יועצי השקעות ישראל
Israel Investment Advisors

Wealth and Capital in Israeli Society

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Political debate in Israel tends to focus on security, relations with the Palestinians, settlements and geopolitical threats. Economic issues are often secondary. When debating the economy, however, inequality is usually the hot button issue. While vociferously arguing about wealth gaps, Israelis sometimes take the wealth creation process for granted. Despite its unequal distribution, most Israeli families experienced substantial increases in wealth and income over the past several decades. Wealth accumulation is reaching a tipping point whereby more of it is spilling into the capital markets with important implications for asset valuations, structural reform, economic growth and social equality.

Thirty years ago Israel emerged from banking and debt crises, hyperinflation and economic stagnation. In the 1980's and early 1990's Israelis faced confiscatory income taxation and their meager savings were mostly channeled into government bonds. When the Histadrut and the government privatized socialist companies, only a small handful of politically connected tycoons were wealthy enough to purchase and recapitalize these assets. The tycoons transformed inefficient companies into profitable enterprises, often building business pyramids centered around Israel's large financial institutions.

Israeli society prospered, but the tycoons benefitted the most. Like any astute businesspeople, the tycoons exploited their monopolistic advantages to raise consumer prices and gain preferential access to capital. The scales are slowly shifting, however, as average Israelis amass larger amounts of wealth. After a fivefold increase over the past 20 years, total financial assets held by Israeli households is approaching $900 billion (Chart 1).

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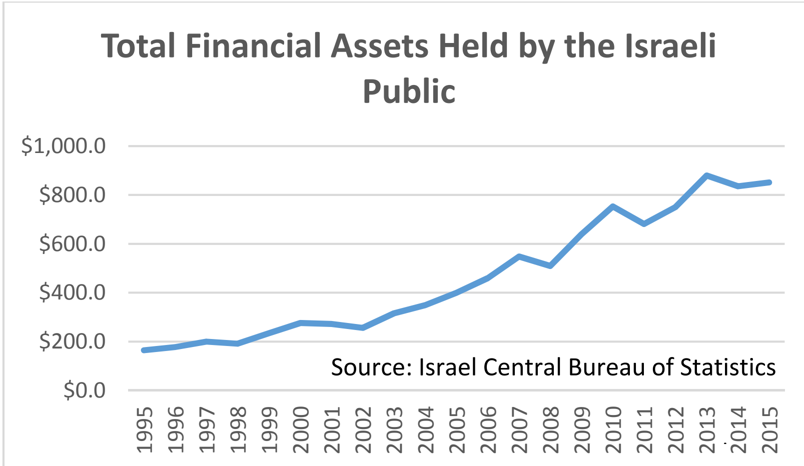
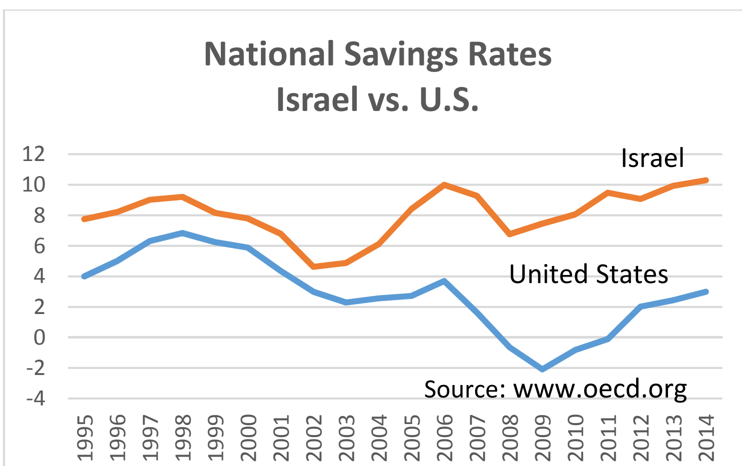
Chart 1



Israel has a High Savings Rate

Israeli households continue to amass wealth at a rapid clip due to their high savings rate. As you can see in Chart 2, net saving as a percentage of GDP stands at 10.2% in Israel vs. 3.0% in the United States. Most of this capital resides in private pension and provident funds. The Israeli savings system is based on tax-advantaged defined contribution plans similar to American 401(k) accounts, but with government mandated contribution requirements by employees and employers. Historically these plans covered government employees or large companies with a unionized workforce, but in 2008 the Knesset expanded this system to virtually all employees in Israel.

Chart 2

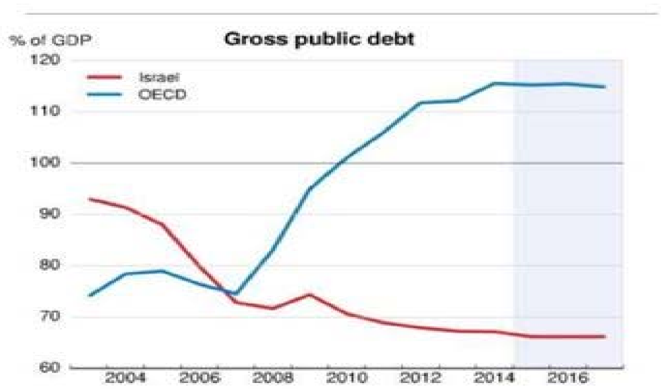


To be clear, Israel also has a tax-funded public pension system similar to Social Security. Contributions into the private system discussed above are individual savings accounts invested in stocks and bonds by asset management companies. Due to the onerous government debt burden in the 1980's and 1990's, Israel required asset managers to invest large percentages of their pension portfolios in government bonds. As Israel reduced its debt burden (Chart 3) the government eased the bond requirement, allowing more capital to flow into stocks and corporate bonds.

Israel is Reducing the Government Debt Burden

Israel was one of the very few countries to reduce government debt as a percentage of Gross Domestic Product (GDP) during and after the global financial crisis (Israel is the red line in Chart 3). Since Israel's own financial crisis in the 1980's the Knesset repeatedly enacted debt-to-GDP targets into law. The current goal is 60% by 2020, down from 67% in 2015. A high savings rate combined with less "crowding out" from government debt means money should spill into capital market opportunities at an accelerating rate.

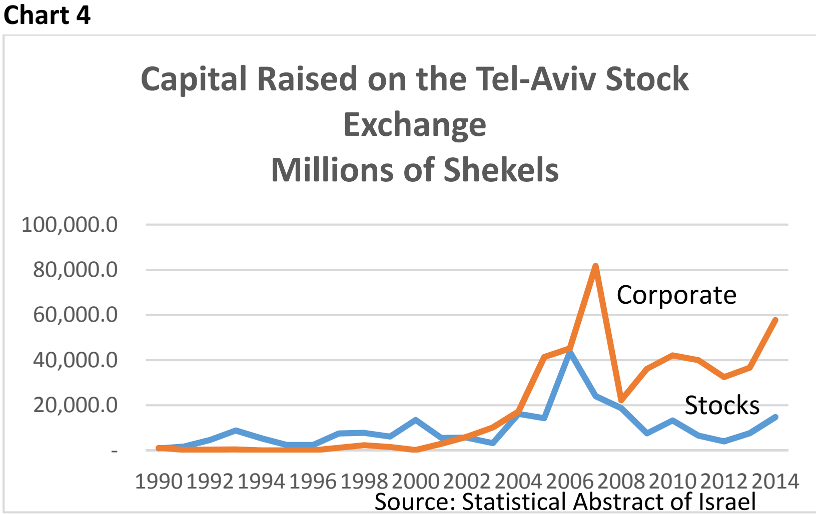
Chart 3



Source: Source: OECD, Economic Outlook database.

Inflation and interest rates in Israel have been low for quite some time and economic growth rather robust. As you can see in Chart 4, Israeli companies issued large volumes of corporate bonds in this environment. Stock offerings lagged in the aftermath of the financial crisis, Eurozone crisis and other episodes of global stock market volatility but ultimately should also benefit from the rising tide of capital available in Israel.

Chart 4



Capital Accumulation Fosters New Competitors

More capital will allow for new entrants into Israel's heavily concentrated financial services industry. The three largest banks in Israel – Bank Leumi, Bank HaPoalim and Israel Discount Bank – control 95% of all deposits. Five asset management companies manage nearly all pension and provident fund assets and a small handful of insurance companies underwrite almost all policies in Israel. On top of this, the controlling shareholders of each of these financial institutions use their privileged positions to control vast non-financial business empires as well. Fortunately, the Israeli government passed the De-Concentration Law in 2013 outlawing joint control of large financial and non-financial firms.

In recent months Prime Minister Benjamin Netanyahu and Finance Minister Moshe Kahlon doubled down on this law with an interesting proposal that would require the two largest banks – Leumi and HaPoalim - to divest their credit card subsidiaries. New banks would be allowed to form around these credit card operations and then Leumi and HaPoalim could reenter the credit card business once the new competitors are established. In addition, they proposed more flexible rules that would allow non-bank competitors such as consumer lending companies, online lenders, or institutional investors like pension funds, hedge funds and insurance companies to extend business loans and consumer credit.

All of this financial sector restructuring will take time to accomplish, but the rising pool of investment capital will be a crucial element for its success. Incumbent players could fight these efforts vociferously unless they also will stand to benefit. Rising liquidity in the capital markets often translates into higher asset valuations and, when combined with greater financial sector competition, reduces the preferential access to scarce capital enjoyed by the business pyramids. In an environment where capital is more widely available from a multiplicity of sources, selling pieces of the business pyramids could be much more valuable for the tycoons than retaining control. We believe the coming evolution of the Israeli economy will be a "win-win-win" for controlling shareholders, outside investors and Israeli society.

Israel in the 1980's was a stagnant socialist economy. The monopoly enterprises were privatized in the 1990's and early 2000's. Their new owners cut costs, invested and turned most of them into profitable companies, but they also exploited their privileged positions to raise prices and stifle competition. The next phase of economic transformation is already underway. Although Israel is unlikely to become a paradise of economic equality, the foundations are now in place for continued wealth accumulation by an expanding percentage of Israeli society and for investors like us.