The political economy of peace

Israel and South Africa are currently undergoing fundamental structural transformation. In both countries, the transition to open economies is being strongly supported by influential large corporate groups. This should minimize the risk of policy failure, despite the fact that political risk appears superficially high.

Until recently, both Israel and South Africa were more or less isolated from their neighbors. This was mainly because of politics, but the economic consequences were similar and baleful. Both countries maintained protectionist regimes designed to deal with external account imbalances. Both found themselves facing similar problems in the 1980s, namely massive military spending, intensifying social unrest, lower investment and chronic stagflation.

Until the early 1980s, the military economy in Israel and the apartheid *economy in South Africa were good for business.*

In recent years, both countries have also broken hallowed political taboos. Israel is talking peace with Arab leaders who it used to vilify as terrorists, and has accepted the principal of returning occupied land. South Africa has abandoned the quasi-theology of *apartheid* and with it the white minority's hold on power. It no longer engages in foreign military adventures. What caused the change of heart?

Part of the answer lies in changing external conditions. The end of the Cold War depreciated the strategic value of both Israel and South Africa for US foreign policy. Increasing globalization also makes it more and more expensive for small countries to maintain a protectionist stance. But perhaps the most important reason for the change is that, until the early 1980s, the military economy in Israel and the *apartheid* economy in South Africa were good for business. It was only when they no longer offered a benign environment for corporate earnings growth that the internal pressure for change accelerated.

As shown by the chart alongside, which is taken from a recent academic study on the Israeli economy, the consolidated net earnings of the five largest conglomerates show a remarkable correlation with the rate of inflation. The reason is partly associated with accounting biases which tend to overstate profits when inflation is rising and understate them when it is falling. But the association is nevertheless a real one.

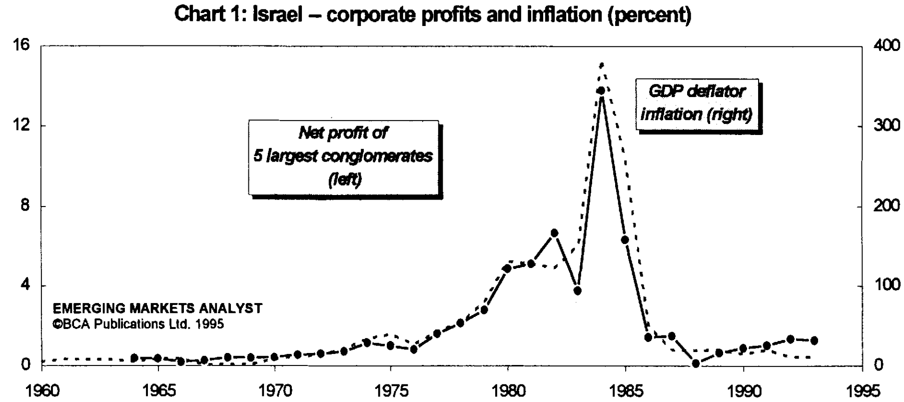
During the late 1970s and early 1980s, financial profits (from equity investment and stock market manipulation) were the main source of earnings for the large banking groups. The conglomerates were also disproportionately involved in the military sector where, until the early 1980s, government procurement and arms exports offered another major source of profits.

However, in 1983, the stock market collapsed, a fiscal crisis necessitated cuts in military spending and the world arms market went into a tailspin. The consequences for the five large Israeli conglomerates were that their profits dropped to less than 1% of GDP, down from a peak of 14% in 1984.

Under these circumstances, the comfortable old business environment of high military spending and high inflation was no longer sustainable. The business elite opted for regional reconciliation, an environment in which they stood to gain most from the prospects of greater trade and investment in the region.

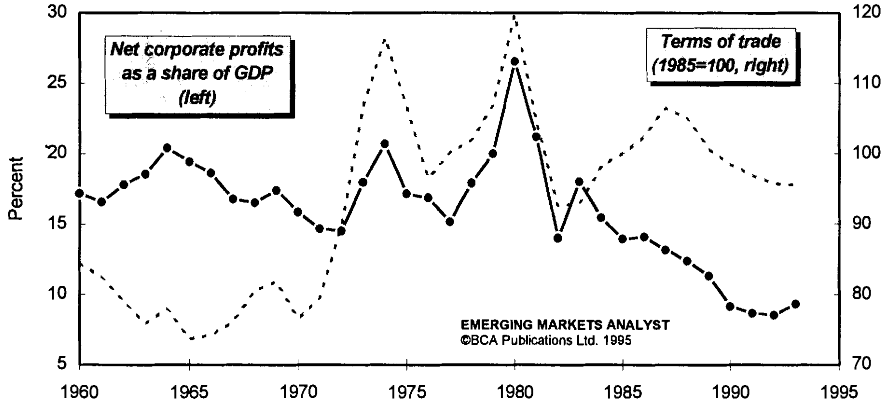
The implications for the current peace process are bullish. The large conglomerates are likely to be big winners from any peace dividend. Support for a hard-line foreign policy (such as the one still being advocated by the opposition Likud bloc) is likely to remain muted.

Chart 1: Israel – corporate profits and inflation (percent)



The 5 largest conglomerates include Bank Hapoalim, Bank Leumi, Discount Bankholding, Koor Industries and Clal.
Source: S. Bichler, *The Political Economy of Military Spending in Israel* (Ph.D. Dissertation, Hebrew University, 1991) and additional data from the author.

Chart 2: South-Africa -- corporate profits and terms of trade



Source: South African Reserve Bank

The South African transition has some interesting similarities with the Israeli case. The mainly English-dominated conglomerates such as Anglo-American and De Beers may have always opposed Afrikaner-imposed *apartheid*, but such opposition did not become overt or effective until the mounting racial conflict in the early 1980s began to impose a real drag on their bottom line. As in the case of Israel, the corporate sector faced disruption to its normal way of conducting business in the mid-1980s.

Given the resource-based nature of the South African economy, it has always been sensitive to relative changes in export and import prices, which economists call the "terms of trade." The chart above shows that until the early 1980s, the ratio of South African corporate profits to GDP rose and fell in parallel with cyclical fluctuations in the terms of trade. (Expressed in its most simplistic terms, this means that rising prices for gold and strategic metals were good for South African corporate profits, and vice versa.)

However, the economic disruptions since the early 1980s, comprised of the impact of military involvement in neighboring countries, rising industrial unrest, tighter international sanctions and the relative decline in domestic living standards and consumer demand conspired to create a profoundly anti-business climate. Corporate profits as a share of GDP fell *despite* improvements in the terms of trade.

For the rest of the 1980s and into the 1990s, the secular nature of the decline in corporate profits became increasingly apparent, and with this decline, corporate support for an end to *apartheid* became increasingly vocal. Such support has recently been explicitly recognized by President Mandela, who has argued that without it, the peaceful transition to a non-racial democracy would have been impossible.

Investment conclusions

• The political transitions underway in both Israel and South Africa are usually portrayed in the international media as "hanging by a thread." This perception ignores the fact that deeply entrenched corporate interests in both countries are solidly behind the process of political reform.

• Although it is conceivable that a spasmodic anti-reform backlash could yet occur in either country, it is most unlikely that any such backlash can be sustained or translated into tangible policy changes in the face of what would likely be intense corporate opposition.

• Over time, the degree of corporate concentration and political influence in both countries is likely to be modified. Local conglomerates will have to make room for trans-national corporations, whose interests are not always identical to their own. In the medium term, the increasing openness of both economies is irreversible as a result of deregulation.