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**Restructuring the Israeli Economy**
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On May 8th Israeli Prime Minister Benjamin Netanyahu scored a major political coup when he announced that the Kadima party will join his governing coalition. He now commands an historic majority in the Knesset. In addition to tackling critical issues such as the peace process and military conscription, Netanyahu's government is likely to implement important economic reforms as well. The Prime Minister's reform package (outlined below) will initiate the next wave of major economic transformation in Israel.

As we noted in past letters, Israel was a Socialist country at birth and it spent the past two decades slowly unraveling this legacy. The first phase of market oriented reforms occurred in the 1990's as the Histadrut labor union privatized its vast business holdings. The second phase came in the 2000's as the government privatized many of its assets, lowered government spending and cut taxes. Along the way, the balance slowly tipped from a predominantly Socialist economy to a market economy.

Unfortunately, privatization did not address the monopolistic structure of Israeli business. In typical Socialist fashion, the Histadrut and the government established monopolies in almost every major field of economic life. The privatizations of the 1990's and 2000's merely transferred these monopoly businesses into private hands. Examples abound, but include the Israeli oil refinery, dairy and other food products, shipping, banking and insurance, wholesale distribution, and a host of others. The acquirers bought companies with weak financials and low valuations. To their credit, the new owners strengthened balance sheets while boosting profitability and growth. Along the way this small group of business people became tycoons, in some cases even billionaires.

We feel the public is conflicted about the role of tycoons in Israeli society. On the one hand, these business owners invested in their companies spurring economic growth and employment. On the other hand, this small group of mega-wealthy tycoons dominates the entire financial sector and large swaths of Israeli business. The public calls them the 25 families (not an exact count), often exaggerating their influence. The tycoons essentially replaced the prior dominance of the Histadrut and the government during the Socialist era. A key difference, of course, is that as private businesses they tend to be more efficient and dynamic.

Compounding the growing concern about monopolies is public anger about high consumer prices and tycoon dominance over the financial system. Several wealthy families created "business pyramids" with one of the banks or insurance companies at the apex, allowing the controlling family to deploy large amounts of capital on preferential terms. Similarly, they are in position to exploit conflicts-of-interest by denying capital to potential competitors. During the global financial crisis several tycoons invested in ill-conceived foreign real estate and financial ventures, treating bondholders and minority shareholders poorly when losses were allocated.

Facing limited competition, newly privatized companies raised prices. For example, following its privatization in 2008 the dairy monopoly Tnuva boosted prices by as much as 40%. Outraged consumers poured into the streets in last summer's "Cottage Cheese Rebellion," protesting the high cost of living in Israel (an estimated 500,000 people participated in a country of 7.5 million). Fueling some of the outrage was an outright ban on imported dairy products, a holdover from the years prior to privatization. In response to the protest, the government quickly scrapped the import ban.

**The Next Phase of Economic Liberalization**

To his credit, Prime Minister Benjamin Netanyahu had already taken steps to address the problem upon assuming office. In October 2010 he established the "Committee for the Promotion of Competition in the Economy" aka the Concentration Committee. Netanyahu explained his reasons for setting up the committee as follows: "I saw that Israeli consumers were suffering from the rise in the cost of living, and because they can compare it with prices for goods and services around the world. We have a cost of living problem because of a lack of competition. My goal is to boost competition in the economy in order to lower the cost of living." Finance Minister Yuval Steinitz added, "Separating holdings between financial and non-financial companies is essential for creating a more competitive market, as well as addressing the issue of complex structures and pyramids."[1]

A few weeks ago the Concentration Committee issued its final report and the expanded coalition government vowed to implement its major recommendations. If implemented these reforms amount to a far reaching restructuring of the Israeli economy and will launch the third phase of Israel's transition from Socialism. The Committee recommended that the government separate the financial and non-financial holdings of Israel's leading tycoons. The goal is to eliminate the conflicts-of-interest that pervade Israel's largest financial institutions. Since just three banks control the lion's share of all financial sector assets in Israel, this will constitute a significant change in the financial system.

The Concentration Committee recommended that business pyramids be limited to three levels. At present, several groups control vast business empires through a multiplicity of interlocking entities. Over the next four years they will be required to unwind large portions of these groups. Over the past decade Israeli companies increasingly turned to the public stock and bond markets to raise capital. The government also privatized several companies directly on the market as capitalization and liquidity increased. Over the next four years the tycoons will need to offer their companies on the stock market, or expand their currently small minority listings to comply with the new laws.

[1] "Committee Recommendations Fight Economic Concentration in Israel" www.jspace.com; September 19, 2011.

The Concentration Committee's recommendations have already been endorsed by the government and the Bank of Israel. These policy reforms respond to the public's concern about the cost of living and they are necessary for Israel's continued economic growth and security. Israel understands it must increase prosperity not only for the well-being of its citizens, but also to afford the high and growing costs of a modern defense establishment.

The prior wave of privatization and reform pushed daily trading on the Tel-Aviv Stock Exchange from $50 million a day to around $500 million per day. We think the next wave will likely produce a similar gain in the coming decade. Greater liquidity should lead to higher valuations. Meanwhile, the Concentration Committee did not cover all of the ongoing reforms strengthening the Israeli economy. In addition Prime Minister Netanyahu appointed another important committee to further address the high cost of living and study the tax system. The Ministry of Communications is in the midst of reforms designed to increase competition, lower prices and spur innovation in the telecommunications industry. These changes will further support Israel's technology companies and consumers. The government is strengthening the role of anti-trust regulation and enacting legal enhancements to protect minority shareholders. Finally, the government is liberalizing the Israel Lands Authority to stimulate construction and moderate home prices. Taken together, our view is that these reforms will intensify business competition, maintain economic growth and expand the financial markets. Global and regional events will always play an outsized role in the short-term. Over the long-run, however, we believe Israel is once again taking concrete steps to maintain its robust economy. Investors who can withstand the volatility stand to benefit.