18.67x25.09	1/4	36 עמוד	the jerusalem report	05.02.2014	40964961-9

שמואל נאמן מוסד למחקר מדיניות לאומית בטכניון - 85300

MARKETPLACE SHLOMO MAITAL

Strong shekel blues

Has the Bank of Israel thrown in the towel in its war against the appreciation of the shekel?

I've got the strong shekel blues
Exports too dear
Economy's slumpin'
Big trouble, I fear
Karnit's battlin'
Buyin' that buck
Ain't makin' no difference
I'm plumb out o' luck

ISRAEL'S ECONOMY is beginning to sing the blues, in part because of its currency.

Generally, states get into trouble when money flees the country and their currencies collapse. This happened to Mexico in December 1994, Argentina in 2001, Thailand in July 1997, Brazil in 1999, Russia in August 1998, and even to Britain, in 1992.

But Israel faces the opposite dilemma. The shekel is too strong, not too weak. As tourists know, the current shekel-dollar exchange rate gives dollar sellers very few shekels in exchange for their bucks – at present, fewer than NIS 3.50 per dollar, compared with NIS 4.00 at the start of last year. This makes exports expensive, and thus hard to sell; and when export dollar earnings are cashed into shekels at the reduced rate, exporters' profitability and profit margins take a hit, and their stock prices too.

And there seem to be relatively few good remedies. Moreover, there is no shortage of those who love cheap dollars and enjoy it when the prices of imported cars and appliances become cheaper in terms of shekels.

How does the strong shekel hurt exports? Here is an example. Suppose you, a hi-tech exporter, signed a deal on June 1, 2012, to sell abroad a medical device made in Israel for $1 million. The exchange rate at the time was NIS 3.92 per dollar. So the value of the deal in shekels was NIS 3.92 million. Suppose your overall costs for making and selling the device, including fixed costs, were NIS 3.4 million. You could thus anticipate a good profit of NIS 520,000, and a profit margin of 13 percent.

Suppose payment is received onDecember 15, 2013, on delivery of the device (such contracts are often signed long in advance). The value of the $1 million check at that time is only NIS 3.48 million. Your profit has almost disappeared. And your profit-and-loss statement has taken an unexpected hit because your revenue is listed as NIS 3.48 million, not NIS 3.92 million.

20.98x25.06	2/4	עמוד 37	the jerusalem report	05.02.2014	40964970-9
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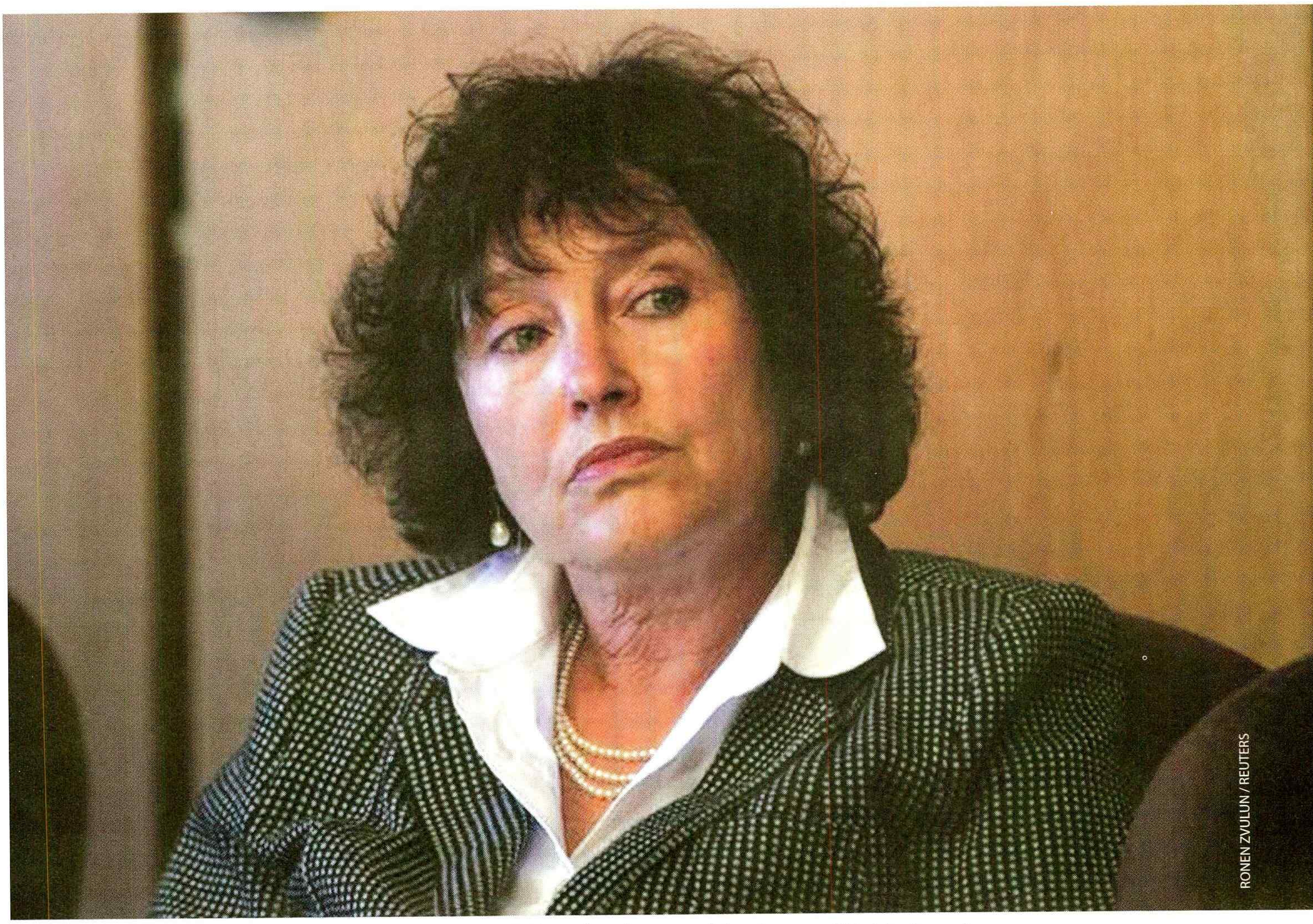

BOI Governor Karnit Flug is keenly aware of the dangers of 'Dutch disease'

Could you hedge (insure against) the exchange-rate risk? Yes but it would be expensive and hence often it isn't worth it. And if you raised your price to say $1.2 million to preserve your profit, you might lose customers.

Responsibility for the exchange rate lies with the Bank of Israel. In her January 6 testimony to the Knesset Finance Committee, Bank of Israel Governor Karnit Flug squarely faced the strong shekel problem. She noted that "the weak point in the Israeli economy in the past two years was exports," and that weakness, in turn, had two causes – "moderating global demand" and "the appreciation [strengthening] of the shekel."

Little can be done when the economies to which Israel sells its exports stagnate and hence import less. But can't the Bank of Israel intervene to mitigate strong shekel blues?

THE GLOBAL FOREIGN EXCHANGE MARKET IS VAST, LIQUID, NEVER SLEEPS AND IS UNREGULATED

Take China, for instance. China's economy, like Israel's, is export-driven. With dollars flooding into China, China's currency, the renminbi (literally, money of the people) should have risen sharply relative to the dollar. But China's Central Bank has for decades bought enormous amounts of dollars and US Treasury bonds, keeping the exchange rate at a current 6 renminbi per dollar, instead of, say, 3.5 per dollar. This policy created a huge mountain of renminbi – the cash pumped into the financial markets to buy the dollars. China's foreign exchange holdings, mostly dollars, totaled $3.8 trillion at the end of 2013.

Back in 2009, facing the global crisis, China bought dollars and increased its money supply by a staggering 30 percent. But it worked. China's economy recovered strongly. Now, China faces the consequences of the huge mountain of money it created, which is causing a worrisome housing bubble and potential inflation.

12.62x33.68	3/4	עמוד 38	the jerusalem report	05.02.2014	40964993-4
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China's currency manipulation is also of doubtful legality under World Trade Organization rules. But America's protests are muted because US firms like Apple desperately need China's low-cost manufacturing.

UNDER THE previous Bank of Israel governor, Stanley Fischer, currently a candidate for vice-chair of America's Federal Reserve Board of Governors, and now under Flug, the Bank of Israel has aggressively bought dollars, like the People's Bank of China, to battle strong shekel blues. This may have kept the exchange rate for dollars from plummeting even more, to NIS 3.30 or even NIS 3.20. In December alone, the Bank of Israel bought $560 million. Nearly half of those dollar purchases were aimed at offsetting the effect of natural gas production; dollars from the sale of gas, when converted to shekels at free-market rates, could have further strengthened the shekel.

But even these massive dollar purchases are a drop in the ocean, like King Canute trying to hold back the sea. Total foreign exchange volume in Israel was $87 billion in December, up nearly 10 percent from November. In 2013, a daily average of $4.4 billion in foreign exchange changed hands. So the Bank of Israel's monthly dollar buying barely amounted to one-eighth of the average daily turnover.

The world has long known that central banks are almost powerless when the tide turns against their currencies (or even in favor of their currencies). Take the famous episode in September 1992 when Britain's pound came under attack. The British government and Bank of England felt they could maintain a fixed exchange rate between the pound and the German mark, as required by legal agreements with the Common Market.

But speculators like George Soros, whose Quantum Fund (one of the earliest hedge funds, a fund that invests in everything, everywhere and in almost every way) bet all its capital (and then some) that the pound sterling would be devalued. Soros sold pounds for future delivery, planning to repay when the pound dropped and became cheaper. Other speculators followed suit, thinking, "I'm not smart, but Soros is, so I'll do what he does."

A MAJOR LIMITATION ON THE BANK OF ISRAEL IS THE LARGE LOSSES ITS CURRENCY TRANSACTIONS INCUR

And indeed, on the evening of Black Wednesday, September 16, 1992, thanks in part to the huge volume of speculative selling of the pound, then chancellor of the Exchequer Norman Lamont emerged from a Verdi opera, the "Force of Destiny," to announce Britain's surrender to destiny. The pound sterling was devalued sharply, from 2.95 marks per pound to 2.20. Ironically, this helped Britain's economy emerge from a recession, by spurring its exports; that Black Wednesday ultimately turned bright green.

Soros made over £1 billion on that single bet, in just a few weeks. When the Bank of England proved powerless against the forex (foreign exchange) speculators, central bankers everywhere realized their limitations. "We are trying to moderate these [strong shekel] trends," Flug told the Knesset committee, but experts understand her power to do so is limited.

The global foreign exchange market is vast, liquid, never sleeps and is unregulated. Close to $5 trillion a day changes hands, 87 percent of it in dollars. One expert, Mansoor Mohi-uddin, of Union Bank of Switzerland's Singapore branch, predicts that daily global forex turnover will double in a decade – to $10 trillion. This means that the value of annual world GDP will turn over in forex trading in one week.

The forex market is booming because central banks have created vast amounts of new money, in the wake of the 2008 global crisis, and investors seek higher returns wherever they can find it. This often requires the sale or purchase of a different currency. "Central banks will have a harder time influencing exchange rates because of the market's size," Mohi-uddin told Bloomberg News. "They will need to act more forcefully to have any sustained impact."

The Bank of Israel knows this well.

History has bitter lessons for nations with strong currency blues. Japan's yen strengthened from 360 per dollar in the 1970s (a rate that boosted Japan's exports enormously) to a peak of 80 in April 1995.

40964999-0	05.02.2014	the jerusalem report	עמוד 39	4/4	26.73x25.59
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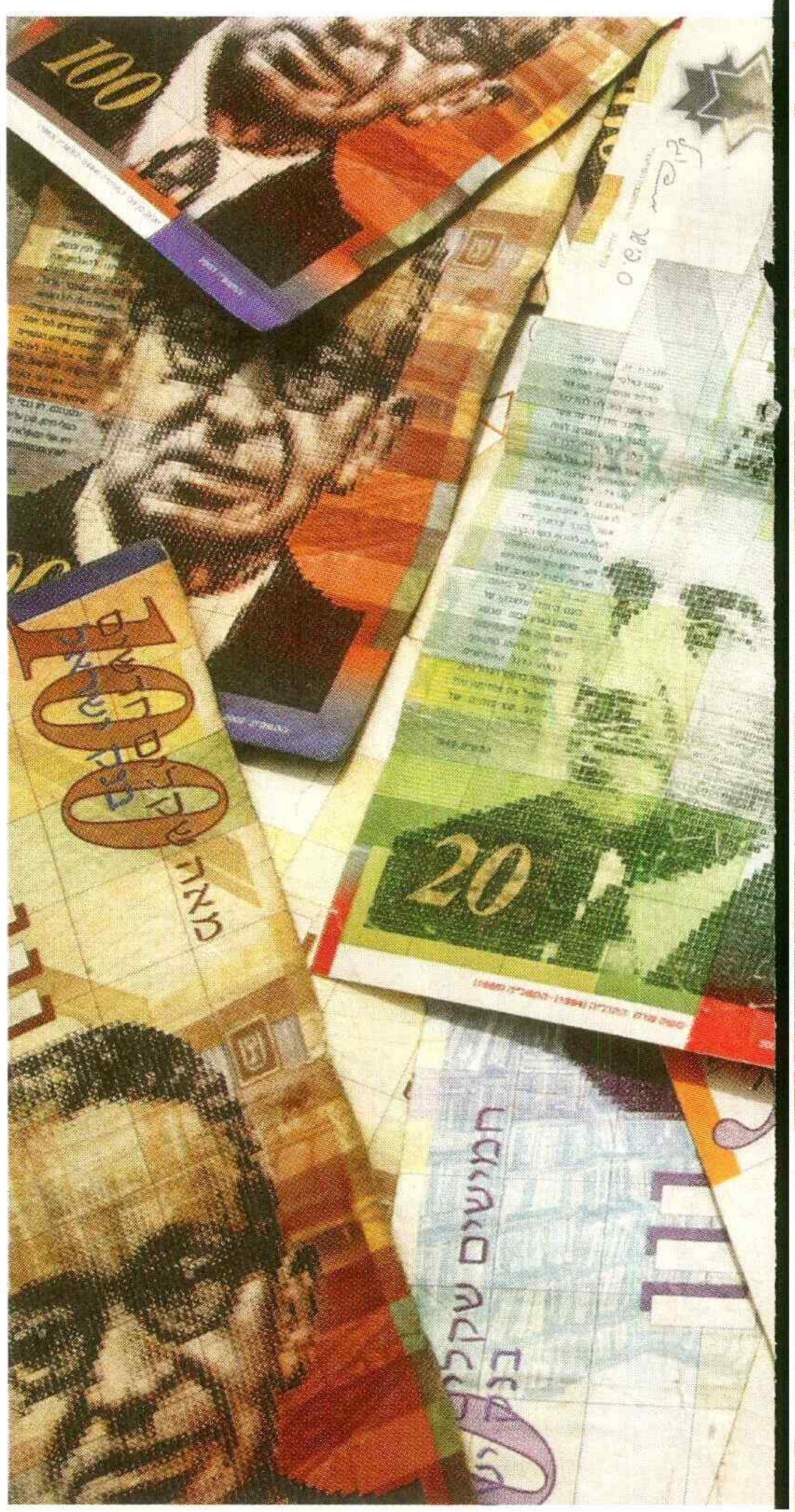

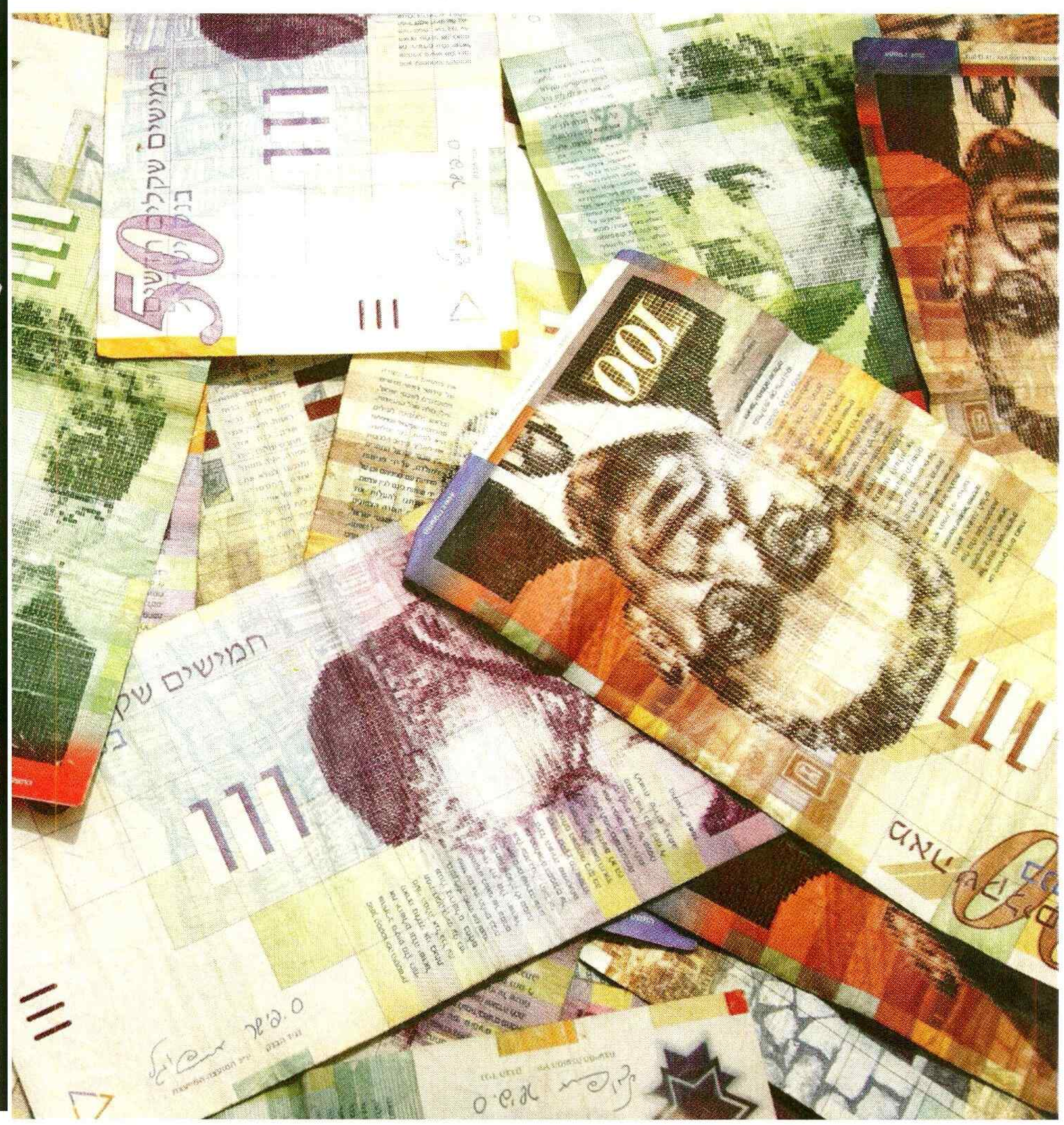

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That steep rise probably helped cause Japan's two decades of stagflation. Lately, Japan has acted aggressively to weaken the yen and this has helped its economy.

After the Netherlands discovered a huge gas field in 1959, its currency, the guilder, rose strongly. As a result, Dutch industrial exports became expensive and uncompetitive and declined rapidly, a syndrome now known as Dutch disease.

GOVERNOR FLUG is keenly aware of the dangers of Dutch disease. In her January 6 testimony, she noted that low-tech and mixed-tech industry in Israel account for 42 percent of all manufacturing and 60 percent of all manufacturing employment. Strong shekel blues hurt all industry and its ability to compete with imports, and hence cause unemployment. Not only hi-tech is impacted.

What should the shekel-dollar exchange rate be?

In 1986, the business weekly, The Economist, offered a whimsical way to find an answer – the "Big Mac" rate. Here is how it works. In 2013, a Big Mac hamburger in America cost an average of $4.13. In Israel, the identical product cost about NIS 15.90. So, $4.13 in buying power is equal to NIS 15.90. This implies a "purchasing power" exchange rate of 15.90/4.13, or NIS 3.85 per dollar. This would make dollars about 11 percent more costly in shekels than today. The Big Mac rate sounds a bit silly, but extensive research shows that market exchange rates tend over time to move toward it.

Making the shekel 11 percent less valuable, in terms of dollars, does not sound like a huge task and would greatly soften the strong shekel blues. But the enormous volume of forex transactions means that moving the market by 11 percent is nearly impossible, even for the Bank of Israel, especially when the market thinks dollars should be cheaper and not more expensive.

A major limitation on the Bank of Israel is the large losses its currency transactions incur. In 2013, the central bank lost NIS 1.9 billion on its foreign exchange holdings, which totaled $81.77 billion at the end of 2013. This is what happens when you buy large amounts of a currency (dollars) whose value is falling. The bank rightly says that this is a paper loss, and a worthy one, because it helped strengthen Israel's exports. Nonetheless, the loss is real and has increased substantially from the NIS 1.2 billion loss in 2012. And it hurts especially because the bank's loss is the speculators' profit, and they are the last persons on earth we want to make wealthy.

I thought about doing a stand-up comedy routine on the shekel. "The strong shekel is bad news? No good, it makes our imports cheaper. That's good? No bad. Weakens the economy. That's bad? No good. Makes us rethink our core values. That's good? No bad. We find we don't have core values. That's bad? No, good…"

But I'm no Woody Allen and the strong shekel blues is a tough act to follow. So I'll stick to writing and teaching, and hope for some weak shekel ragtime someday soon.

Postscript: On the afternoon of Monday January 27, the Bank of Israel bought $250 million worth of dollars aggressively trying to prevent the shekel from strengthening. The result was minimal; the dollar strengthened, by only 0.18 percent. According to the financial daily, The Marker, Eldar Tamir, head of Tamir Fishman investment house, said, "It appears the Bank of Israel has thrown in the white towel in the global war on weakening domestic currencies…" ■

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