Bridging Israel's Productivity Gap

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March 31, 2022

Israel's economic growth is powered by four engines: rapid population growth, increased labor force participation, technological innovation, and improved productivity. While the first three engines are roaring, productivity is sputtering a bit.

Population growth averaged 1.8% annually over the past 15 years, while job creation was even faster. The Israeli labor force expanded 2.6% per year as larger percentages of the Orthodox and Arab communities shifted into paid employment. Despite Israel's booming technology sector, worker productivity lagged, growing just 0.9% per year during the same period.

Israeli Economic Indicators, 2006-2021

	Population	Labor Force	Real GDP*	Real GDP per Capita*	Productivity Growth
2006	7.1 million	2.8 million	$263 billion	$37,042	NA
2021	9.4 million	4.2 million	$480 billion	$51,595	NA
Annualized Growth	1.80%	2.60%	3.90%	2.00%	0.90%

***Adjusted for inflation to 2021 dollars.**
Source: Israel Bureau of Statistics; Bank of Israel

Why is productivity not keeping pace? The story of the Israeli economy in recent decades has been one of decreased monopolization and increased competition, but not all industries have reduced concentration as much as they might. There appears to be a correlation between slow deconcentration and sluggish productivity growth.

Measuring Productivity: The Financial Sector

Economists measure productivity in several ways, but output per hour worked encapsulates the impact on rising living standards. Understanding economy-wide productivity can be counterintuitive, since more productive companies increase sales with fewer employees. Highly productive economies simultaneously shed jobs in established businesses while creating even more jobs from new products, services, and companies.

As an example, let us examine Bank HaPoalim, one of Israel's largest banks. As in other wealthy countries, inflation and interest rates in Israel plunged in the years following the Global Financial Crisis of 2009. As with other banks around the world, low interest rates pressured Bank HaPoalim's lending revenue and profit margins. Meanwhile, the Israeli government deregulated alternative financial instruments and markets, such as corporate bonds, to better compete against large banks like Bank HaPoalim.

In this more difficult operating environment, Bank HaPoalim increased revenue by just 6% over the past decade, from 13.6 billion shekels in 2012 to 14.5 billion shekels in 2021. In response, the bank reduced headcount from 13,769 employees in 2012 to 8,535 today. This 38% reduction in jobs at Bank HaPoalim helped boost profits by 90%, from 2.6 billion shekels in 2012 to 4.9 billion shekels in 2021. Rising interest rates will likely enhance Bank HaPoalim's revenue growth and might staunch employee attrition. Rising revenue per employee, however, should continue since automation at Bank HaPoalim is less extensive than at similarly sized banks in the United States.

When the Israeli government broke up the monopoly powers of the leading banks 15 years ago, it allowed the insurance industry entry into a variety of competitive financial services, such as pension and asset management. As a leader in the insurance industry, Harel Insurance, Investments, and Financial Services Ltd. benefited from the deregulation. Harel's revenue grew from 12.6 billion shekels in 2012 to 27.7 billion shekels today.

In addition to this tremendous revenue growth, productivity at Harel also improved. Total headcount increased by 15% from 4,025 in 2012 to 4,635 at the end of 2020, boosting revenue per employee from 3.1 million shekels to 5.9 million. Although established firms such as Bank HaPoalim and Harel did not collectively expand employment, total employment in the Israeli financial industry nonetheless increased from 116,400 people in 2012 to 130,800 in 2021, as a wider array of competitive financial institutions came onto the scene.

Technology Is Not the Whole Story

Although we associate innovation with technology, the economic impact of technological products is limited without associated changes in business processes and organizational structures. Over the past 30 years, Israel became a powerhouse of technological innovation, mostly for export. Unfortunately, adoption by domestic companies outside the technology sector did not keep up since competitive pressures were weaker.

Economic reforms in Israel are gradually reducing competitive barriers. Increased competition motivates management to invest in productivity-enhancing technologies and processes. Nonetheless, many domestic Israeli companies still wield significant market power. The Bank HaPoalim example above illustrates the benefits to investors of Israel's gradual productivity acceleration. Facing mounting but less intense competitive pressure than an equivalent bank in the United States, Bank HaPoalim's productivity-enhancing investments resulted in significantly improved profits. In a more competitive environment, consumers, rather than shareholders, might have received a larger share of the benefits.

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Israel's Economy Is Still Swiftly Scaling Up

Not that typical Israelis have not benefited from growth, even without a commensurate rise in productivity. Since the end of the Second Intifada in 2005, Israel's annual Gross Domestic Product (GDP) growth averaged 3.9%, substantially faster than the major G-20 economies. After declining 2.1% in 2020 due to COVID-19 restrictions, the Israeli economy rebounded 8.1% last year – faster, once again, than every developed economy except Ireland. GDP clocked in at a record $480 billion in 2021, and GDP per capita topped $50,000 for the first time. While remarkable, this strong number probably overstates living standards for the average Israeli by 20 to 25%, due to the persistently high cost of living, exacerbated by pandemic inflation and the strong shekel.

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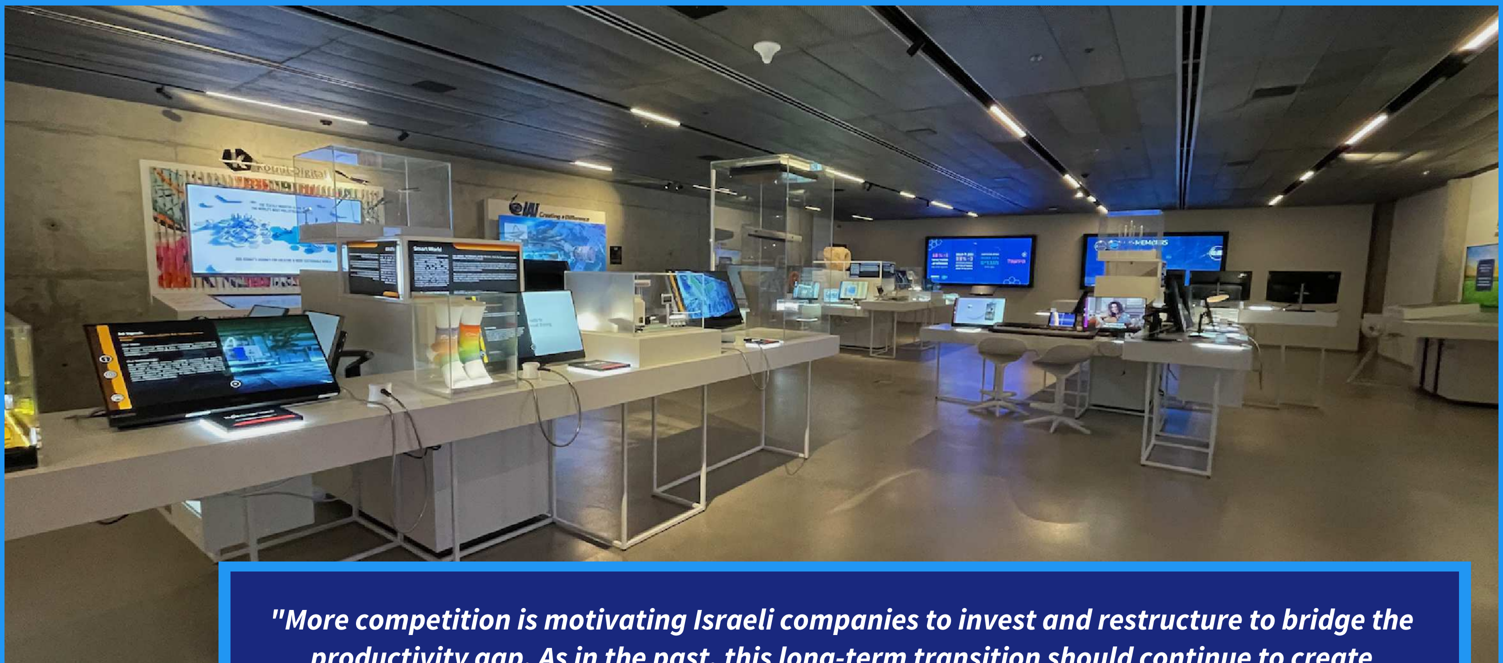
The transformation of Israeli technology companies from "Start-up Nation" to "Scale-up Nation" will contribute mightily to future economic growth, but technological adoption and business restructuring trails in the 90% of Israeli GDP outside the technology sector. Along with technological innovation, population growth and labor force expansion will likely remain the primary economic drivers in the coming decade.

Although straggling behind the other three economic drivers, productivity growth is slowly accelerating as competitive pressures intensify. More competition is motivating Israeli companies to invest and restructure to bridge the productivity gap. As in the past, this long-term transition should continue to create opportunities for alert investors like us.



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