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# Build Back Better: Toward a Visual Strategic Plan for Successful Emergence from COVID-19 The Case of Israel

## Part II

## SWOT Analysis: A Global Benchmarking Study of Israel


Prof. Shlomo Maital
Ella Barzani



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## SWOT Analysis:
## A Global Benchmarking Study of Israel

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*"For a healthy politics to flourish, it needs reference points outside itself — reference points of truth and a conception of the common good."*

Prof. Moshe Halbertal, Dept. of Philosophy,

The Hebrew University of Jerusalem

## Abstract

This report is Part II of a three-part research paper, *Build Back Better: Toward A Visual Strategic Plan for Successful Emergence from COVID-19 – the Case of Israel.* In it we present a SWOT analysis of Israel's strengths and weaknesses, risks and opportunities, based on global benchmarks. It is based on a new book by Ruchir Sharma, 10 Rules for Successful Nations[1] which includes analysis of extensive global historical data for 56 nations that have achieved sustained economic growth[1].

In Part III which follows, we propose a strategic long-run plan for Israel, as it emerges from the COVID-19 pandemic. employing a visual approach for benchmarking economic, social and political performance of Israel, relative to other nations, which we call the SNI Wheels of Life.[2] The foundations for Part II and Part II were built on an extensive literature, surveyed in Part I, falling under the rubric of "Build Back Better", on how nations have recovered from past natural disasters, with the goal becoming a better economy and society than before the crisis.[3]

Currently, Israel and other nations focus single-mindedly on dealing with the public health crisis caused by COVID-19, as well as on the short-term economic crisis it has brought. This is understandable, with widespread unemployment and even hunger. The resulting crisis, however, has the potential for initiating powerful long-term reforms. We suggest a modest visual roadmap for implementing such reforms in Israel.

## Background: Successful States, Failed States

A comparison of the 56 successful nations[6] and the 2020 global list of 85 failed, fragile or ‘potentially fragile’ states[4] reveals a bitter, ominous truth. *There is a slippery slope leading from ‘success’ to ‘failed’.* Of the 56 states listed as ‘successful’ by Sharma, based on their 1960-2010 growth rates (see Box below) fully 26, or 46%, now appear in the list of failed or fragile states.[i] (See Boxes below). They have declined from ‘successful’ to ‘failed’, many in a rather short period of time, usually owing to political troubles.

In contrast, the number of states, out of the list of 85 ‘failed’, that appear strong candidates to move into the ‘successful’ list in the coming decade is very small. I find it hard to identify a single one.

There is a very strong lesson here for Israel. The gap between ‘successful’ and ‘failed’ is often narrow, short in time – and often invisible, until it is too late to repair.

### >>> The 56 Post-War Success Stories, 1960-2010

(10 year rolling average of GDP growth)

Algeria, Angola, Azerbaijan, Bahrain, Belarus, Brazil, Cameroon, Chile, China, Costa Rica, Dominican Republic, Ecuador, Egypt, Estonia, Guatemala, Hong Kong, Hungary, India, Indonesia, Iran, Ireland, Israel, Japan, Kenya, Korea, Lebanon, Malaysia, Mexico, Morocco, Myanmar, Nigeria, Oman, Pakistan, Panama, Paraguay, Portugal, Qatar, Romania, Russia, Saudi Arabia, Singapore, Spain, Sudan, Syria, Taiwan, Tanzania, Thailand, Tunisia, Turkey, Turkmenistan, Uganda, Ukraine, United Arab Emirates, Uzbekistan, Vietnam, Yemen.

Source: R. Sharma[5], Appendix

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[i] Note: We have included in “fragile’ Hong Kong and Ecuador, which have both encountered political unrest and instability that has damaged their economies, in recent months.

## >>> List of "Fragile" Failed or Potentially Failed States

(Fund for Peace): 85 Countries: 2020

Listed in order from "Most Fragile" to "Alert"


Yemen Somalia South Sudan Syria Democratic Republic of the Congo Central African Republic

Chad Sudan Afghanistan Zimbabwe Cameroon Burundi

Haiti Nigeria Guinea Mali Iraq Eritrea Niger Libya Ethiopia

Myanmar Guinea-Bissau Uganda Republic of the Congo Pakistan Mozambique Venezuela Kenya

North Korea Liberia Cote d'Ivoire Mauritania Angola Egypt Rwanda

Burkina Faso Togo Bangladesh Lebanon Zambia Sierra Leone Malawi Iran

Equatorial Guinea Eswatini Timor-Leste Djibouti Nepal Papua New Guinea Gambia

Sri Lanka Comoros Philippines Cambodia Solomon Islands Guatemala Madagascar Turkey Lesotho

Tanzania Nicaragua Laos Honduras Colombia Tajikistan Jordan India Israel/ West Bank

Bolivia Algeria Senegal Kyrgyzstan Uzbekistan

Brazil Russia Benin
Azerbaijan Georgia Morocco Micronesia Thailand São Tomé and Príncipe

Bosnia and Herzegovina South Africa

Source: List of countries by Fragile States Index (wikipedia)

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### >>> The 26 States on Both "Successful" and "Failed/Warning" lists

Algeria, Angola, Azerbaijan, Belarus, Brazil, Cameroon, Egypt, Guatemala, India, Iran, Kenya, Lebanon, Morocco, Myanmar, Nigeria, Pakistan, Sudan, Syria, Tanzania, Thailand, Turkey, Uganda, Uzbekistan, Yemen [Hong Kong] [Ecuador].

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## Introduction: 10 Rules of Successful Nations: A Framework for Israel's Emergence Strategy

Ruchir Sharma is an Indian investor and fund manager, Chief Global Strategist and head of the Emerging Markets Equity at Morgan Stanley Investment Management; he manages $20 billion in assets. In his new book[1] he offers a framework for understanding which nations achieve sustained economic growth and prosperity, based on decades of data.

We choose to use this framework as a kind of checklist for Israel's build-back-better strategy, as the basis for Part III, our SNI Wheels of Life visualizations of Israel's economy, society and political system, benchmarked against the world.

In sharp contrast to Sharma's rules for successful, there is the book by MIT Professor Daron Acemoglu, with James Robinson, *Why Nations Fail* [6].

The difference between successful nations and failed nations brings to mind the memorable opening sentence of Tolstoy's novel *Anna Karenina*: "Happy families are all alike; every unhappy family is unhappy in its own way." Paraphrasing Tolstoy: Happy nations are all alike; unhappy nations are unhappy each in its own way.

In what follows we present the 10 rules, examine how Israel measures up with each, and offer policy implications that derive from them.

The Ten Rules for Successful Nations:

1. Population – a growing labor force sufficient to meet the economy's needs, through fertility, longevity and immigration.
2. Politics – "successful nations rally behind a reformer".
3. Inequality: "successful nations produce ***good*** billionaires (who generate productive industries).

4. State Power: “successful nations have ‘right-sized’ governments (not too large, not too small).
5. Geography: “successful nations make the most of their location”.
6. Investment: “successful nations invest heavily and wisely”.
7. Inflation: “successful nations will control both kinds of inflation: in consumer markets and in financial markets.”
8. Currency: “successful nations feel cheap” (i.e. foreign currency buys a lot).
9. Debt: “successful nations avoid debt mania (and debt phobia)” – i.e. they avoid excessive public and private debt, but also, avoid limiting debt excessively.
10. Hype: “successful nations rise *outside the spotlight”.*

Below, we benchmark Israel’s strengths, weaknesses, opportunities and threats based on the 10 key dimensions outlined in Sharma’s book. But first, a brief description of SWOT.

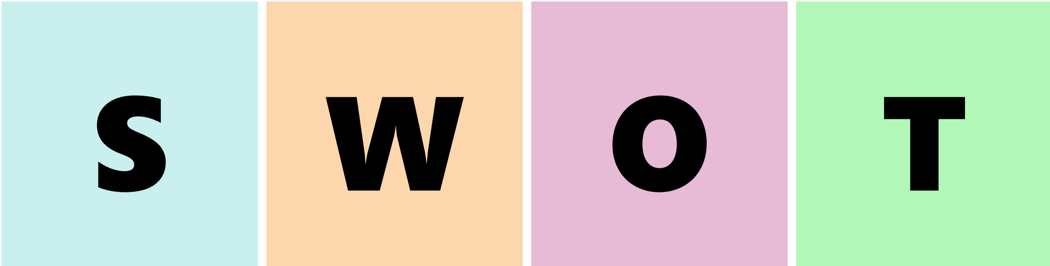
## SWOT Analysis: A Short Introduction

SWOT stands for Strengths, Weaknesses, Opportunities, and Threats.

Strengths and weaknesses are internal to Israel - they are variables that policy makers have some control over and can change Some. examples include: Human capital, innovation, political stability, economic freedom, democracy.

Opportunities and threats are external - related to external, geopolitical environment outside of Israel. Israel can respond to opportunities and protect itself against threats, but is unable to alter them. Examples include external terrorism, growing global markets, military threats on the part of neighboring countries, and

We prefer to employ a matrix approach to SWOT (See Figure below). We list strengths and weaknesses as rows, and opportunities and threats as columns. This generates four ‘boxes’ or cells. Each cell needs to be ‘filled in’, addressed, by showing a) how internal strengths are leveraged to seize opportunities (SO); b) how internal strengths are leveraged to respond successfully to threats (ST); c) how internal weaknesses are directly confronted in order to respond to emerging opportunities (WO); and d) how internal weaknesses are confronted in order to forestall impending external threats (WT).




| | Opportunities | Threats |
|---|---|---|
| Strengths | S O | S T |
| Weaknesses | W O | W T |

Figure. A SWOT matrix: a) leverage strengths to seize opportunities (SO); b) leverage strengths to meet threats (ST); c) confront weaknesses in order to make it possible to capture opportunities (WO); d) Confront weaknesses in order to enable meeting threats successfully (WT).

After using the Sharma 10-rule framework to analyze Israel's strengths, weaknesses, threats and opportunities, we will return to the matrix above and as an introduction to Part III, propose some policy directions, based on 'build back better'.

# 10 Rules for Successful Nations: The Case of Israel – a Global Benchmark

## #1 Population - "a growing labor force sufficient to meet the economy's needs, through fertility, longevity and immigration." [ii]

Fertility, longevity, immigration. Israel scores high on each; this is one of Israel's major internal strengths.

Fertility in Israel stands at 3.1 children per woman – the highest fertility rate in the OECD, and almost one full child above the next highest fertility countries, Mexico and Turkey.

"According to the "A Picture of the Nation 2019" report published by the Taub Center for Social Policy Studies in Israel -- the higher fertility rate among religiously observant women is *not* the sole reason for the difference: the fertility among secular and traditional women is 2.2, and has been rising for the past 20 years. An analysis of fertility trends from a historic and international perspective shows that the last time that fertility rates in Western European countries were as high as 3.1 was 1931 in Italy, 1914 in Germany, and 1889 in the UK and France. The report shows that the later age at which Jewish women give birth to their first child is not detracting from their fertility. The average age at which women gave birth to their first child rose by three years in 1994-2016 among Christian and Druze women and by one year among Muslim women, accompanied by a 6% drop in the fertility rate among Christian women, a 41% drop among Druze women, and a 30% drop among Muslim women. While the average age at which Jewish women gave birth to their first child rose by 2.8 years in this period, however, their fertility rate increased by 0.4 children.

Israel differs from other countries with similar per capita GDP, which have far lower fertility rates, e. g. South Korea (1.24) and New Zealand (2.02). Other countries with fertility rates like that of Israel have much lower per capita GDP - an average of one fifth of Israel's per capita GDP [iii]

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[ii] The quotes following each of the 10 rules are directly from Sharma[1]

[iii] Israeli fertility rate highest in OECD (globes)

Longevity: “With global life expectancy on the rise, Israelis in the year 2040 are projected to live among the longest, on average, on the planet, according to statistics released Wednesday. At an expected 84.4, Israelis will be ranked seventh in the world in longevity, moving up from their current 13th place spot (82.1). [iv]

Immigration: “From the establishment of the State of Israel to the end of 2017, about 3.2 million immigrants arrived in Israel. 26,400 immigrants arrived in Israel in 2017.”[v] The rate of immigration remains over 20,000 annually. Between 1990 and 2000, some one million immigrants arrived from the former Soviet Union – many of them highly-educated doctors, nurses, scientists and engineers. These immigrants fueled Israel’s hi-tech boom, and proved to be a crucial source of vital skills for many startups.


Strategic Strength/Opportunity: Fertility, longevity, migration -- this is a major strategic opportunity for Israel. Nobel Laurate W. Arthur Lewis once summed up the difference between successful growing nations and stagnant ones, in two words: National energy! As many Western countries have aging populations, one can sense a decline in their national energy. Israel has exceptional youthful national energy, and it is palpable on the streets of Tel Aviv, its leading startup ecosystem. But this strength also embodies a worrisome threat.


Strategic Strength/Threat: There is a growing global scarcity of, and search for, creative talent. Young educated Israelis have major opportunities abroad, in the US and elsewhere, and they are increasingly ‘footloose’ – they migrate easily and quickly to seek opportunities. It is *vital for Israel to create sufficient opportunities at home, along with a vibrant society that is attractive and inclusive, to forestall major brain drain, which has already became a growing problem.* This issue of brain drain is complex, because many Israeli startups relocate abroad in the natural course of scaling up globally. So

[iv] Israel ranks 7th in global life expectancy rankings for 2040 (timesofisrael)

[v] PM Netanyahu meets with Chad Cabinet Chairman Deby and Head of the Chad Intelligence Service Kogri (mfa)

part of the threat involves bring home Israelis who have 'temporarily' migrated – with 'temporary' becoming increasingly permanent.

## #2 Politics – "successful nations rally behind a reformer"

How rapidly can entire countries transform from 'great' and successful, to fragile and failed? A lot faster than is believed and understood. The danger to Israel is real.

As we noted above, there is a very strong lesson here for Israel. The gap between 'successful' and 'failed' is often narrow, short in time – and often invisible, until it is too late to repair. The slippery slope from 'successful' to 'failed' or 'fragile' is a fact of life, and Israel may be dangerously close to it.

Like a car, Israel can easily shift from Start Up to Doesn't Start. All it takes is a dead battery. And our battery is running dangerously low.

Israel's political system is clearly broken, reflected in the three national elections held within less tan two years – and the threat of a fourth, narrowly averted (for now). There is a desperate need for a reformer – but none is in sight.

According to The Economist's 2019 global Democracy Index, Israel ranks 28th in the world, or 7.86/10, on a scale of 1 to 10, making Israel a "flawed democracy".[vi] Israel scores:

9.17 on "electoral process and pluralism"

7.86 on "functioning of government"

8.89 on "political participation"

7.50 on "political culture" and

5.88 on "civil liberties".

With the coalition government proving inept, it is likely Israel's 'democracy score' will decline, perhaps sharply, in 2020 and 2021. The low score on civil liberties is particularly worrisome.

[vi] Democracy Index (wikipedia)

**W** **T** Strategic Weakness/Threat: Failed nations become so in general because of the failure of their political system. Autocratic nations fall into dissension, division and protest – and democratic nations can slide into autocracy. For Israel, born as a strong vibrant successful democracy,

## #3 Inequality - "successful nations produce ***good*** billionaires (who generate productive industries)"

In 2020, Israel ranked 18th in the world in the number of citizens who were billionaires -- 17! (See Table below). This, despite Israel's tiny population of 9 million. Israel ranks 11th in the world in per capita billionaires, while small enclaves like St. Kitts Lichtenstein and Monaco top the list.[vii]

Table. Israeli billionaires, 2020. [viii]

1. Eyal Ofer, $7.3 b. real estate
2. Stef Wertheimer, family $6.2 b. manufacturing
3. Teddy Sagi, $4.5 b. Gambling software
4. Yuri Milner, $3.8 b. Tech investments
5. Shaul Shani, $4.8 b. Telecom
6. Idan Ofer, $3.7 b. Gas, shipping.
7. Shari Arison, $3.3 b. Carnival cruises
8. Arnon Milchan, $3.3 b. Movies
9. Yitzhak Tshuva, $3.2 b. Gas, real estate
10. Gil Schwed, $2.3 b. Hi-tech
11. Michael Federman, family $1.7 b. Hotels, defense
12. David Wertheim, $1.7 b. Beverages
13. Shmuel Harlap, $1.4 b. Automotive

[vii] Petersen Institute for International Economics (piie)

[viii] World's Billionaires List - The Richest in 2020 (forbes)

14. Marius Nacht, $1.6 b. Hi-tech

15. Dan Gertler, $1.2 b. Mining

16. Bino Zadik, family, $1.1 b. Banking, oil

17. Morris Kahn, $1 b. Hi-tech

How many of Israel's billionaires are, in Sharma's words, "good billionaires" – those who create industries and well-paying domestic jobs?

The benchmark for "good" is #2, Stef Wertheimer and family, whose metalworking tools business Iscar, acquired by Warren Buffett's Berkshire Hathaway in 2006, employs some 12,000, providing manufacturing jobs mainly in northern Israel, with strong inclusion of ethnic minorities. He is followed by #10, Gil Schwed, who remains CEO of Check Point Technologies, established in 1993, and a market leader in firewall/cyber defenses, along with his co-founder Marius Nacht, #14, a serial entrepreneur, and Morris Kan, #17,founder of Amdocs (mobile phone billing software).

A large majority of the Israeli billionaires became so through real estate investments, inherited wealth, banking, or possibly dubious adventures in African natural resources.

### >>> Case Study: Russia

Consider Russia, known by many as a kleptocracy (from the Greek word, *kleptes, or thief):* "a government whose corrupt leaders (kleptocrats) use political power to appropriate the wealth of their nation, typically by embezzling or misappropriating government funds". There are a hundred billionaires in Russia, and they became so largely by appropriating the formerly state-owned businesses of the Soviet Union, with tacit or overt government approval. Decades after the collapse of the USSR, Russia's economy remains highly dependent on oil and gas.

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Israel began its life as an independent country in May 1948 and was led by a labor-socialist government for over two decades. The degree of equality in the distribution of income and wealth was very high, as a result. According to Milgrom and Bar-Levav[ix]:

- "Wealth inequality in Israel is significantly greater than income inequality. While the top decile owns 27% of national income, it holds 51% of the wealth.
- A significant part of the wealth is concentrated in the top percentile. The richest 1% of the households own 22.5% of all the wealth, equal to the share of the seven lowest deciles combined.
- With regard to wealth held by the top percentile, Israel ranks 6th out of the 19 developed countries. When measuring wealth inequality according to the Gini index, Israel ranks 9th.
- The average wealth of the household in the top decile stands at 10.8 million NIS, and the average wealth of the top percentile stands at 47.9 million NIS. The wealth of Israel's 500 richest people equals 7.4% of the national wealth.
- 11% percent of Israeli households hold assets worth under 1,000 NIS. 5% of Israeli households have no assets or have negative wealth value, i.e., they have more debts than assets.
- 17% of the population (approximately 425 000 households) are living in asset poverty, defined as a household whose net wealth does not cover the cost of the household's basic needs for a period of three months."

This study reflects the situation several years ago. If anything, the degree of high wealth inequality has increased since then, and is exacerbated by the pandemic.

**W** **T** Strategic Weakness/Threat: Israel is a nation in which social resilience is vital – Israel faces military threats from its neighbors and has experienced frequent armed conflicts on its borders as well as terror attacks. A

[ix]The Distribution of Wealth in Israel, by Maor Milgrom and Gilad Bar-Levav. Institute for Structural Reforms: Nov. 2015. (ref-inst)

key component of social resilience – the ability to bounce back from crisis and threats – is the feeling of national unity.

That unity is fractured when a tiny fraction of the population holds a large fraction of national wealth. The concentration of wealth is closely related to the decline of democracy (see above), as politics and wealth become intertwined, and as wealth (through extensive lobbying) buys legislation and regulation that feeds into even greater wealth.

## #4 State Power: "successful nations have 'right-sized' governments (not too large, not too small)"

Israel's government, it can be argued, is both too large and too small.

According to the Heritage Foundation's Index of Economic Freedom (the extent to which a nation's economy reflects free, open markets), Israel ranks 26th in the world, just behind South Korea. [x] It would rank higher, were it not for (high) government spending and (high) tax burden. \

Both of these reflect high military spending. Israel's military burden—measured by defense spending as a percentage of gross domestic product (GDP)—was among the highest in the world in 2018, Israel spent $15.9 billion on defense in 2018, or 4.3% of its GDP, ranking seventh in the world.[xi]

At the same time, massive defense spending, reflecting geopolitical threats from neighboring nations, may have crowded out vital social spending, for healthcare, social welfare, education and infrastructure.

Trajtenberg and Poplikar [xii] note that prior to the pandemic crisis, public spending as a % of GDP in Israel was 40%, compared with the OECD average of 43.5%. They note: "we believe that it is necessary to establish a target for public spending that is higher than pre-pandemic, and to aspire to close the gap [between what exists and the OECD average]. This, while safeguarding a responsible debt-to-GDP ratio and adapted both to the geopolitical situation of Israel, and to the global economic environment."

[x] Heritage Foundation's Index of Economic Freedom (heritage)

[xi] according to the Stockholm International Peace Research Institute (SIPRI)

[xii] "Toward a Balanced Fiscal Policy: Budget Responsibility vs. Social Needs". M. Trajtenberg and I. Poplikar, S. Neaman Institute for National Policy Research, August 2020.

They also observe: “Providing greater resources (for public services) should be conditional on proving the effectiveness of such spending, by establishing ongoing mechanisms for this purpose.” The authors refer to the need for random experimental tests, not unlike those used for clinical trials of pharmaceuticals.

**S** **O** Strategic Strength/Opportunity: Emerging from the pandemic, Israel does so with relatively low public debt, leaving fiscal room for additional borrowing and public spending on social needs, and taking advantage of historically low borrowing rates, as central banks work to keep interest rates close to zero. This strength offers an opportunity to rethink Israel’s fiscal policy, to shift resources toward pressing social needs in healthcare and education, and in infrastructure, while controlling defense spending. The plan proposed by Trajtenberg et al. offers a thoughtful approach to increasing public spending on civilian needs, without increasing the public debt as a % of GDP.

## #5 Geography: "successful nations make the most of their location"

Israel lives in a bad neighborhood, so to speak. It does have peace agreements with two neighbors – Egypt and Jordan – and has just signed a third with another, the United Arab Emirates (not a bordering neighbor, but a major Mideast nation). The peace agreement with Egypt is described as a “cold peace” with little trade and travel between the two countries; the peace with Jordan is warmer, but still trade is limited.

This is a major weakness -- in international trade, substantial trade is carried on with a nation’s neighbors – that can become an opportunity.[xiii]

The European Union, originating in the Common Market, was created on the premise that nations that traded together, and grew wealthy together, would not go to war – after two disastrous European World Wars. And it has worked.

[xiii] The main trading partners of the US are, for example, Canada (northern neighbor) and Mexico (southern neighbor); this applies too to Canada and to Mexico. Most European Union trade occurs within the EU.

**W** **O** Strategic Weakness/Opportunity: Israel's geopolitical situation – located in the unstable hostile Mideast, with several actively hostile borders, and with unstable neighboring states (Lebanon, Syria) and threats from Iran and from terrorist organizations – is widely regarded as a serious strategic weakness.

The Israel–United Arab Emirates peace agreement, or the Abraham Accord, was agreed to by Israel and the United Arab Emirates (UAE) on August 13, 2020. It was followed by a peace accord with a mainly Muslim country, Kosovo, in which Kosovo and Israel recognized each other mutually.

This geopolitical weakness can become a major opportunity, when other Mideast countries find it opportune to sign peace agreements with Israel, engage in trade and investment, and enable tourism. Israel can offer its advantages in high technology to oil-and-gas-rich nations seeking to diversity and modernize their economies.

## #6 Investment: "successful nations invest heavily and wisely". "…if a nation's [internal] supply chain is built on inadequate road, rail and sewer lines, supply cannot keep up with demand…investment is the critical spending driver of growth"

This is a major strategic weakness of Israel. To understand why, it is important to understand some economic jargon.

Gross fixed investment, or gross fixed capital formation, is the value of resources invested in productive capital – structures, factories, machines and so on. It is called "gross" because it includes "capital consumption" – resources used to replace worn out structures, computers and machines.[xiv]

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[xiv] Here is the formal definition: Gross fixed capital formation (formerly gross domestic fixed investment) includes land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings.

A more accurate, significant, measure of real investment is net fixed investment – NEW machines and structures, not just those that replace OLD ones. But this number is hard to find in the official statistics, because it is rather difficult to estimate capital consumption.

Gross fixed investment in Israel, as a percentage of GDP, is 20-21% and has been at this level for a decade or more, since 2008. It peaked in 1970, at 30% of GDP.

But this figure is highly misleading and overly optimistic. Because it includes capital consumption (replacement of old capital), it does not reflect new additions to productive capital.

Here is a rule-of-thumb that has proved useful. On average, let us assume that capital equipment wears out every 20 years. Computers wear out every 3 years, building wear out in 40 years…so let's take an average of about 20 years, or, a rate of depreciation of 5% of the value of the capital stock yearly.

Capital Consumption = 0.05 times Capital Stock

Another rule of thumb: Capital Stock is about three times GDP. This is called the capital-output ratio.

Capital Stock = 3 times GDP

Therefore:

Capital Consumption = 0.05 times 3 times GDP

= 0.15 times GDP

Or, Capital Consumption is about 15% of GDP.

That implies that Net Fixed Capital Formation for Israel is only 20-21% minus 15% = 5%-6% of GDP.

This is grossly insufficient. It implies that fixed capital is growing only at 1.7% - 2% yearly. And it has been inadequate for over a decade. It has left hospitals, schools, universities, roads, communications, etc. obsolete and unreliable. In contrast, China's gross fixed capital formation has been 42-44% of GDP consistently, for a decade at least.

For example, "according to an internet speeds report by Akamai Technologies, for the first quarter of 2017, Israel ranked 33 out of 148 global nations, with an average connection speed of 13.7 Mbps compared with 28.6 Mbps for South Korea, which topped the ranking, followed by Norway, with a speed of 23.5

Mbps." [xv] For a nation calling itself Startup Nation, and whose economy lives and dies by its hi-tech, this is shameful.

Earlier, we observed an external threat to an internal strategic strength: Israel's creative innovative young people who disproportionately flock to launch startups – and who may be attracted to live and work abroad. One of the obstacles facing young Israelis is the high cost of housing.

Israel's housing price index almost doubled, from 250 in 2010 to 425 in 2020, despite several failed government programs aimed at moderating housing inflation.

Why is capital formation inadequate in Israel? Fixed investment is funded by two sources: Foreign investment and domestic saving. Domestic saving in Israel is very low -- inadequate personal saving is offset by negative public saving (budget deficits), and business saving (retained earnings) is moderated by heavy payment of dividends, and corporate borrowing.

**W** **T** Strategic internal weakness and external threat: Israel's failure to invest in modern infrastructure and in, for example, what is known as the Fourth Industrial Revolution (advanced manufacturing)[xvi], is an external threat, as other nations invest heavily and are overtaking Israel in key leading technologies. On the bright side, prior to 2003, Israel had an net outflow of capital, in its Balance of Payments accounts, but since that year, has had a net inflow.

According to the UN's World Investment Report 2020, Israel's investment flow decreased by 12% between 2018 and 2019, reaching USD 18,2 billion in 2019. The stock of foreign direct investment (the value of profits accumulated in Israel by foreign-owned subsidiaries) was about USD 166 billion in 2019, an increase of USD 100 billion when compared to 2010. It is possible to argue that this inflow of foreign capital is a kind of internal weakness. Israeli startups tend not to scale up and grow into global giants, but are almost always acquired by foreign companies, who often choose to leave the R&D personnel in Israel. The result of these 'exits' is to create great wealth for a handful, but at a cost of jobs and wealth for far large numbers of Israelis, were the startup to scale up and

[xv] Times of Israel

[xvi] See G. Fortuna, Mapping Advanced Manufacturing in Israel. S. Neaman Institute, 2020.

remain independent, as a global company. Among the last to do so were Check Point and Amdocs, founded over two decades ago.

## #7 Inflation: "successful nations will control both kinds of inflation: in consumer markets and in financial markets"

There is a widespread misunderstanding about inflation in recent times. Consider this typical report: "The economic environment in the United States has changed substantially over the past four decades. Inflation has fallen from its highs in the early 1980s and has recently been running below the Federal Reserve's target rate of 2%."

In other words, the typical Central Bank problem is not 'inflation' but the lack of it.

This is not the case. There *IS* inflation. But the rise in prices is in the price of assets, not in the price of goods and services. Central banks have been impressively successful in controlling the prices of consumer goods (though not through any wise policy of their own). But they have been massively unsuccessful in preventing inflation in asset markets – in fact, they have actively encouraged it, with massive expansions of money and credit and near-zero interest rates.

Even the enormous decline in economic activity has seemingly had no impact on asset prices. (See Box: Comparison of Israel and US capital markets). Asset price inflation brought the collapse of the global economy in 2007/8, and it could well happen again.

### >>> A summary of capital market performance in the US and Israel In the wake of the novel coronavirus pandemic

### United States

Year to year, to Sept. 4, the Dow-Jones Industrial Average rose by 4.86%.

For the same period, the S&P 500 index rose by 14.7%

…and the NASDAQ 100 rose by 46.1%

In contrast, real gross domestic product (GDP) decreased at an annual rate of 32.9 percent in the US, in the second quarter of 2020, according to the Bureau of Economic Analysis. In the first quarter of 2020, real GDP decreased 5.0 percent. The rate of unemployment in the US is now 8.4%.

## Israel

The Tel Aviv Stock Exchange 100 TASE 100 was at 1,684 on February 12, the onset of the pandemic in Israel. It fell to 1,106 points on March 23, a decline of one-third in 39 days – but recovered to 1,454 points on August 26, a rise of 31%, before falling back to 1,372 points on September 7, reflecting similar declines in stock markets in the US and abroad.

The TASE 100 is now 17% higher than its level on Feb. 16, 2009, when it had fallen to 1,172 points, in the wake of the 2008 global financial crash.

The second-quarter figures for Israeli GDP are the worst quarterly GDP drop since Israel's inception, the CBS said. The data shows that in the first half of 2020, Israel's economy shrank by an annualized basis of 10.1% after growing 3.4% in the second half of 2019.

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Here is the clearest explanation we have seen, why consumer prices are stable and asset prices are highly inflated:[xvii]

“In the old economy, the money that reached the marketplace was spread among everyone. When they used the money to buy goods, prices rose and this led to inflation. In the new economy, the money reaches only a few of the very rich, who mainly buy stocks, bonds and real estate. These are not included in standard measures of inflation, therefore it seems like there is no inflation.”

“Lately, Donald Trump, US President, has boasted about his ability to flood the system with limitless amounts of money and without causing inflation.

“Really? How can this be understood? There have been a few explanations of this phenomenon, that on the face of it contradict the Keynesian economic model: Huge budget deficits, together with an expansionary monetary policy and zero interest rates, and all this with full employment…and no inflation. A true economic miracle, that invites other politicians, including some among the Democrats, to offer the nation a Paradise on Earth, of unlimited prosperity through printing money. How did this happen? Is this really sustainable? Or, is

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[xvii] Arie Ruttenberg, founder of Kesher-Barel (now McCann Erickson) and Club 50, in Jerusalem report, “The Great Money Mystery”, June 10, 2019, pp. 40-41.

it an illusion, with inflation hidden and disguised as something else? And is there a ticking time bomb, very very quiet, a social ‘bomb’ that will result in a deafening explosion soon?”

“A common explanation for this phenomenon is linked to globalization and technology. The argument is that we are at the dawn of a new macro-economic age, based on enormous global productive capacity and perfect competition through digital trade accessible for all. This explanation is only very partial, because it fails to explain why huge amounts of printed money enter the market and ‘evaporate’ without causing any increases in prices.”

“My argument is that the budget deficits and the monetary expansion indeed have had an enormous impact, but in contrast with the past, they have not caused significant inflation in consumption goods, but instead have mainly brought a rise in the price of equities, bonds and commercial real estate, which in turn increase economic and social inequality.

“John Maynard Keynes’ model assumes a uniform economy in which all consumers have similar preferences and compete for the same goods and services, available in limited quantities in the consumer goods markets. In this case, any additional money in the hands of consumers competes for the given amount of goods and so necessarily causes a rise in prices.

“I propose that we think about consumers, in terms of two groups: a) owners of capital and b) those who earn a living by their labor. Owners of capital earn far more than they need for their subsistence, and they save the difference, mostly by investing in equities, bonds and commercial real estate. These investments continue to expand their incomes, from year to year, but the added income does not necessarily increase their consumption, which is already very high. The second group, wage-earners or free-lancers who make a living from their wages, spend nearly all their income on their subsistence, and their savings are mostly targeted toward their pensions – that is, future consumption. Ultimately those savings will be almost completely eroded in value.

The gap between the two groups continues to grow over time, and continually increases the degree of inequality between them.

*The columnist asked Ruttenberg, So, in your view, what happens to the economy when the government vastly expands the amount of money? Or when the Central Bank creates huge amounts of credit at zero interest rates?*

The answer is: Most of the money and credit flows into the hands of the owners of capital, who grow wealthier as their assets expand, and as they continue to grow their wealth and create more jobs for wage-owners, until the economy reaches full employment. The wealthy grow even wealthier and those who live on their wages earn only enough to barely survive. In this way, the economy reaches full employment, but income and wealth inequality grow."

"Why don't prices rise, too? Because of the two new phenomena I mentioned, globalization and technology. Through those two forces, we have turned the majority of workers into commodities – that is, into a basic good that has cheap plentiful substitutes. These two forces create a situation in which the supply of labor becomes almost infinite -- in economists' jargon, perfectly elastic. Therefore, when the owners of capital expand their businesses and assets, they do so almost without raising wages at all. When there is full employment, you can always hire cheap foreign workers.

"Why doesn't the fall in unemployment bring a major increase in the demand for consumer goods and hence, a rise in their prices? Because of the same two reasons -- globalization and technology. Workers can today buy cheaper goods anywhere on earth, via the Internet, and the supply of such goods is becoming nearly infinite. In this way, inflationary pressure in the goods market is prevented.

Why doesn't the rapid growth in incomes of the owners of capital cause inflation, when they spend that income? There are two reasons. First, because wealthy capitalists cannot eat two steaks for breakfast; and second, because it does cause inflation, but it is not called inflation, it is called "a rise in the stock market" and "a rise in the price of commercial real estate". Yes, the excess demand caused by the budget deficit and cheap credit creates strong inflation in the main "goods" that the wealthy consume, but because these rises in equity prices and real estate prices are not included in the consumer price index, it is regarded as part of economic prosperity, and not as inflation."

Why do the wealthy people continue to buy stocks, bonds and real estate after they have become so costly? Because the rate of interest is zero, and because there are no other investment opportunities. Thus, the wheel continues to turn, over and over, never stopping, when: a) the wealthy grow more and more wealthy, pocket trillions of dollars of wealth, and feel super-rich; and b) the wage-earners enjoy full employment, stretch their income to last the full month, and are content. This can be described as the "happiness of the poor"; c) the politicians waste money endlessly and are pleased with themselves; d) the governments expand the debt they owe and nobody cares; e) the central banks expand their balance sheets, and again, nobody cares. Hallelujah! The messiah has come!

Can this go on forever? There is no reason why not, on condition that: a) a few madmen do not arise and start to complain about the social inequality that is becoming unbearable; b) a 'crazy' US Central Banker does not appear who starts to raise interest rates, and thus puncture the stock markets, bond markets and real estate prices; c) a stupid American President does not appear who crushes globalization, imports of cheap goods and imports of cheap foreign labor, through trade wars.

“Then, what happens to the global economy? It becomes an economy of rich feudal lords, and contented vassals who earn exactly as much as they need to go to bed with a full stomach, get up the next morning and to serve their lords. Is this what Paradise looks like? No, this is what the economics of wealth inequality looks like.

“At the end of the 1970’s, Israel had a cabinet minister who used the phrase “blessed inflation”, to describe the impact of influence on accelerating economic activity – until, that is, the inflation destroyed the Israeli economy. When the US President brags about flooding the American economy with money in order to create growth, he is boasting in fact about “increasing blessed inequality”.

**W S O T** Strategic internal strength/ weakness, external threat/opportunity -- asset price inflation is probably the most ambiguous and uncertain of the threats and opportunities that face Israel. Some see the ability of asset prices to defy gravity, in the face of collapsing economies, as a threat. Others, as a sign of hope and optimism.

The stellar performance of the NASDAQ stock index, driven mainly by technology stocks, far superior to non-tech stocks, reflects in part the fact that the pandemic has created enormous demand for hi-tech products and services -- software, smartphones, laptops, tablets, etc. The four major global technology giants – Apple, Amazon, Facebook, Google – have a total market value today of $7.2 trillion, fully one-third of total US GDP. Since October 2019, the market cap of the Big Four has risen by 75%.

Whenever asset prices rise steeply, there are always voices cautioning about a stock market bubble – and bubbles always burst. Israel’s capital market is closely linked with those abroad; a ‘bubble burst’ in the US would strongly and quickly impact Tel Aviv, as it did in 2007/8.

## #8 Currency: "successful nations feel cheap" (i.e. foreign currency buys a lot)

If successful nations feel cheap, Israel is in this dimension unsuccessful – the cost of living here is very expensive. According to a daily newspaper:

"A year-end report released Wednesday found that the cost of living in Israel is among the highest of developed nations. The Taub Center's "State of the Nation Report 2017" showed that while employment was up and salaries had increased over the past 12 months, "price levels in Israel remain among the highest in the OECD." *The report found that Israel's price index was 23 percent higher than the average of countries in the Organization for Economic Cooperation and Development.* Only Switzerland, Iceland, Norway, Denmark, Australia and New Zealand had higher price indices, according to the data. Israel's high cost of living and runaway real estate prices have been a major concern for several years, sparking large scale protests and promises of government reforms to bring down housing costs."[xviii]

Lately, one cause of the high cost of living is the decline in the shekel-dollar exchange rate and appreciation of the shekel.

The shekel-dollar rate has been on a roller-coaster ride. It plummeted from NIS 3.88 per dollar on July 7, 2016, to only NIS 3.39 on January 19, 2018, soared to NIS 3.78 on December 27 2018, dropped to NIS 3.41 on Feb. 18, 2020 (the onset of the pandemic in Israel), then soared again to NIS 3.81 per dollar on March 19. In recent months, as the value of the dollar declined worldwide, the shekel-dollar rate fell to a ten-year low of NIS 3.38 per dollar. The appreciating shekel has made imports more expensive and hence, increased the cost of living.

Israel, Startup Nation, regularly sees a large influx of foreign capital, to acquire startups. Despite persistent Bank of Israel incursions into the forex market, to buy dollars and restrain the shekel-dollar appreciation, the shekel's external value continues to rise.[xix]

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[xviii] Israeli cost of living among highest in developed world, report finds (timesofisrael)

[xix] Foreign Exchange Reserves at the Bank of Israel, December 2019: Israel's foreign exchange reserves at the end of December 2019 stood at $126 billion, an increase of $3.640 billion from their level at the end of the previous month. The reserves represent 32.8 percent of GDP. They have grown considerably since December.

The strong shekel, together with monopolistic domestic markets for consumer goods, contributed to Israel's high cost of living relative to OECD countries. High real estate prices exacerbate the problem. The strong shekel also makes exports less competitive.

**W** **T**

Israel's high cost of living, an internal weakness, may contribute to an increasing brain drain – an internal and external threat, as young persons with technology skills are lured abroad. The cost of living in Israel is more expensive than in 84% of countries in the World (14th out of 82).[xx] The high cost of living relative to incomes has in the past led to social unrest and protest.

## #9 Debt: "successful nations avoid debt mania (and debt phobia)" – i.e. they avoid excessive public and private debt, but also, avoid limiting debt excessively

Israel is fortunate that for over 20 years, the trend in public debt-to-GDP has been sharply declining, owing to conservative deficit policies that kept government deficits below the 3% threshold. Debt-to-GDP was 98% in 1995, and in 2019 fell below 60%, before rising in 2020 owing to pandemic emergency spending. This is in contrast with the United States, where public debt now exceeds GDP by a significant margin.

According to Sharma[1], it is untrue that growing public debt always generates financial crises. "The idea that financial crises typically have their roots in fiscal problems [i.e. government borrowing] is not supported over the long sweep of history…. The most consistent precursor of major credit crises was *private sector debt, growing faster than the economy for a significant length of time". And it is apparently the pace of the increase, not just the size, that creates crises.*

Growing private debt is known as leverage. US private debt rose from 143% of GDP in 2002 to 168% of GDP in 2007 – just prior to the financial collapse. In

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[xx] Cost of living in Israel (expatistan)

the wake of the 2008 crisis, significant private debt was taken over by the US government and shifted to the government's books.

Strong empirical evidence shows the opposite of private leverage -- insufficient leverage on the part of the public treasury, in the wake of economic collapse. The European Union imposed austerity (reduced spending and budget deficits) in response to the 2008 financial crisis and ensuing economic decline – this proved to be a major error, imposing hardship on many EU nations.[xxi]

**S** **O** Israel's relatively low public debt/GDP ratio, in the midst of the pandemic crisis, presents an opportunity for government to stimulate the economy strongly, without risking fiscal instability. Sources show: Household debt decreased to 41.7 percent of GDP in the fourth quarter of 2019 from 41.80 percent of GDP in the third quarter of 2019 and has increased modestly from 36% in 2008. From 2010 to 2016 private sector debt as a % of GDP fell, to 123% and has since risen modestly.[xxii] Strategically, then, Israel is in a strong position to provide large stimulus to the economy, without destabilizing the banking system and the currency.

## #10 Hype: "successful nations rise *outside the spotlight*"

Sharma observes that "the next economic stars often emerge from among countries that have fallen off the media radar …the most successful nations often rise from the shadows. ….media love is a bad sign. Media indifference is a good one."

**W** **T** Israel basks in its own spotlight of "Startup Nation". This generates serious complacency. Israel's startup ecosystem and the creativity of its people have generated wealth and economic prosperity. But this may not be a well with infinite resources and a perpetual lifetime. As the nation

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[xxi] The State of the European Union: The Failure of Austerity. 2012. (FES)

[xxii] Source: Trading Economics.

broadcasts its startup nation mantra worldwide, other nations are investing in higher education, basic research, R&D and entrepreneurship – and they are gaining. The internal weakness of complacency has become an external threat – and there are always other burning issues to distract from this key one.

## Summary and Conclusion

Rarely will any country look good on all ten [rules for successful nations], Sharma observes. But together the rules sketch the ideal habits of successful nations.

Overall, Israel is basically sound. The pre-pandemic data show this clearly. Some 69% of those aged 15 to 64 have paid employment, slightly above the OECD average. 87% of adults 15-64 have completed high school, above the OECD average – although the average student scored 472 in literacy, math and science, in the OECD Program for International Student Assessment (PISA), below the OECD average.

Israelis live long, three years longer than the OECD average. There is a sense of community; 88% of people believe they know someone they could rely on in time of need. 72% voted during recent elections, higher than the OECD average. And significantly, in general, Israelis are more satisfied with their lives than the OECD average; asked to rate their general satisfaction with life, 0 to 10, Israelis scored 7.2 on average, higher than the OECD average of 6.5.[xxiii]

Israelis are socially and individually resilient, having faced wars and terror attacks for 72 years.

In the next and final report in this Build Back Better report, we will undertake a visual presentation of Israel's economy, polity and society, and will use it to suggest a strategic roadmap for building back better.

[xxiii] Source: OECD Better Life Index.

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# Economy

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