strengthening of the shekel against the euro. As of 2016, the EU countries account for about 43 percent of Israel's total imports (not including diamonds), which made the EU the largest exporter to Israel, with the US and China (13 percent each) lagging far behind. This figure is particularly reflected in Israeli imports of processed food, of which 50 percent originates in the EU. The top-ranked countries of origin for Israeli imports are (in descending order) Germany, Switzerland, Belgium (diamonds), Britain, Holland, and Italy.<sup>7</sup> Imports consist mainly of machinery and vehicles (45.4 percent), and pharmaceuticals and chemicals (18.2 percent).

The positive trade relations between Israel and the EU are expected to continue and even improve in coming years. The acceptance of Israel as a member of the European Neighborhood Policy (ENP) *inter alia* led to the implementation of new agreements between the sides. These include trade agreements for agricultural and fishing products, which went into effect in 2010; the Agreement on Conformity Assessment and Acceptance (ACAA) signed in 2013, which recognizes the standards for industrial and pharmaceutical goods approved in Israel and is intended to facilitate trade in those goods; the "open skies" agreement signed in 2013, which enabled more European airline companies to enter the Israeli market; and the Eurocontrol agreement of 2016 for coordination of air traffic and air defense.

The reentry of Israel in 2014 into Horizon 2020, the EU's research and development program, was also a major step forward in strengthening ties between the sides. The program provides researchers, companies, and universities in Israel with access to a budget of 77 billion euros up to 2020 for the funding of joint scientific research and projects. According to data from the Israel-Europe R&D Directorate (ISERD), the previous round of the program, which ended in 2013, awarded 2110 Israeli participants with research grants in the amount of 840 million euros, which made the EU into one of the major growth engines for Israel's R&D.<sup>8</sup> The program also constitutes a lever for bringing Israeli scientists back to Israel and creating new research laboratories in academia, although as of 2015 Israel's balance of leaving/returning researchers was still negative.<sup>9</sup> The countries with which Israeli researchers have had the majority of collaborations are (in descending order) Germany, Britain, Italy, France, and Spain.

In addition to investment in R&D, the EU makes available about 12 million euros as part of the ENP to non-government organizations operating in Israel for the promotion of goals and values that Europe supports (such as democracy, human rights, and promotion of the peace process). This policy also creates political tension with the government of Israel, since part of the funding reaches organizations that Israel defines as “anti-Israeli” seeking to undermine Israel’s legitimacy. These political tensions will likely affect the continuation of the bilateral economic partnership, since many of the current proposals for the improvement of Israel’s status as a preferred EU trade partner include progress in negotiations between Israel and the Palestinians as a precondition.

### **Political Economics: Boycotts, Opposition Organizations, and Illegal Construction**

The growing political tension between Israel and EU institutions surrounding the Palestinian question is also reflected in the economic realm and is influenced by the Israeli economy’s dependence on Europe. In July 2013, the EU adopted recommendations whereby any new economic agreement signed with Israel will not apply to the settlements and the Jewish neighborhoods in East Jerusalem, but rather only to areas within the 1967 borders. In November 2015, the EU approved the labeling of goods produced in the settlements that are exported to Europe, a measure that was perceived in Israel as assisting the vocal BDS organizations that operate in Europe. It was also seen by Israeli policymakers as a warning light in advance of more serious economic sanctions that have been on the table since 2015. These include proposals to limit the activity of Israeli banks in Europe that invest beyond the Green Line or provide loans and mortgages to residents there.<sup>10</sup> Such measures have a potential to generate real harm to the Israeli economy, but at this stage their economic effects are marginal and do not justify the media attention they receive in Israel.

To date, the European steps against products from the settlements have not had much of an effect on Israeli industry.<sup>11</sup> From the outset, the harm was not expected to be serious, since the vast majority of the one thousand Israeli factories established in industrial zones and settlements in the West Bank market their output (consisting mainly of furniture, metal and construction products, textiles, and footwear) primarily in Israel, rather than Europe. The main focus therefore is on processed food and agricultural products.

However, the exports of the Israeli food industry to Europe actually grew in 2016 by 3.5 percent, which is higher than the rate of the preceding two years.<sup>12</sup> In contrast, agricultural exports fell by 0.7 percent, though presumably the strengthening of the shekel is the main cause of this trend. In any case, it is also possible that against the background of calls in Western Europe for a boycott there is a trend of increasing Israeli agricultural exports to Eastern Europe and Asia, although in those regions Israel is competing with cheap producers in Turkey and elsewhere. In these markets, prices are lower and thus the revenue that returns to the Israeli economy declines. Therefore, if political conditions permit, an Israeli exporter will always prefer to market products to Western Europe and North America.

Beyond the threats of a boycott and sanctions, an additional focus of tension between Israel and the EU is the European funding of opposition organizations and non-government organizations that operate in Israel and in the West Bank and are perceived as undermining the state's interests. According to NGO Monitor, the EU delegation has in recent years awarded 16.7 million euros to 42 Israeli or Palestinian organizations that openly support a boycott of Israel.<sup>13</sup> A particularly thorny issue is the direct funding provided by the EU to Palestinian construction in Area C based on humanitarian pretexts, without building permits or coordination with the government of Israel.<sup>14</sup> Taking into consideration the volume of the trade and its being a major portion in Israel's global trade and other economic interests, it is doubtful whether Israel has an effective response beyond expressing its dissatisfaction in the short run and making greater efforts to diversify its markets in the long run. In the long term Israel's growing economic relations with Asia create an interesting option for Israel. Exports to China, which is now the third largest market for Israel, continue to grow, and military exports to India are of a significant economic importance to Israel. New, more comprehensive trade agreements that are being negotiated with these two countries could contribute to a major shift in Israel's balance of trade from politically-linked trade with Europe to politically-free trade with Asia.

### **Future Issues: Brexit, the Transatlantic Rift, and the Look to Asia**

A number of global issues that are not directly related to Israel are liable to affect the level of its trade with Europe. First, the withdrawal of Britain from the EU has created uncertainty for Israel, since it is unclear what new arrangements between Britain and its EU trade partners will take shape.

Currently, Israel's trade with Britain is worth about \$5 billion, and the UK is the first-ranked destination for Israeli goods in Europe. However, Israel does not have a bilateral trade agreement with Britain, since the legal basis for trade between the countries is the EU Association Agreement. As a result, there will be a need to negotiate new bilateral trade arrangements with Britain, which could be less favorable to Israeli companies than those achieved within the framework of the EU. A new EU-UK agreement may result *inter alia* in a devaluation of the English pound against the Israeli shekel, harming Israeli exports to the UK. Alternatively, in a more positive scenario, the UK exit from the EU will improve the competitiveness of Israeli goods in UK markets *vis-à-vis* goods from the EU. These issues will become clearer once the EU and the UK conclude their new framework for their future relations.

Relations between the United States and the European Union affect Israel's political and economic relations with the EU. A growing distance between the two allies across the Atlantic weakens the US ability to influence the EU policy on issues related to the Israeli-Palestinian conflict and Israel's long term security. The US decision to pull out of the JCPOA with Iran could have adverse effects, for example, in the ability of the EU and the US dialogue on other issues related to Israel's security, such as the situation in Syria.

Under pressure from President Trump and because of the growing threats to their domestic and external security, the Europeans may increase their defense expenditure. This may result in a growing cooperation between Israel and Europe in defense equipment production and procurement. The potential in this field has been overlooked for decades because of political considerations but the new global and regional circumstances in Europe and the Middle East may open new opportunities for Israel in Europe. The deterioration of the relations between Turkey on the one hand, and the US and Europe on the other, will require Europe to reevaluate the strategic implications. So will the Russia's policies in Europe and the Middle East, with one of the possible outcomes of such a reassessment being a changed, more positive, European view of Israel.

## Notes

- 1 See European Commission, Trade, Policy: Israel at <http://ec.europa.eu/trade/policy/countries-and-regions/countries/israel/>.
- 2 Central Bureau of Statistics, "Foreign Trade – Goods 2016," [http://www.cbs.gov.il/www/presentations/16\\_17\\_010maznis.pdf](http://www.cbs.gov.il/www/presentations/16_17_010maznis.pdf).
- 3 Israel Export Institute, "European Union: Agreements and Trade Relations," <http://www.export.gov.il/heb/Countries/Europe/European%20Union/Trade%20Agreements/>.
- 4 Ora Koren, "Defense Exports in 2016 Grew by \$6.5 Billion; Europe has Become the Main Destination," *The Marker*, March 29, 2017, <https://www.themarker.com/allnews/7.3399383/1.3956895>.
- 5 Israel Export Institute, "Developments and Trends in Israeli Exports: Annual Report for 2016 and Forecast for 2017," <http://www.export.gov.il/heb/About/Economics/makro/news,11035/>.
- 6 Central Bureau of Statistics, "Export of Goods According to Economic Sector 2016," [http://www.cbs.gov.il/reader/newhodaot/hodaa\\_template.html?hodaa=201716206](http://www.cbs.gov.il/reader/newhodaot/hodaa_template.html?hodaa=201716206).
- 7 Central Bureau of Statistics, "Foreign Trade – Goods 2016."
- 8 ISERD, "Horizon 2020: The European R&D Program is Launched," [http://www.iserd.org.il/\\_Uploads/dbsAttachedFiles/ISERD\\_HEB\(2\).pdf](http://www.iserd.org.il/_Uploads/dbsAttachedFiles/ISERD_HEB(2).pdf).
- 9 National Program to Return Academics, "The Leaving/Returning Academics Report 2016," 2016.
- 10 Tomer Varon, "Proposal in Europe: Restrictions on Israeli Banks that Invest Beyond the Green Line," *Calcalist*, July 22, 2015. <https://www.calcalist.co.il/local/articles/0,7340,L-3665072,00.html> [Hebrew]
- 11 It is difficult to measure accurately the potential or actual harm resulting from a boycott or the labeling of Israeli products in Europe. The first reason is that the State of Israel has no interest in publishing such data, for understandable reasons. The second reason is the difficulty in differentiating between the effect of the labeling of products and calls for a boycott on the one hand, and the many other factors that might be leading to a drop in the purchase of Israeli products in Europe on the other hand. These include the strengthening of the shekel during the last two years and the entry of cheaper competitors from Asia. In addition, many Israeli suppliers make sure to mix their products from the settlements with goods produced within the Green Line, thereby bypassing the EU laws, but also making analysis difficult.
- 12 See "European Union, Trade in Goods with Israel," European Commission, [http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc\\_113402.pdf](http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113402.pdf).
- 13 "EU Financing for Organizations Active in the BDS Campaign," *NGO Monitor*, January 23, 2017. [http://www.ngo-monitor.org.il/reports/eu\\_bds\\_funding/](http://www.ngo-monitor.org.il/reports/eu_bds_funding/).
- 14 Assaf Gavor and Zeev Kamm, "The EU on the Financing of Construction in the Territories: Humanitarian Assistance," *NRG*, August 11, 2015. <http://www.nrg.co.il/online/1/ART2/716/503.html>.