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MONDAY, JULY 3, 2006

Israel: No Peace, No Growth

By **BERNARD AVISHAI**

DOES THE ISRAELI ECONOMY REALLY NEED PEACE? Some are taking this question seriously, at least since the former finance minister, Benjamin Netanyahu, argued that peace is a "useful, but not a necessary, condition" for Israel's economic growth.

In spite of the current diplomatic stalemate, endless vendettas, and the confused state of Palestinian politics, Israel's economy grew 6.6% in the first quarter. Berkshire Hathaway recently sank \$4 billion into Iscar, Israel's flagship high-tech company.

In effect, Netanyahu assured Israelis that educated workers, genius technology and market freedoms are enough to lure the necessary investment capital. He explained that the country's economic contraction between 2001 and 2004 was a result of the "bursting of the high-tech bubble," not of any *intifada*, or uprising, among Palestinians.

Fortunately, Prime Minister Ehud Olmert knows better than this, as do most Israeli entrepreneurs. Olmert's new government is potentially the most pragmatic since 1967, because he holds a vision of integration into the global economy, something for which mainstream, educated Israelis hunger. His bet on globalization, more than any current response by (or to) Hamas, revives hopes for negotiating an end to the occupation. A continued stalemate is not a prescription for growth, but for a catastrophic brain-drain.

On the surface, Israel's economy is holding its own. Israelis earn, on average, about \$21,000 per annum, a comfortably Western standard. The country booked a record \$6 billion in direct foreign investment in 2005, and two-thirds of its approximately \$40 billion in exports were, like Iscar's, high-tech "solutions" -- customized components, software bundled with services -- like Iscar's, mostly to Europe. Exports included network security software, plastic products and telecom components, aircraft and avionics, and generic pharmaceuticals.

Thanks to immigration from the former Soviet Union, more than one-third of Israeli adults hold a university degree. Israel has published, per capita, more engineering papers than any other country.

Since the 1984 meltdown, when inflation climbed to an Argentinean 400%, the government has stabilized the shekel, built out the transportation infrastructure, provided seed capital for startups, privatized telecommunications and banking, and transformed capital markets by reforming pension funds.

Israel's defense establishment has incubated leading technologies -- like Check Point's firewall software -- and the Israel Defense Forces remain a perfect finishing school for young people to learn team-based problem-solving.

In electronics and information, there are over 260 active businesses.

In 2005, Tel-Aviv 100 equities grew in value by more than 26%. Israel has been the home of 3,000 start-up companies since 1990, and more than 200 Israeli companies are listed on

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This focus on high tech doesn't mean that the Israeli government has been reconciled to the idea that just a few people will be making a decent living. Netanyahu was right to imply that many knowledge companies can employ as many people as a few big manufacturing concerns -- that wealth can trickle through.

But these numbers conceal severe social tensions. In 2004, the wealthiest 10% of Israelis earned about \$8,200 a month, the bottom ranks, about \$800. A third of children live under the poverty line. Oriental Jews earn a third less than European Jews. Israeli Arabs, a fifth of the population (and a quarter of Israel's first-graders), make up a large part of the poorest group. The real unemployment rate, when discouraged workers and Orthodox Jews on their special dole are taken into account, is closer to 18% than the official 9%. In the Bedouin villages of the Negev Desert, joblessness may be as high as 40%.

Meanwhile, the educational system is underperforming. High-school graduates score among the lowest of any in developed countries; universities are running huge deficits. The government will need enormous revenue to reverse this decline.

The price of fiscal discipline since 1984 has been a budget-allocation process in perpetual crisis -- often accompanied by arbitrary cuts to social-welfare spending, hospital aid and support for the handicapped, the elderly, the arts and public media. Nevertheless, the budget deficit in 2004 was 4% of gross domestic product, and the national debt was 75%. If Israel were a member of the European Union (which many business people dream about), it would have been in breach of EU fiscal standards.

Current levels of growth might yet get the country over this huge hump, but in spite of Netanyahu's claim to the contrary, gains have tracked inversely with political violence -- due, in part, to the collapse of industries driven by tourism or consumer confidence, like hotels and construction. These sectors each employ many more people than high-tech does.

During the latest *intifada*, beginning in 2000, under 1 million tourists a year have come to Jerusalem, while Prague got 8 million. Clinical trials conducted by global biotech firms were cancelled; restaurants shut down; real-estate prices plunged.

Even in technology sectors, there were problems. "If the peace momentum [goes] away," Check Point's CEO, Gil Shwed, told me in 1998, "we will lose our edge in attracting customers and top-flight management to Israel." This was prophetic. None of the 36 largest foreign companies currently in Israel (from Intel to Siemens) established operations between 2000 and 2004. From 1994 to 1999, the days of the Oslo talks, the Israeli economy grew by 74%, while Ireland, a comparable economy in many ways, grew 58%. But from 1999 to 2004, Israel grew only 18%, versus Ireland's 74%. Bubble shmubble.

Venture-capital investments, it is true, remained steady. In 1993, just one venture fund operated in Israel; today, there are more than 60, which have invested over \$10 billion during the past 10 years. They troll for innovative ideas in consumer medicine, telecom products, Internet sites. But competing on innovation mainly means building sustainable business that build solutions for other businesses, not consumers: Iscar makes custom blades for global machine-tool companies, Amdocs makes billing systems for global telecom companies. Solutions require market 'know-about,' not just technical know-how. To sustain growth, many more Israeli firms will need to be welcomed in Europe and Asia.

So Olmert's coalition does not fear radicalized Palestinians, who can be isolated, as it should fear isolated Israelis, who cannot eat algorithms. Shwed also said, "People who think they are going to suffer here for long will go live someplace else." Already, 750,000 Israelis (including Olmert's sons) live in the U.S. According to a 2004 poll, nearly half of Israel's young people didn't "feel connected" to the state, and a quarter of them didn't "see their future" in the country.

Olmert's first priority, and Israel's best hope of holding onto its best youth, is an advanced knowledge economy, which depends on peace. But then sustaining peace will depend on this same economy, which will spread science, management -- and even hope -- to the West Bank and beyond.

BERNARD AVISHAI, a former editor of the Harvard Business Review, is a visiting professor of business at Duke University. He is the author of *The Tragedy of Zionism*, and is working on a book about Israeli democracy.

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