Why We Are Excited by Israel's Latest Economic Reforms

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Many investors in the Israeli economy – both foreign and domestic – focus exclusively on technology startups. We are one of the few firms focused on larger, publicly traded, Israeli companies. At an even deeper level, we pay careful attention to evolving opportunities from structural reforms in Israel.

Technological innovation, of course, is very exciting to us, but so are the nerdy minutia of economic policy, which can result in momentous changes, as reforms enacted in November 2021 seem likely to do. Yet investors and the press, even in Israel, often overlook such policy reforms. To understand why these policy shifts are so important, it helps to know the larger history of Israel's ongoing structural economic reform.

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Stasis Is Not an Option

Economists typically place government economic policies into three major categories: fiscal, monetary, and structural. Fiscal policy relates to government revenues and expenditures, including tax policies and social welfare systems. Monetary policy is the purview of the Bank of Israel in Israel, similar to the Federal Reserve in the United States, involving the relationship between money supply, interest rates, inflation, and unemployment. Structural policies include laws, regulations, and institutions that impede or enhance business competition, productivity, innovation, and scale.

As we discuss at greater length in our monographs "**A Brief History of Israel's Economy**" and "**The Past, Present and Future of Israeli Finance**," Israel transitioned from monopolistic socialism in its early history to capitalism in recent decades. This transition, however, is an incomplete and ongoing process. Most countries around the world with similar need for reform did not rise to the challenge, accepting economic stagnation instead. At each step of the way, the Israeli government enacted often far-sighted legislation, despite entrenched political opposition and across the partisan divides of coalition governments. Perhaps Israel's existential threats motivate action in ways that countries such as Greece, Italy, Japan, and Russia do not feel.

The Economic Arrangements Law

In response to the early-1980s financial crisis that left Israel's economy in a shambles, the Labor-Likud "national unity" government passed an Economic Stabilization Plan (ESP) in 1985. The ESP included an initial reform package that was meant to be a temporary addendum. The primary goal of the ESP was fiscal and monetary policy, but the government created an emergency fast-track legislative process for structural reforms called "The Omnibus Law of Arrangements in the State's Economy" or the "Economic Arrangements Law." Meant to help curb hyperinflation, this legislation allowed swift and sweeping changes to laws related to labor relations, wages, taxes, and certain regulations.

Although intended as a one-time emergency legislative process, an Economic Arrangements Law has been a feature of every annual budget since 1985. A single Knesset committee, usually the finance committee, debates and enacts economic laws through this streamlined process, rather than allowing legislation to stall as it slowly winds its way through multiple committee reviews. Although critics sometimes consider this procedure insufficiently democratic, every government since 1985 has used the Economic Arrangements process to push through reforms strengthening Israel's market economy.

Beyond Partisan Politics

Those of you following former Prime Minister Netanyahu's political machinations over the past several years are probably aware that the Israeli government failed to pass a budget for more than three years. Four elections in three years precipitated this delay, but the logjam finally broke with the formation of the current coalition last May. Although the coalition brought together many strange political bedfellows, it confounded skeptics by finally passing a budget in November. This budget once again contained an Economic Arrangements Law.

The government coalition contains parties considered to be right-wing, left-wing, and centrist, and there is even an Islamic party. Nonetheless, the Economic Arrangements Law once again contains substantial market oriented structural reforms.

Among these are substantive reforms to accelerate housing construction, reduce regulatory red tape for business, eliminate the kashrut certification monopoly, boost mass transit, and increase bank transparency. The government predicts significant consumer savings and GDP per capita growth from the law's provisions, including some outlined in the infographic below.

From our vantage point, two provisions are particularly important: import liberalization and elimination of designated pension bonds.

Highlights of the 2021 Economic Arrangements Law and Projected Annual Savings in Shekels

8 BILLION

Imports: Israeli standards authorities no longer need to inspect products authorized in other developed countries, reducing consumer prices.

7.5 BILLION

Deregulation: A new authority will promote smarter and less excessive regulation on businesses. Projected to raise GDP per capita by 6% over 10 years.

26-34 BILLION

Transportation: A proposed metro train system connecting 24 municipalities in central Israel should spur suburban development and reduce traffic congestion.

Source: Jerusalem Post

Import Liberalization

Protectionism is an unfortunate legacy of Israel's socialist past, imposing high prices on consumers for a wide variety of products. Although Israel reduced many direct and visible import barriers such as tariffs and quotas over time, expensive impediments remain. Perhaps the most pernicious trade barrier is Israel's unique set of product standards and costly inspections. Some of these standards penetrate deep into the Israeli economy. For example, certain construction standards privilege domestic electrical appliances. The more limited competition raises appliance prices but also increases construction costs.

The new Economic Arrangements Law eliminates Israel's unique standards regime, accepting common global standards alongside Israeli standards. The law also accepts many foreign product inspections and drastically reduces costly domestic safety and quality re-inspections. The goal is to boost domestic competition and lower prices, with the Finance Ministry estimating savings to Israeli consumers of as much as 8 billion shekels per year.

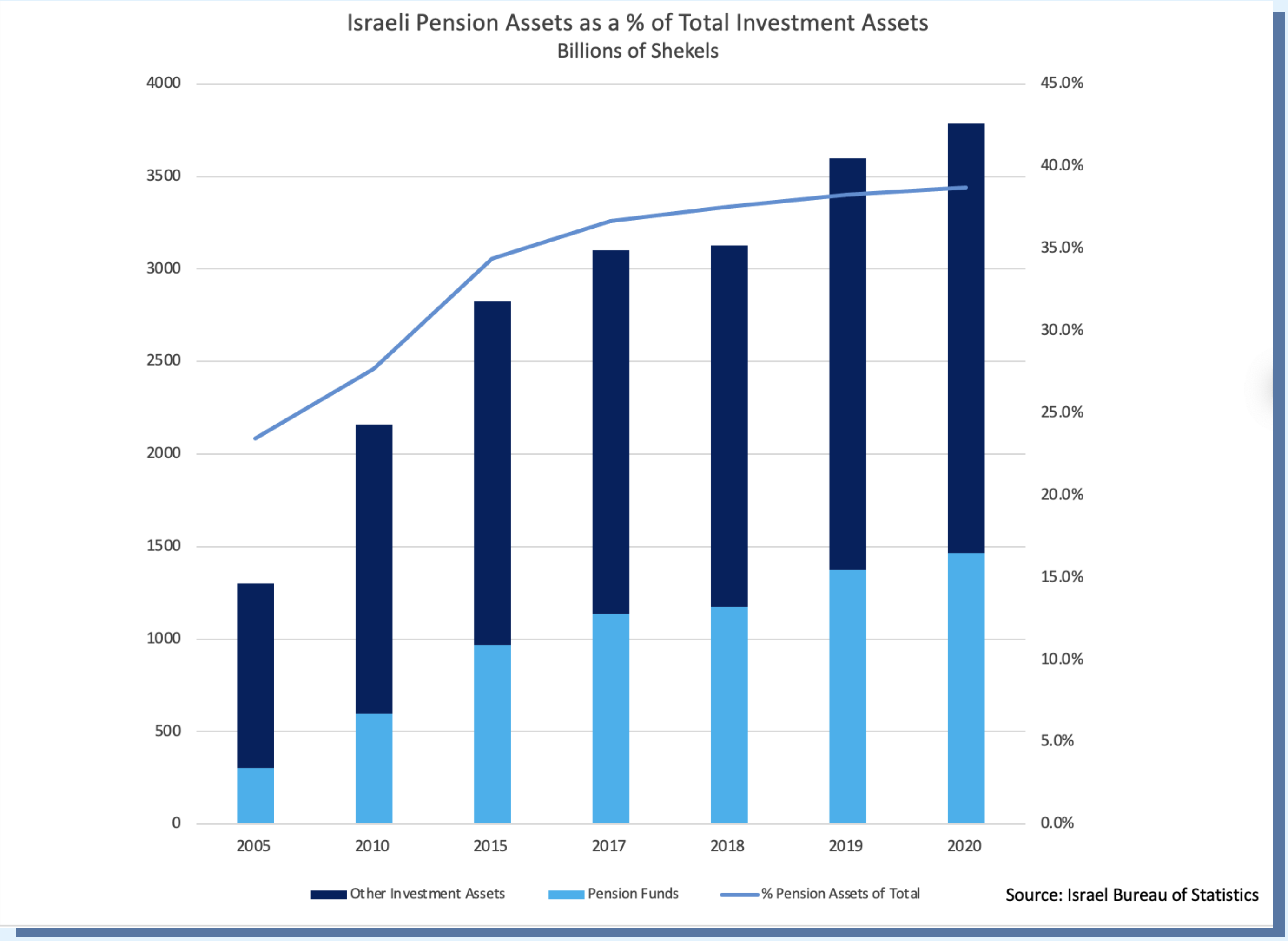
Not all the protected industries will survive intact, but others already adhere to global standards and compete in global markets. The law could dent profits in the short run, but lower consumer prices are a long-run economic growth accelerant. Inexpensive imports helped big box retailers in the United States such as Wal-Mart, Target, and Home Depot achieve massive scale. We expect larger Israeli retailers will benefit similarly in the coming years.

Designated Pension Bonds

A provision of the Economic Arrangements Law related to pension funds received limited coverage even in the Israeli press, despite its importance for the capital markets. In the 2000s, Israel transitioned from high government debt and high interest rates to low debt and low interest rates. Lacking many alternatives in Israel's early years, the government used pension savings as a captive source of finance. Pension funds are required to hold specially earmarked government bonds.

When debt was high, the Israeli government required pension funds to hold 90% of their portfolio assets in these bonds. As the debt burden eased, the government gradually reduced the designated bond requirement to its current 30% of pension assets. Meanwhile, the mandated 4.86% yield on bonds – by which bondholders had effectively subsidized the government when debt and interest rates were high – reversed and became a payout from the government to pension savers once debt and interest rates plummeted.

Since pensions are Israel's largest pool of capital, money moving out of designated bonds contributed to the robust development of Israel's stock and bond markets. (See chart below.)



Now that the government can readily issue low interest debt to domestic and global investors, designated bonds are an unnecessary burden. Responding to these changed circumstances, the Economic Arrangements Law eliminates designated bonds altogether.

The government will replace designated bond requirements with a minimum return guarantee of 5.15% annually for 30% of pension fund assets, allowing pension managers to fully invest their portfolios in capital market instruments as existing bonds mature. In coming years, this portfolio shift will gradually and steadily boost the liquidity of Israel's stock and bond markets with billions of shekels in unlocked capital.

This Economic Arrangements Law is Big, but a Small Detail May Be More Important for Us

Past reforms included in Economic Arrangements legislation were sometimes more impactful than this current bill, but the scope of the current law is nonetheless significant. So far, flashier provisions of the law, such as the Tel-Aviv metro system and congestion fee for commuters, received the most attention in the press. The least discussed provision, however, related to designated bonds might prove to be the most significant for stock market investors like us. We will continue to monitor economic and policy developments others may have overlooked, with our eye on the investment opportunities that may result.

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