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Israel and the Global Currency War

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Strong currencies are evidence of strong economies, but a very strong currency weakens the economy, as is now the case in Israel. That is why many countries around the world work to weaken their local currencies as compared to other currencies, thereby giving themselves a competitive edge over other countries in the global marketplace. This phenomenon has been called the currency war. While Israel too is involved in this currency war, it is at a distinct disadvantage. The strength of the shekel will eventually lead to Israel's defeat in this war, and is liable to place national growth at risk and severely damage the labor market.

Israel's currency has strengthened over the past two years. An exchange rate of 3.82 shekels to the US dollar has dropped to 3.47 shekels, i.e., the US dollar has been devalued by more than 9 percent as compared to the shekel. The euro has been devalued by some 4 percent, and the yen by some 33 percent. The shekel's relative strength against the dollar is very significant compared to the marginal profits of many Israeli industries and companies. Those bearing the brunt of this reality are the exporters whose income is in foreign currency but whose main expenses are in shekels, including manufacturers of electronics, pharmaceuticals, chemicals, metals, food, and more. Furthermore, Israel is becoming more expensive for tourists. Exports of goods and services represent some 38 percent of Israel's GDP, which is why damage to export also curbs market growth. According to initial data for 2013 released by the Central Bureau of Statistics, the total exports of goods and services, not counting startups and diamonds, dropped by 1.1 percent, compared to their 4.1 percent increase in 2012.

Israeli manufacturing for the domestic market has also been affected because of the appreciation of the shekel, as the strong shekel makes it difficult to compete with imports, along with the fact that some countries have a cheaper labor market. Real investments are also liable to suffer, as investors receive fewer real assets for the same dollar amount, which increases the risk of a future severe devaluation of the shekel, in turn raising investor risk.

The ones profiting from the strong shekel are the importers and merchants who are enjoying demand for imports. Consumers too are benefitting from cheaper goods, assuming importers are dropping prices. But this advantage cannot last in the long term if imports edge local industries out of the economy.).

According to economic theory, in a developed free market the situation eventually balances out: several factories in Israel will close, exports will drop, tourism will decline, unemployment will grow, and the shekel will weaken and then settle at a new equilibrium. Some would say this is a natural process in which the government must not interfere and that Israeli industry must adapt to the new reality. The problem is that this process takes a heavy social toll and its efficiency is ensured only given some very specific circumstances that have little to do with Israel's current reality in general and the global currency war in particular.

While the shekel's strength partly stems from the robust economy, there are some foreign currency sources of particular impact. For example, the energy sector contributes to foreign currency surpluses thanks to the discovery of natural gas in Israel (leading to savings on imports) and loans the Israel Electric Corporation takes out in foreign currency abroad (in 2013, bonds at high interest rates were issued for a total of $1.1 billion). In the security sector, US military aid for a total of $3 billion represents significant savings on military imports, while exports of Israeli armaments reached $7 billion (in 2012). In the hi-tech industry, according to a report by PwC Israel, the total value of exits by Israeli technology companies in 2013 was $7.6 billion. And while these sectors make a welcome contribution to the economy, they all have the same side effect: strengthening the shekel way beyond the scope of the Israeli economy, which threatens the survival of some local industries, in particular the labor intensive ones.

A strong currency is one of the factors in economic crises affecting some countries around the world, such as members of the Euro bloc in southern Europe. A currency suited to the strong German economy damages the competitiveness of nations such as Greece, Italy, Spain, and Portugal. In 2013, for example, unemployment in Spain reached 27 percent of the labor force, compared to 7 percent in Germany. The weakening of the local currency is therefore an obvious interest. The currency was weakened in the European Union, the United States, and Japan as a result of lowered interest rates and the purchase of long term bonds by the central banks ("quantitative expansion"), moves meant to stimulate economic activity. Likewise parties to the currency war are also China, South Korea, India, Brazil, the Czech Republic and others. As the currency war expands, its effectiveness diminishes and its risks (inflation, damage to solid saving, and more) increase. But the nations uninvolved in the war suffer to a much greater degree.

To date, Israel has tried to prevent the shekel's appreciation by having the Bank of Israel buy foreign currency on the local market, lower interest rates, and hem in the government's dollar-shekel debt portfolio. It seems that these steps amounted to too little, too late.

One of the factors slowing down the Israeli response in the past was concern about the effect that lowering interest rates would have on the rising housing prices. This effect has been reduced thanks to limitations imposed by the Bank of Israel on mortgages consumers. Another factor is the cost of keeping foreign currency reserves accumulated by the Bank of Israel (more than $80 billion at the end of 2013). The foreign currency reserves earn the Bank of Israel negligible interest, whereas in order to buy the foreign currency the bank takes loans in shekels that bear a higher interest rate. Lowering interest rates in Israel and proper management of foreign currency reserves could reduce the cost of keeping them and allow a more resolute purchasing policy.

There is broad agreement that a strong shekel is one of the most significant dangers to rapid growth of Israel's economy in the coming year. Struggling against market forces may seem like swimming against the current, but the cost of doing nothing may be higher. It is best to act to the extent possible until there are changes overseas that will ease the situation, such as an increase in interest rates in the United States and Europe.

Israel should act on several fronts simultaneously and intensively, while demonstrating greater determination than in the past (psychology and expectations are of utmost importance on the financial market). Among the recommended measures:

- Significantly increase foreign currency purchases on the local market in 2014 and manage the reserves more effectively.
- Reduce the amount of foreign currency on the local market by reducing loans in the government sector abroad and taking loans in shekels instead.
- Reduce the Israeli interest rate again in accordance with the situation in Western economies.
- Examine the cancellation of the tax exemption on profits from bond purchasing given to foreign investor (as proposed by the Bank of Israel).
- Prepare a contingency plan that would fix an absolute lowest exchange rate for the dollar.

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