THE RESILIENCE OF THE ISRAELI TECH AND ECONOMY TO SECURITY CRISES

A Historical Data Analysis to Address Foreign Investors and Partners Concerns

OCTOBER
2023

START-UP NATION
POLICY INSTITUTE

The recent events in Israel naturally raise big concerns among foreign investors, partners, and customers of Israeli technology companies. They ask themselves (and their Israeli counterparts) whether the Israeli hi-tech can weather the storm, or using terms they care about – is it still attractive to invest in, partner with, or buy from Israeli tech companies.

It is still not possible to know how long the current war will last and what its full consequences will be for the country and the economy. At this point, we can draw on experience from significant combat events of the last twenty years, in particular, Operation Protective Edge (Tsuk Eitan) in 2014, and the Second Lebanon War of 2006.

Macroeconomics

As a reminder, the Second Lebanon War took place in the summer of 2006, it lasted 34 days, required an extensive reserve mobilization of 89,000 soldiers, and included incursions into Lebanon. The direct cost of the war was estimated at 9.4 billion ILS (equivalent to 13 billion in 2023 prices).

Operation Protective Edge lasted 50 days in the summer of 2014, and included reserve mobilization of some 75,000 soldiers, and an incursion into Gaza. The cost of the operation was estimated at about 7 billion ILS (7.8 at 2023 prices). For comparison, the total allocation for expenditures on security and public safety in the 2023 government budget is 105 billion ILS.

The immense pain and suffering such wars bring as well as economic hardships to many households notwithstanding, their macroeconomic significance is quite limited.

First, in terms of **direct costs** and impact on fiscal policy: since the costs of the war are borne over several budget years, and are financed partly through cuts to other expenses, and partly with foreign aid, none of the aforementioned war events created a significant government deficit. As can be seen in chart 1, the only two years in which deficits were unusually large were 2009, following the global financial crisis of 2008, and 2020, as a result of the Covid19 pandemic. That is, both cases are a result of non-security related events. The Second Lebanon War and Operation Protective Edge did not require the procurement of hundreds of planes and tanks (as after the Yom Kippur War, for example), and therefore their budgetary consequences were much less dramatic.

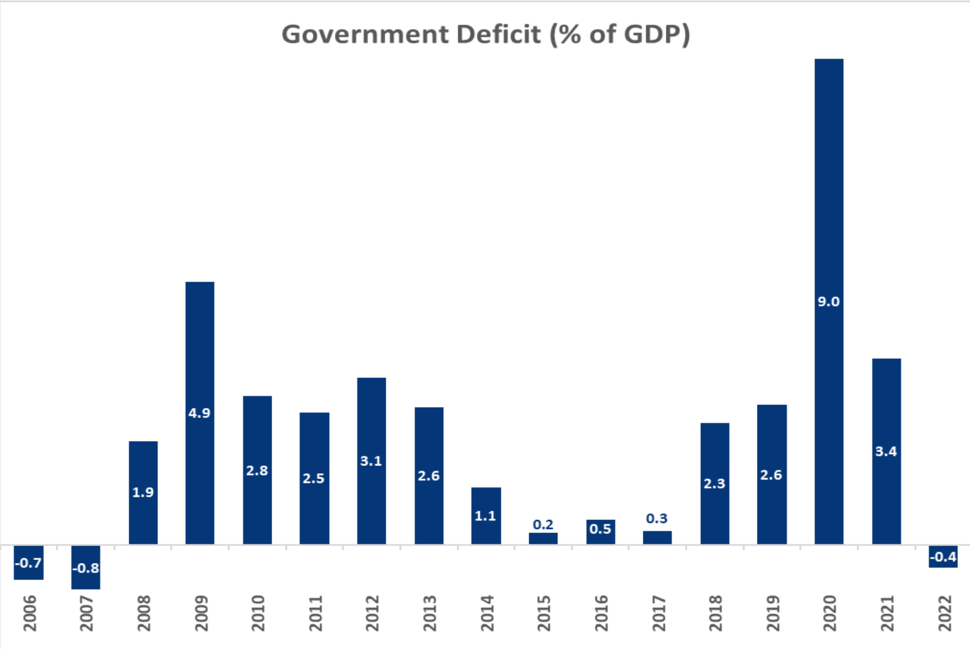

Figure 1 General government deficit. Source: CBS and BOI

Another significant difference from earlier decades is that thanks to the stabilization plan of 1985 (and other reforms) that strengthened the independent status of the Bank of Israel and the Monetary Committee, the Israeli government cannot finance increases in spending through unlimited monetary expansions. The Bank of Israel will use (in fact, it already does) its monetary policy instruments to allow the government to increase the deficit without excessively increasing the external debt, but it will do so in a balanced way that also ensures price stability. Therefore, there is also no reason to fear abnormal **inflation.**

The **indirect effects** on the economy were also not particularly large and lasted only a short time (see chart 2). The Bank of Israel estimated the total cost to the economy of the Operation Protective Edge at about 0.3% of GDP and the Second Lebanon War at 0.35-0.5% of GDP (see Bank of Israel Report 2014, Chapter 2). Furthermore, the loss of output resulted from factors such as damage to tourism, damage to the export of goods (as opposed to services), and damage to private consumption - factors that have a lesser effect on the high-tech industry.

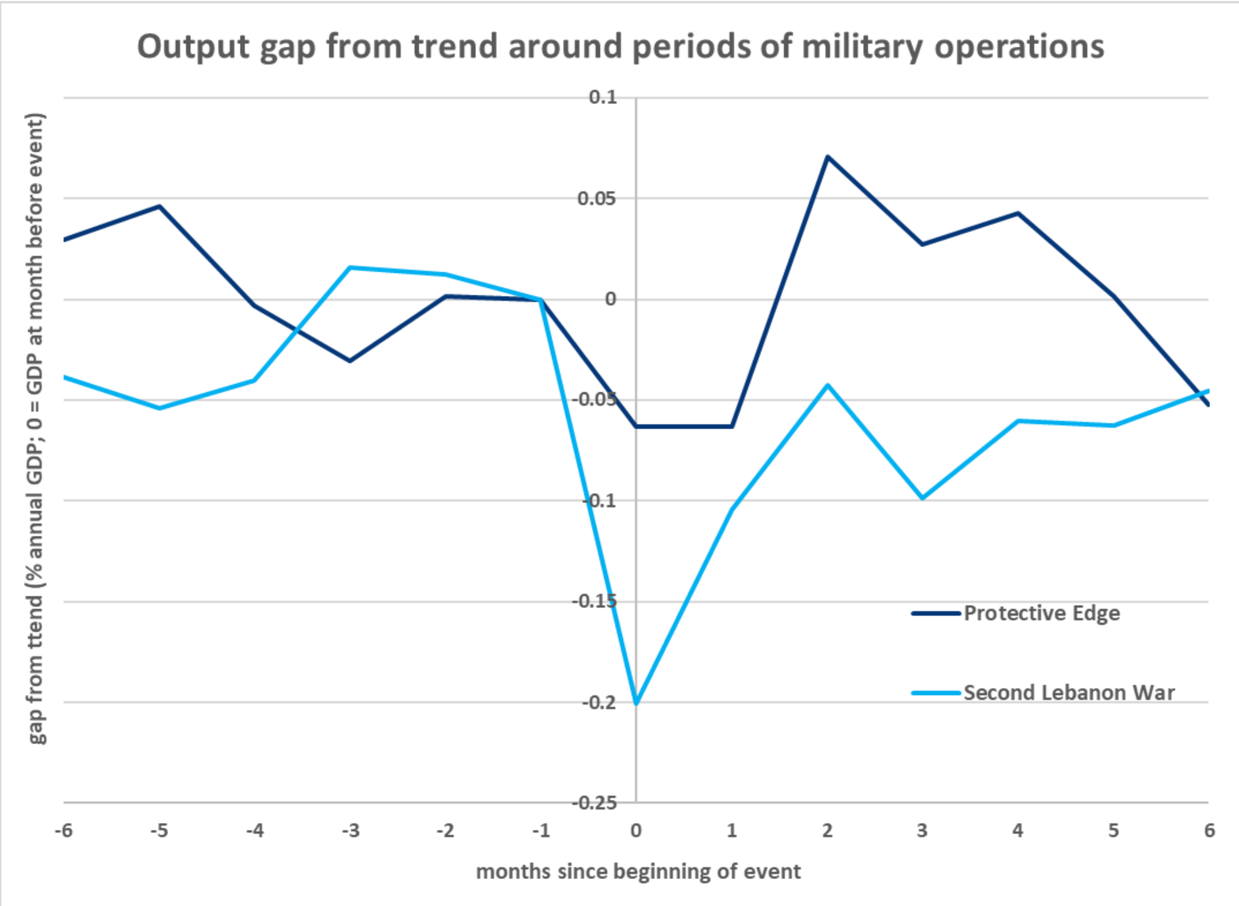

Figure 2 Output gap from trend around military operations (monthly, % of annual GDP). Source: BOI

Financial markets react negatively to military operations, and often overreact drastically. However, the acute reaction tends to fade quickly, and the entire gap tends to disappear within 2-3 months. Thus, for example, in the Second Lebanon War, the TA125 index (see Chart 3) lost about 8% of its value in the first two days of the fighting, but returned to its pre-war level in less than 40 days. Operation Protective Edge did not cause sharp fluctuations in the markets, and even then, TA125 returned to its pre-war level in less than two months. In fact, in both cases a year after the outbreak of hostilities, the TA125 index showed increases: 36% after the Second Lebanon War, and 17.8% after Operation Protective Edge.

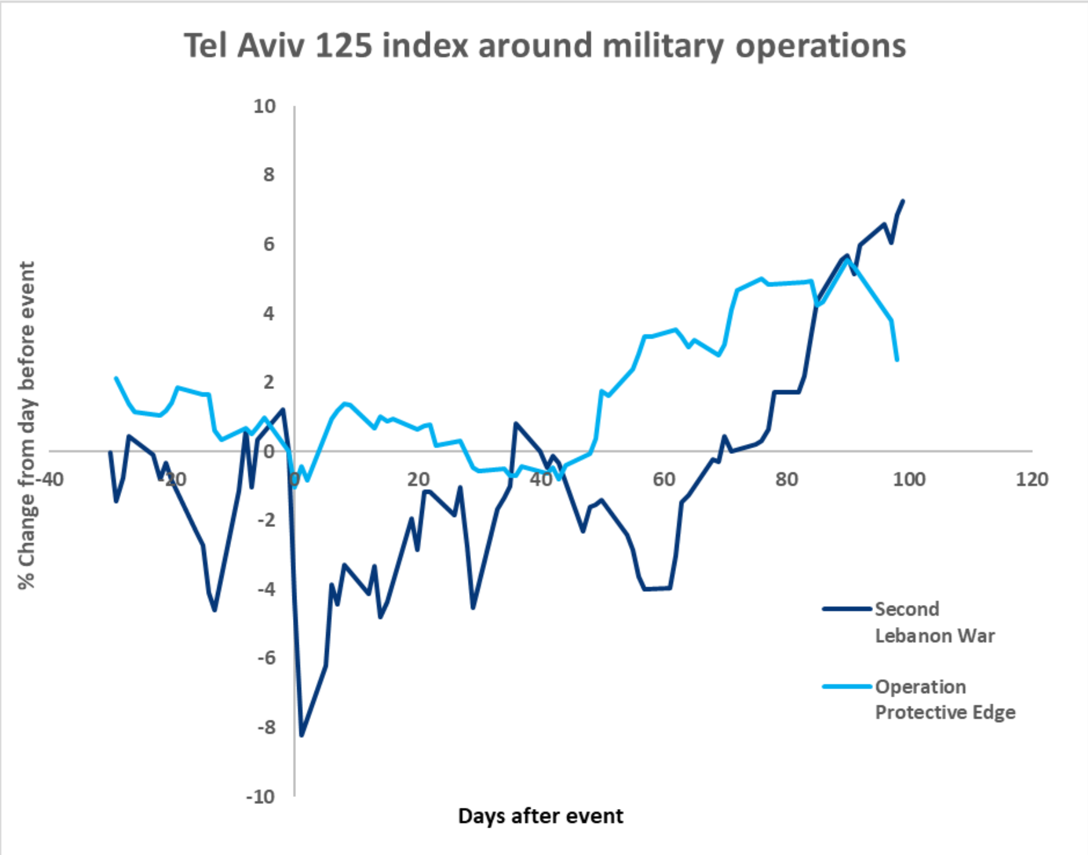

Figure 3 Tel Aviv 125 stock index around military operations (% change from last trading day before operation). Source: SNPI

The high-tech industry

Focusing on the **high-tech industry**, the available data only allows for analysis of the sector's performance after Operation Protective Edge, thus, we focus on this period. The table below shows some data on Israeli high-tech in the two years after the operation:

	2014	2015	2016
VC investments in Israeli companies ($b)	2.9	4	5.6
No. of active foreign VC funds in Israel	69	88	100
Total no. of active foreign investment institutions (VC funds, corporate investors, and corporate VC funds)	117	169	212
Number of exits	99	137	135
Total value of exits ($b)	6.9	8.3	10
Number of new start-ups	1038	1011	1073
Total employees in high-tech (thousands)	249	258	271

As you can see, the Israeli high-tech industry has proven very resilient. In fact, no decline in activity was observed after Operation Protective Edge. Since then, the situation has only improved: Israeli companies have continued to gain experience, learned to work remotely (due to the Covid19 epidemic), established international development and support systems, etc.

Another reason for the resilience of the high-tech industry is that investment in high-tech is mainly investment in the development of IP (as opposed to investment in physical assets such as manufacturing plants); and this type of capital is hardly affected by security threats. That is, the risk of investing in this industry is very low compared to the risk of investing in physical capital.

Some fear that the situation is somewhat different this year because the war has caught the sector in the midst of a slowdown that has occurred since the end of 2022. It is likely that today there are more companies than in the past that are close to or in financial distress. However, this can and will be addressed by various short-term interventions. In particular, the Innovation Authority (IIA) and the Bank of Israel have already started implementing programs aimed at helping companies in immediate distress.

Israeli high-tech has proven its ability to overcome crises of this sort in the past, and it will do so again now and emerge stronger.