

Operation Protective Edge: Economic Summary

Eran Yashiv

This article explores three interrelated issues: economic aspects of Operation Protective Edge; implications for both the state budget and aid to Israel's southern population; and an assessment of the economic situation in the Gaza Strip and the prospects for a massive economic program to help solve the conflict. The first two questions are discussed as a description of the developments; the third question combines an economic analysis and policy recommendations.

Economic Aspects of Operation Protective Edge

There are three main aspects to the economic loss: a decline in economic activity and a loss of output; military expenses incurred in the fighting; and damage to inventory and property. Injury or death among soldiers and civilians, and psychological or social effects, which are obviously important, are not included in the current discussion.

Loss of Output

Operation Protective Edge caused a loss of output as a result of absences from work (e.g., people serving in the reserves and mothers forced to stay home with their children), a drop in demand (in particular, internal tourism, foreign tourism, and dining and entertainment services), disruption of regular activity (e.g., work stoppages caused by alerts, disruption of supplier operations), lower productivity, and so on. Small and medium-sized businesses in the south were hit particularly hard. The partial shutdown of flights to Ben Gurion Airport also had a negative impact on economic activity.

Israel's annual GDP totals NIS 1.05 trillion. GDP averages NIS 4.2 billion a day for every working day (248 days per year). During Operation Protective

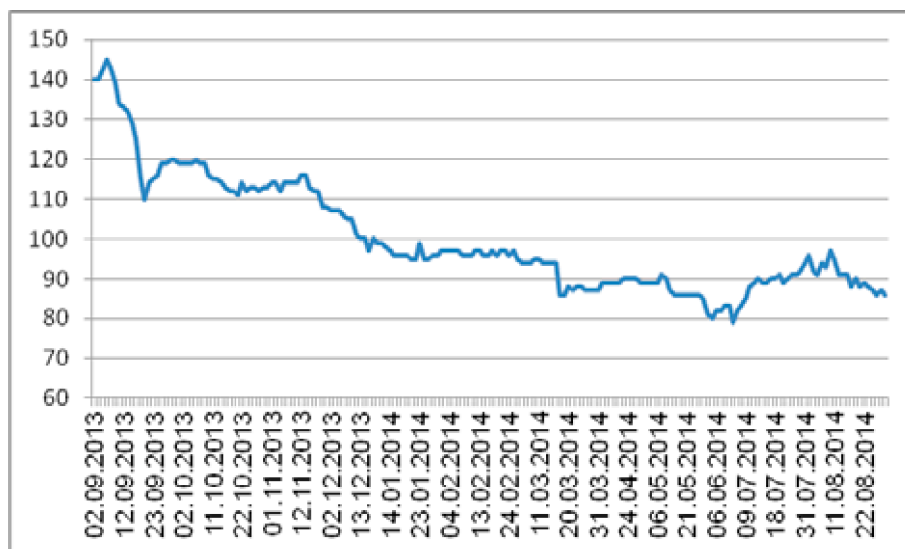


Figure 1. CDS Spread, September 2013-August 2014

Source: Bloomberg; data taken from Deutsche Bank Research

Edge, there was probably a loss of 10-20 percent of this daily GDP; the 43 working days out of the 50 days of the operation, therefore, imply a total loss of NIS 18-36 billion, or 1.7-3.4 percent of annual GDP. A more precise figure is unattainable at present; a clearer estimate will be available in late 2014 with the publication of third quarter national accounts figures by the Central Bureau of Statistics (CBS). According to a CBS report of October 20, 2014, the GDP growth declined by 1 percentage point in 2014. While this is not a measure of the output loss due to Operation Protective Edge, it is consistent with the above numbers.

For the sake of comparison, the growth rate now (in GDP) is about 3 percent a year; Israel has then lost about two thirds of its annual growth for the year. However, this is a one-time occurrence and not a permanent reduction in the rate of growth.

The capital market reacted somewhat to both the operation and the poor economic figures that preceded it. For example, the shekel-dollar exchange rate remained around NIS 3.41 to the dollar during July, but with the publication in early August of figures indicating a slowdown in the first half of 2014, the shekel weakened to NIS 3.58 to the dollar in early September. At the same time, the confidence in the capital market was not affected during the operation. Figure 1 displays the CDS (credit default swap) spread¹ representing the

confidence of overseas investors in the Israeli economy over the past year. A smaller spread indicates more confidence. The spread increased slightly during the operation, meaning a drop in confidence, but fell again when the operation ended. From a year-long perspective, the increase was negligible in comparison with the large scale downtrend in the spread, indicating a major rise in confidence. The Tel Aviv Stock Exchange rose at the beginning of Operation Protective Edge, then fell below the pre-operation level. In late September, it was 2.4 percent higher than before the operation.

Military Expenses

Estimates of the campaign's expenses that appeared in the media, including figures cited by IDF officers, ranged between NIS 100 million per day before the entry of ground troops to NIS 200 million per day during the ground operation. There were reports of massive, even wasteful, use of ammunition in certain cases. A cautious estimate for the military costs during the 50 days of the operation is therefore at least NIS 7 billion, without payment for reserve days and air force armaments. Estimates by the defense establishment of some NIS 9 billion and a demand for an NIS 11 billion supplement to the 2015 defense budget appeared in the media. The same reports quoted sources in the Ministry of Finance, which estimated the costs at NIS 4-5 billion.

For the sake of comparison, the Second Lebanon War lasted 34 days, and at its end the IDF received NIS 8.2 billion in direct compensation (plus more in different forms). Operation Cast Lead lasted 22 days and cost NIS 3.8 billion; the Ministry of Finance paid NIS 2.45 billion. Operation Pillar of Defense lasted eight days, and its cost was approximately NIS 2 billion.

Damage to Inventory – Homes and Means of Production

Rockets and mortars hit private homes, public buildings, companies, factories, and agricultural areas, resulting in loss of capital stock. Losses are difficult to estimate, because they are necessarily based on damage reports and claims for compensation with various biases. According to an announcement by the Ministry of Finance on August 7, 2014, claims for direct damage totaling NIS 50 million were filed. The ministry nevertheless estimated the indirect damage at NIS 750 million-NIS 1 billion, and it is unclear whether this includes GDP damages of the type described above.

Implications for the Government Budget and Israel's Southern Population

The immediate effect of these developments was an increase in the government budget as a percentage of GDP. Spending rose, tax receipts fell with the drop in economic activity, and GDP itself was affected. Even before the operation, the deficit was a problem that was aggravated by these developments.

Discussions of the 2015 budget were postponed due to the operation, and the government was forced to deal with the budget in September-October 2014. The first important discussion in the full cabinet took place on August 31, 2014, when it was decided to cut NIS 2 billion from the 2014 budgets of all government ministries except for defense, increase the defense budget by NIS 1.5 billion, and allocate NIS 500 million to residents of the communities around the Gaza Strip. Additional aid for residents of the south over the next five years was also promised.

Future disputes are expected between the Ministries of Finance and Defense concerning the budget supplements needed by the Ministry of Defense in 2015 and on a subsequent multi-year basis. There are various aspects to this problem: the division between the defense budget and the civilian budgets, the multi-year consequences for the budget, and the consequences of the government deficit and debt. For example, the Locker Committee, which is tasked with discussion of a framework for the multi-year defense budget, will have to include the consequences of Operation Protective Edge in its recommendations.

The budget approval process is expected to include both professional disputes, as that between the Ministry of Finance and the Bank of Israel, for example, and political disputes. As of the writing of this paper, it is too early to know what the effect of the operation will be on the 2015 budget, not to mention the following years. Aid for residents of the south will be greatly affected by the decisions made about the defense budget.

Over the years, there has been a significant drop in defense spending as a percentage of GDP, from over 30 percent in the early 1970s, to 20-25 percent by the mid-1980s, and around 6 percent in recent years. The decline notwithstanding, according to the World Bank Israel had the fourth highest rate of defense spending in the world in 2009-13, 5.6 percent of GDP, behind Oman, Saudi Arabia, and Afghanistan. For the sake of comparison, the World Bank figures put US defense spending at 3.8 percent of GDP, and

the UK and France at 2.3 percent, meaning that by international standards, defense spending in Israel is still high. In order to remain at these levels, the defense budget must be increased by no more than 3 percent a year, Israel's expected economic growth rate for the coming years, amounting to an annual increase of no more than NIS 2 billion in 2014 terms.

An Economic Program for the Gaza Strip

Background

Even before Operation Protective Edge, the Gaza Strip was at the bottom of the global economic totem pole: 1.76 million residents live amidst the third highest population density in the world – 4,800 people per square kilometer. The infrastructure in Gaza is insufficient, and even in peacetime there are many halts and disruptions in electric, water, sewage, and other systems; power outages of 7-8 hours, for example, are a matter of routine. The labor market is marked by high unemployment: in the Gaza Strip in the second quarter of 2014 it was 45 percent, compared with 26 percent in the West Bank. Among young people in the 15-29 age group, unemployment was 58 percent. Under these conditions, there is no possibility of production on a significant scale. Per capita GDP in the Gaza Strip is around \$1,500-1,600 per year, compared with \$3,100-3,200 in the West Bank. On a global scale, the Gaza Strip ranks 174 out of 223 countries in the World Bank's calculation. In comparison, Israel is 32 on this scale, with a per capita GDP of \$36,000 per year. Given these figures, the poverty indicators are predictable: the incidence of poverty is 39 percent (compared with 18 percent in the West Bank), with the poverty line being a monthly income of NIS 2,293 per five-person household. The incidence of extreme poverty is 21 percent (compared with 8 percent in the West Bank), with the extreme poverty line being NIS 1,832 in monthly income. It is obvious what standard of living is possible when per capita income is NIS 400 a month (about \$4 a day).

Economic distress frequently drives nations into military conflict or other aggression. Furthermore, the already desperate economic situation in Gaza worsened with the change of regime in Egypt, its activity to close the tunnels and border crossings, and the more stringent border restrictions imposed by Israel. Indeed, the Gaza Strip has been under a severe closure regime imposed by Israel and Egypt for a long time. In addition to the general economic restrictions, financial support for Hamas from Iran and Syria has waned, and there are problems in paying public sector salaries in Gaza.

This is the reason why Hamas' demands in both the ceasefire negotiations and the negotiations with Fatah on establishing a reconciliation government concentrated on the "blockade" of Gaza and the opening of the economy. The tunnels to Sinai are the "natural" response to a state of economic isolation.

The Economic Program

One solution to this situation is a substantial improvement in the economic situation. If Gazans have something to lose, they will be much less ready to enter into a conflict. Economic prosperity is likely to reduce the power of Hamas and other Islamic movements, provided that the economic change is substantial and carried out by suitable agencies. Minor changes of the type already tried in the past will not bring about the desired change.

The Gaza Strip has several economic possibilities,² among them development of tourism along the coast, development of services (including entry into hi tech, as has occurred among Israeli Arabs in the north), and gas production (following the discovery of a significant off-shore gas field in 1999). In the short and medium terms, investment and employment can be channeled toward development of physical infrastructure and public services. It is important to stress, however, that a fundamental change means a major step forward, not merely the easing of the blockade and some opening of the border crossings. Small steps will not achieve the actual goal, and will even make the situation worse in the long term. The establishment of new international mechanisms to implement the change is needed, not handling by Hamas or Israel. These mechanisms require the agreement of several countries and international agencies to join together in a serious effort. This means the establishment of special agencies with professional personnel and knowledge. If goals and parameters are not stated specifically and concretely, they will dissolve, and the hoped for turnaround will not take place.

How can this be achieved? The following elements are needed:

- a. *Repair and construction of infrastructure*: Concomitant with the repair of the ruins from the July-August 2014 attacks, repair of infrastructure and construction of absent infrastructure should begin. An international agency, such as the World Bank, can assemble a task force that will review the situation and establish priorities over time. It can be expected that Gaza can be brought to a reasonable state of economic infrastructure within three years (from the start of work), and to a good situation

within 6-8 years, in part by employing local unemployed workers. It is very important that this mechanism be under international control, use external specialists, and clearly and transparently publicize its work. The transparency will promote the change in awareness necessary for economic progress in the Gaza Strip. Beyond the cost of rebuilding the destroyed houses and buildings, \$800 million-1 billion in infrastructure investment is needed in each of the next three years, and \$500 million in investment in the 3-5 years following. Reconstruction of the homes and buildings at a much higher level than they were before destruction will be a positive step; such action can greatly bolster the population's support for economic development.

- b. *Financing*: Financing for moving the Gazan economy forward will come from rich Arab and Western countries. It is very important that there be a variety of donor countries to share the financing risks and to prevent one country from taking over the process is important. At the outset, this can be done through an emergency fund managed by the World Bank. In the medium and long terms, a special bank can be set up for development of Gaza on the same format as institutions of this type around the world, such as those established in Eastern Europe in the 1990s after the fall of the Soviet bloc.
- c. *Supervision of inputs*: A key question in Israel about the Gaza Strip is concern that inputs for production can be used for military needs. This concern notoriously materialized in the use of building materials to create dozens of offensive tunnels, under conditions of the Israeli closure. This issue has been solved elsewhere: the World Bank and other institutions have discovered more than once that aid was reaching corrupt rulers or self-interested groups, instead of the intended recipients. Mechanisms were therefore developed for transferring economic assistance, usually in the form of direct transfer to the recipients, while making receipt contingent on progress in the projects. Such methods can also be used in the current case through moderate Arab parties and international agencies. These mechanisms must also include supervision of the selection of the aid recipients themselves, which are liable to emerge as targets for control or influence by Hamas.
- d. *The political environment*: These measures cannot be carried out in the midst of a cycle of violence. The entry of a UN force into Gaza is necessary, for example, the type of force stationed in 1992-95 in the countries that

were formerly part of Yugoslavia, which constituted an international force making economic activity possible. The active involvement of the UN, the World Bank, and the Development Bank will include hundreds of foreigners – both soldiers and specialists – “on the ground” in Gaza. The combination of these functions is essential, as is the transparency and public reporting of their actions.

The activity of Palestinian Prime Minister Fayyad in the West Bank in 2007-13 is proof that substantial economic progress can be achieved when professional parties lead the processes. The idea that economic progress prevents war is deeply rooted in Europe, and was successfully applied in the second half of the twentieth century, following two world wars in the first half of the century. The opposite is also true: economic distress leads to conflict and bloodshed. At the same time, the implementation of these ideas is highly dubious right now, due to the lack of willingness on the part of the relevant countries and the fact that they are not initiating this type of process. Continuation of the economic problems, with all their negative political consequences, is therefore a highly plausible scenario.

Notes

- 1 The CDS spread is a financial instrument that provides insurance against a default, in this case on Israeli government debt. The spread is actually the insurance premium. A higher premium represents a greater risk. Data for the figure was taken from [https://www.dbresearch.com/servlet/reweb2.ReWEB?rwnode=DBR_INTERNET_EN-PROD\\$EM&rwobj=CDS.calias&rwsite=DBR_INTERNET_en-PROD](https://www.dbresearch.com/servlet/reweb2.ReWEB?rwnode=DBR_INTERNET_EN-PROD$EM&rwobj=CDS.calias&rwsite=DBR_INTERNET_en-PROD).
- 2 It is obviously desirable that a development process take place in addition and independently in traditional fields, such as textiles and agriculture, and that there be a removal of the (strict) export barriers to Israel.