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REVIEW OF "ISRAEL AND THE WORLD ECONOMY: THE POWER OF GLOBALIZATION"

BY ASSAF RAZIN*
MIT Press (2017)

Reviewer: Laura Alfaro**

Cross-border flows in goods, services, investments, and ideas burgeoned during the 1990s and early 2000s. Changes in world politics (e.g., the end of the Cold War, collapse of the Soviet Union, and political and policy changes in Latin America and Asia, particularly China), facilitated the dismantling of policy barriers. Rapid technological progress, in particular the global information and communication (ICT) revolution, allowed for new and different ways to produce, sell and buy, and to organize economic activity. Growth in trade and capital flows during the period known as the Great Moderation (1985–2007) fostered reductions in inflation and output-employment fluctuations.

Growth stalled during the Global Financial Crisis, notable for its speed, severity, and international span—the first worldwide slowdown since World War II. Triggered by a liquidity shortfall in the US banking system in 2007, the crisis quickly spread to nonfinancial sectors and economies around the world, resulting in countries experiencing substantial declines in economic activity. Many feared increased protectionism. Brexit represents for many the first case of rising populism and backlash against globalization, primarily migration.

Israel, a thriving economy at the frontier in technological innovation, as Assaf Razin notes, stands as an example of the benefits of globalization in this new world of doubt. The country's successful globalization-based development strategy and economic path reflect a deep integration to global trade, capital, ideas, and migration. Israel's Law of Return, for example, enables free immigration while granting returnees immediate citizenship. Israel's path has few parallels in the world. Its success, however, cannot be taken for granted. The country has dealt with economic, social, political and national security threats since its birth. In economic terms, it has had to overcome hyperinflation, financial crisis, inward and outward migration flows, and recurrent external shocks. Israel's trajectory warns of the challenges faced by, and provides important policy lessons for, open economies.

Razin's engaging presentation of Israel's development warrants thorough and thoughtful scrutiny by economists, policymakers, and business leaders as well as historians and other interested readers. Unable, in a review, to do justice to the wealth of material

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contained in this book, I will highlight within a summary of the main topics some interesting points and lessons learned. At once a textbook of international economics, blending theory and empirical work, and a review of the contemporary history of economics rich in policy implications, the book proceeds chronologically in three sections—Historical Background; Globalization, Disinflation, High Tech, and Foreign Direct Investment; and Trending Developments—and concludes with a consideration of Early Literature.

a. An international economics textbook

Razin presents the main topics of international economics using rigorous theoretical frameworks. The text combines and enriches theories standard in the field with research developed by the author in prior work. Through the eyes of Israel, the book injects life into such topics in international macroeconomics as balance of payment crises, the "trilemma", sterilization, hyperinflation, fiscal deficits, and capital flows.

Readers learn, for example, about the difficult trade-offs policymakers face between monetary autonomy, a stable fixed exchange rate, and free capital mobility policy. Termed the "irreconcilable trilogy," the open-economy "trilemma" is that only two of these three objectives can be achieved simultaneously. A central bank that does not want the currency to depreciate, for example, must either increase interest rates to attract capital or purchase its own currency using foreign exchange reserves. If capital flows are large, a central bank might quickly exhaust its foreign exchange reserves with little influence over the final outcome. Israel's crisis of the early 1980s, Razin observes, similar, perhaps, to the case of Argentina in 2001, highlights some of these tradeoffs, as well as teaching about currency crises, credit crunches, financial instability, and bank runs.

Razin uses appendices to detail numerous mechanisms identified in the academic literature that can engender currency and financial crises. In the canonical "first-generation" crisis models (e.g., Krugman (1979) and Flood and Garber (1984)), a government with persistent money-financed budget deficits is assumed to use a limited stock of reserves to peg its exchange rate, a policy that would ultimately be unsustainable, and investors' attempts to anticipate the inevitable floating of the exchange rate would, once reserves fall to a critical level, generate a speculative attack on the currency. In "second generation" models, a government chooses whether to defend a pegged exchange rate by trading off short-term macroeconomic flexibility against longer-term credibility. Defending the peg is more expensive (via higher interest rates) if the market believes the defense will ultimately fail. Multiple equilibria are thus occasioned by speculative attacks on the currency originating from a predicted deterioration of fundamentals or via a self-fulfilling prophecy (e.g., the EMS Crisis in Europe in the 1990s). "Third generation" models developed to account for the crises of the late 1990s (characterized as currency and financial crises) emphasize balance sheet effects and implicit government guarantees (e.g., the Asian financial crisis). Razin shows how Israel, through its responses to these crises, strengthened its monetary, fiscal, and financial institutions.

Countries experiencing net capital inflows, on the other hand, face appreciating exchange rates and an increasing money supply that can lead to undesirable inflation or fuel unsustainable credit. Israel's "Black Thursday" of 1983 is an example of an instance of such credit "going bust." Central banks can "sterilize" increases in international reserves by selling government bonds, thereby reducing domestic credit, but doing so tends to keep interest rates high at a non-trivial cost to the government. Razin discusses how circumstances can determine when sterilization is more or less effective.

Israel and the World Economy also illuminates topics in trade, foreign investment, and migration, and their reinforcing effects and benefits. Razin shows migration, such as the exodus that brought Soviet Jews to Israel in the 1990s, to have contributed a more educated, diverse, and productive work force that has, hand in hand with open borders, enabled the country to sustain a comparative advantage in high-tech sectors.

"Innovation", Razin emphasizes, "requires scale, and scale requires trade. An isolated small economy cannot be a center of innovation." Israel's economy is one of the most high-tech-dependent in the world, and exemplary of the benefits of agglomeration economies and clusters. Tel Aviv is a vivid example of the benefits that emerge when firms and workers cluster and draw from a common pool of resources, particularly with respect to the diffusion of ideas.

Israel is also, however, vulnerable to high-skill brain drain. Moreover, as Razin observes, the migration episode that fostered increases in labor productivity might also engender income inequality with fiscal, social, and political implications. Razin's analysis of this circumstance exploits political economy models to arrive at a deeper understanding of the challenges and effects of globalization.

Razin also tackles topics of importance not usually treated in textbooks, such as the costs and benefits of inward and outward migration and population growth, the rise in income inequality, social and political effects such as polarization, and national security. An exceptional virtue of *Israel and the World Economy* is that Razin's examination of theory is inspired by practice and disciplined by empirical facts.

b. An empirical work

With content rich in data and empirical evidence, *Israel and the World Economy* is a case book that engages readers with a mix of rigorous theoretical foundation embedded in real concerns and issues of importance to policymakers and practitioners. Economics, macro and international economics in particular, have evolved from cases. Macroeconomics was born of the Great Depression, international economics spawned by currency and financial crises. Trade has been changed by the ascendance of China. Razin uses the history of Israel to inspire and motivate research topics in international capital, trade, and labor mobility. To deepen understanding and provide perspective and benchmarks, he compares Israel's story with stories from Europe, Latin America, and East Asia.

Latin American economists, for example, long viewed with interest Israel's efforts to combat inflation. Several failed stabilization programs preceded Israel's eventual defeat of hyperinflation. As in Latin America, governments ran, and central banks printed currency to cover, budget deficits. An unsustainable fiscal deficit will lead to reserve losses, a current account deficit, real appreciation, and inevitable collapse. Cutting budget deficits is a difficult political task, as the case of Israel illustrates. Razin brings the causes and effects to life with Israel as background, while presenting other related cases for comparison. *Israel and the World Economy* is rich with comparisons of similar economies.

c. A history of economics

The book's historical background section transports readers back to Israel's hyperinflation episode in the 1970s. To impart a broader perspective on the consequences of globalization and policy challenges, Razin presents an overview and rigorous analysis of the principal episodes that shaped the global economy over the past forty years.

Israel and the World Economy walks the reader through the oil shocks of the 1970s, the collapse of the Soviet Union and the fall of the Berlin Wall, the ascendance of China, the Great Moderation, and the Global Financial Crisis and its aftermath. The foundation for this historical perspective is developed in the contexts of the trade and capital mobility observed during the Great Moderation and global financial remedies and policies undertaken to deal with the effects thereof.

d. A policy book

Small open economies have grappled with the effects of external shocks, more recently the effects of the Global Financial Crisis and surge in capital flows following quantitative easing in the United States and Europe. Here again, Israel provides guidance and lessons. Israel's resilience in the face of the Global Financial Crisis reflected decades of superior monetary, fiscal, and financial regulation. The country did not allow for a credit boom and exhibited lower exposure to toxic assets, thereby limiting contagion. As the book underscores, in small open economies, and particularly in emerging markets, there is a potentially explosive multidirectional interaction among government finances, currency markets, and the banking and corporate sectors.

Israel and the World Economy is designed to afford readers an appreciation for the critical role institutions and policy play in affecting patterns of trade, international capital flows and migration, and governments' abilities to manage them effectively. With globalization, good institutional quality and policy-making have become ever more critical. As Razin notes: "Once well-regulated institutional setup and time-consistent macroeconomic policy are put in place, the economy is capable of riding on top of globalization flows and weathering outside storms."

This book is an excellent resource for anyone inclined to blend theory, empirical facts, cases, and history in learning and teaching about international economics. The first section includes three chapters (Swell and Retreat of High Inflation; Immigration Wave: Soviet Jew Exodus; and Understanding Migration and Income Inequality). The second section includes Chapters 4 to 6 (Great Moderation and Israel's Disinflation; The 2008 Global Crisis and Israel-Economy Resilience; and Israel's High Technology and Globalized Finance). The third section is composed of four chapters (Israel and East Asia; Brain Drain from Israel and Skill-Biased Global Immigration Policy; High Fertility and Low Skill Acquisition; and Rising Cost of Occupation). I recommend it highly to economists and policymakers as well as to any reader interested in acquiring a comprehensive understanding of international economics and economic history.