

The Threat of Demographics and the Promise of Peace

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Over the past year, the slowdown of the Israeli economy has heated the debate between the "Keynesian" industrialists and their "monetarist" foes at the central bank.

In their attacks on central-bank governor Frankel, the Industrialist Association and the finance ministry argue that tight monetary policy is killing the economy. High interest rates, they say, keep the cost of borrowing too high, thus leading to low investment. In addition, by attracting "hot money inflows," high interest rates keep the currency "overvalued," which encourages imports, limits exports, and lowers the profitability of exporters. This cocktail, they claim, is a recipe for economic disaster.

The central bank, on the other hand, argues that a loose monetary policy is the last thing the country needs right now. There are two reasons for this. First, contrary to popular opinions, the monetary authorities can control only short-term interest rates. Real investment in the economy is affected by long-term rates which are determined by broad domestic and global market forces and over which governor Frankel exercises no control. The central bank can affect long-term rates indirectly, however, by keeping inflation low.

The logic goes as follows: leaders seek to protect the real value of their assets, so if they fear higher inflation they will demand higher interest rate premiums as protection (in Israel much of this takes place automatically through the indexation of bonds). This means that long-term interest rates tend to rise and fall with inflationary expectation, and this is where the central bank comes in. By keeping tight monetary policy and high short term rates, the central bank limits the amount of excess liquidity in the system, which in turn reduce expectations for future inflation. Because Israel still suffers from inflationary inertia, goes this logic, the only way to reduce long-term rates is by keeping short-term rates high.

The second reason for tight monetary policy is that Israel now has to play by the global rules of mobile capital. Foreign portfolio investment is

highly-sensitive to monetary instability and so is direct foreign investment. Because of its large current account deficit, Israel needs both flows and the only way to attract them is by maintaining a stable monetary environment.

So far, Frankel seems to have the upper hand. But whether his tight-money policy is "right" or "wrong" is largely irrelevant for the long-term course of economic growth.

As it turns out, both the industrialists and the monetarists insist on ignoring two far more fundamental issues: demographics and the peace process.

Over the long haul, economic growth in Israel as elsewhere is intimately tied to demographic growth. Rising population expands the economy directly, but it does much more. It encourages investment spending in housing, infrastructure, and factories which create a large source of new demand. And new investment, by its very nature, tends to raise productivity, thus further augmenting overall economic growth.

The impact of Israeli demographics on its investment is all too clear from the chart. Until the mid 70s, rapid population growth, fueled by immigration, has underwrote a massive investment boom. From then on, however, demographic growth started to wane, sending both investment and the economy into a tailspin.

The NEP (new economic policy) of 1985, fashioned after the classic stabilization principals of the International Monetary Fund (IMF), has done little to lift the economy from the doldrums. The hope then, much like today, was that lower inflation and greater monetary stability will spur the "animal spirits" of investors. This hope failed to materialize. Inflation indeed fell, but the economy remained stuck in the mud. It was only with the opening of the Soviet floodgates and the massive influx of Russian immigrants, that investment and the economy began to boom.

The demographic engine behind this process is now coming to a close, and the potential implications are no less than dramatic.

The rapid growth of investment since the early 1990s has augmented the economy's productive



Enterprises employ many foreign workers and the inhabitants of Or-Akiva (near Haifa); workers demonstrate against the increase in unemployment.

capacity. But as population growth recedes, much of this new capacity will prove “excessive,” at least as a business proposition. Under these circumstances, *additional* investment in houses, infrastructure, factories and shopping malls will become decreasingly profitable. The decline in capital formation is already evident from the sharp drop in cement sales and construction. Most significantly, the importation of investment goods is now falling for the first time since the beginning of the 1990s upcycle.

The immigration boom has raised hopes for large productivity gains. The expectation was that as Russian immigrants integrate into the economy, their higher “human capital” will be more efficiently used, boosting the economy’s overall productivity. Although this process is still taking place, its effect on overall growth is inherently short-lived.

The reason is not hard to contemplate. In some sense, the effect on productivity growth of the Russian immigration in Israel works much like the integration of rural populations into the capitalist production orbit in the “emerging markets.” In the first case, labor skills are better utilized, whereas in the second they are upgraded.

There is one big difference, however. In the truly “emerging markets,” the proletarianization of the rural populations is still in its early stage, whereas in Israel the immigration process has pretty much ended. The proportion of urban population in countries such as Malaysia or the Philippines, for instance, is still less than 55%, whereas in China and India it has not even reached 30%. For comparison, urban dwellers in Israel account for over 90% of the total, and even the remaining 10% are well-integrated into the market

system. The integration of Russian immigrants into the economy acted as a temporary catalyst, equivalent to the proletarianization of 15% of the population, but as we said, this process is nearly over. In a few years time, when most of the immigrants would have found their “proper” place in the economy, their integration will no longer add to productivity and growth.

Israel hence faces the specter of a major economic slowdown, with declining population growth, followed by falling investment and far slower productivity improvements. If this scenario were to unfold, the severity of its coming recession could rival that of the late 1970s.

This risk has evaded most Israeli politicians. The conventional wisdom is that Israel could sustain an export-led economy, based on high-technology industries, particularly computer software. Unfortunately, this software-export euphoria of the 1980s could prove a dangerous pipe dream. In a global context, competitive software industries must fulfill one of two requirements. One is market power, which is the case of the US. Its companies dominate the world software industry partly due to their sheer size and partly because of Washington’s political ability to impose intellectual copyrights and the like. The other requirement is cheap labor. Because software development is becoming increasingly standardized, more and more could be done in the emerging countries. The Indian software industry, for example, has been expanding at a neck-breaking pace of 50% annually, with a growing share of its output commissioned by the world’s largest transnational corporations.

Because Israel possesses neither market power nor a meaningful cost advantage, its competitive

position could deteriorate sharply in the years ahead.

From a *long-term* perspective, the only sustainable solution is regional integration. The current emphasis on globalization has led many to neglect the potentially far more important role of local and regional integration. As a consequence of the North American Free Trade Agreement, for instance, US export to Canada and Mexico has risen from 26% of the total in 1991, to 36% in 1995. The same applies to Latin America, where regional trade through the Mercosur trade agreement has grown far more rapidly than inter-regional trade. And in Asia, intra-regional trade is now 37% of the total, up from 28% in 1988. In contrast, Israeli trade with the Arab countries is less than 5% of its total.

The Arab economies are smaller and poorer than that of Israel. In the short-run, their effect on the Israeli economy is therefore bound to be limited. In the long-run, however, their present underdevelopment implies a significant growth

potential: Israel has no rural population to proletarianize but could benefit immensely from the proletarianization of its neighbors.

If Israel were to integrate into such a process, the effect will be much more than growing exports. Because of its strategic position and relatively superior infrastructure, Israel is likely to enjoy significant investment as a regional hub. Moreover, regional integration tends to generate cooperation in public development projects and private ventures, which will contribute further to Israeli growth.

Needless to say this process will not take place, nor will Israel benefit from it, unless there is true peace in the region. The Israeli elite thus has to make an important decision: either to abandon its past refusal positions and decide to go for a real just settlement with its neighbors, particularly with the Palestinians, or face the largely unpredictable but most certainly negative consequences of spoiled expectations ■

Rights Of Palestinian Workers In Settlements Unprotected

Around 10,000 Palestinian workers are employed in more than 100 enterprises in Israeli settlements over the green line. The number of such workers has risen by around 50% since the imposition of the closure in 1993, in parallel to an increase in the number of Israeli-owned factories in the occupied territories (especially in the West Bank). This increase is due to a government policy encouraging the relocation of factories to the occupied territories by means of large investment subsidies and income tax reductions.

In contrast to Palestinians employed in Israel itself, the salaries of Palestinian workers employed in the settlements are not paid via the Payments Section of the State Employment Bureau. The Payments Section ensures that workers are paid at least the minimum wage and enjoy the accompanying social benefits (holidays, rest and recuperation pay, sick pay, pension funds). In the absence of such protection, free and unregulated exploitation has become the norm in the settlement enterprises. Wages paid to Palestinians working in the settlements range from seven to 13 NIS per hour, although the legal minimum hourly wage is 14.3 NIS.

Representatives of Palestinian trade unions are prevented from visiting work places in the settlements and cannot carry out their function.

In cases of work accidents in settlements, only workers who are Israeli citizens are insured by the National Insurance Institute. The employers are indeed required to provide Palestinian employees with private medical insurance, but there is no supervisory authority ensuring that they do so, nor is there any state supervision concerning safety conditions for Palestinian workers in the settlements. This exposes them to an increased risk of work accidents and occupational diseases.

The employers in the settlements enjoy astonishing extra-benefits: huge subsidies, tax reductions, and the freedom to ignore all the limitations which the Israeli market employs on the exploitation of workers. In cases of litigation initiated by Palestinian workers against settlement employers, the latter choose courts in the occupied territories and benefit from the application of the laxer Jordanian labor law still in force there. It is Palestinian workers (and the unemployed in Israel) who are paying the price.

from *Kav Le'Oved* [Workers' Hotline] Newsletter, August 1998