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COMMENTS ON THE PAPER BY MICHAEL W. KLEIN BY JOSEPH D. DJIVRE

1. INTRODUCTION

The paper written by Michael Klein constitutes a survey of six books on the Israeli economy written over the past five decades. Two of them are compilations of articles [Ben-Porath (1986) and Ben-Bassat (2002)] while the others were written in their entirety by their respective authors [Patinkin (1960), Halevi and Klinov-Melul (1968), Michaeli (1975) and Razin and Sadka (1993)].

In the first part of his paper the author identified five economic issues common to all six books: 1) The definition of the relevant comparison group; 2) Immigration, integration and inequality; 3) The roles of the government and markets in the economy; 4) The openness and dependence of the Israeli economy; 5) Inflation, crises and stabilization.

In the second part he briefly described the evolution of the Israeli economy during the period covered by the books surveyed, and in the subsequent part he presented the views of the corresponding authors on the aforementioned issues through the use of quotations.

The comparative presentation of the views of Israeli and foreign economists on major economic issues confronting the Israeli economy since the establishment of the State of Israel is itself important and interesting because it throws light on the former's evolution . It suffers though from some shortcomings. In my comments I will address two of them.

The first one arises from the fact that sometimes the quotations used to present the viewpoints of the corresponding authors on the five issues singled out overlooked the economic analysis on which they were based. A direct consequence of that is the lack of analysis of the causes and economic implications of the surveyed issues for the rest of the economy and the interdependence among various economic factors related to them. In its turn, the lack of detection of such an interdependence did not allow the identification of a common link among the examined issues and their integrated analysis, thus limiting the investigation to separate pieces of a much broader puzzle. A major factor of this kind, serving as a link among the last four common economic issues across the six books surveyed, is the Arab-Israeli conflict.[1]

The second shortcoming of the paper is that it overlooked a seventh common issue, that of productivity, which appears in all books and whose slow growth in the seventies was reflected in the slowdown of output growth with adverse effects on the economy's macroeconomic stability, as I will explain later on.

[1] In my opinion the first issue, which refers to the definition of the appropriate comparison group, does not constitute an economic issue common to all books but rather a methodological issue. Indeed the relevant comparison group depends on the economic issue analyzed, a fact which demonstrates that assigning Israel to a specific comparison group does not constitute but a technique of economic analysis. Moreover in all the material reviewed except for Patinkin (1960), Syrquin's paper in Ben-Porath(1986) and the paper by Fischer and Orsmond in Ben-Bassat (2002) international comparison is made incidentally, is very short and is not instrumental to the corresponding paper and therefore does not justify making an issue out of it.

In the remainder of my comments I will try to clarify the two aforementioned points and to throw some light on the surveyed issues, enhancing the reader's understanding of the development of the Israeli economy and of Michael's contribution to it.

2. INTERDEPENDENCE OF ISSUES

a. The economics behind the issues

In this section I will concentrate on providing some economic insight with respect to the last four economic issues singled out by Michael .

a.1 Immigration, integration and inequality

In this section Michael provides a chronicle of immigration and its absorption during the first fifty years since the establishment of the State of Israel, as it transpires from the books surveyed. The importance of immigrant absorption is not sufficiently clarified in any of the books besides the general ideological justification that it constituted the reason of existence of Israel and was instrumental in the fast growth of the economy. However immigration and its absorption touch upon some additional economic issues which have been addressed extensively in most of the books surveyed but were not conveyed in Michael's paper.

The need to increase the appeal of Israel to new immigrants and to mitigate the inequality in the distribution of income gave rise to welfare policies, creating the basis for a welfare state and determining, together with defense expenditure, the structure of the government budget that reflected considerable transfer payments and a high employment rate in the public sector. All of the aforementioned elements, the welfare state character of Israel, the structure of the government budget reflecting attempts to cope with social and educational differences among immigrants and the high employment rate in the public sector were mentioned previously by Patinkin (1960), and appear also in Halevi and Klinov (1975) and in Ben-Porath (1986). [2]

A second point which is also extensively mentioned in the books surveyed is the interdependence between immigration, productivity and economic growth which was not addressed by Michael and on which I will elaborate in Section 3 below.

a.2 The role of markets and the government

In this section Michael describes various fields of heavy government intervention as documented in the books surveyed. He concentrates on government control of business activity and ownership, on government intervention in the investment process and in the allocation of investment funds, on the process of financing the current account deficit through foreign

[2] Ben-Porath writes in this respect: "A great deal of effort and many resources were aimed at closing the gaps between Jews in the hope of achieving rapid integration and equalization. This social policy has been reflected in Israel's particular development as a welfare state, both in terms of the transfers system and in terms of public consumption." See also Berglas (1986 b).

funds and on government intervention in the capital market. He also relates to government interference with market mechanisms in the allocation of goods and to government involvement in economic activity, measured by the size of government expenditure with respect to domestic product.

The references to various books appearing in this section tend, sometimes, to be descriptive without conveying the content of this intervention to the reader. In this way, in the context of the government involvement and intervention in the capital market, the reader does not have a clear picture of the nature and the extent of this intervention after reading that " For years, the government's hand and foot were very much visible in the capital market." This intervention consisted of, among other things, the compulsory diversion of private investment funds to government bonds [Ben-Bassat (2002) and Djivre and Tsiddon (2002)] whose implication for the structure of financial markets was not examined either (see discussion below). In addition to the imposition of investment requirements on government bonds the government used other ways to make its debt more attractive to the public. These included capital controls, after the short-lived liberalization in 1977, the creation of a foreign-currency-linked money substitute (the PATAM), and the smoothing of fluctuations in the yield of indexed government bonds through the intervention of the Bank of Israel in the Tel-Aviv stock exchange, to mention only a few.

Michael referred to some of the reasons provided by various authors for this government intervention such as the inability of the private sector to raise funds abroad in order to finance domestic investment or the need to lower the cost of financing of the budget deficit by establishing a monopsonistic position in the capital market. However there are some causes which have been overlooked most probably because they were not explicitly mentioned by the various authors, even though they could have been derived from the facts documented in the surveyed books. These causes are interesting because they suggest that heavy government intervention may have served economic expediency, its ideological motivation providing an ex-post justification.

Halevi and Klinov, for example, have pointed out that most government ownership in the business sector was limited to public utility companies, the electric company having been nationalized in the 1950’s (p.115), or companies in fields of basic overhead investment. By doing so they implicitly provided us with an economic explanation. The very high infrastructure investment required risk sharing because otherwise the entrepreneurial risk would be too high, especially in the presence of country risk due to the regional conflict. In the absence of a developed capital market the government provided this risk sharing by directly financing the required investments, on the one hand, and covering the incurred deficit through the sale of government bonds to the public, on the other. Moreover, the return on overhead investment to the private investor is usually lower than that to a central planner because of the aforementioned positive externalities, a fact which provides an additional explanation for the heavy government involvement in this field of activity. The belated nationalization of the electric company documented by Halevi and Klinov supports the interpretation that the government was forced to get involved in overhead investment projects because of the unwillingness of the private sector to bear the risks of investment in infrastructure. Similar reasons and the need for fast absorption of destitute immigrants and the provision of a minimal level of services so as to increase the appeal of Israel to successive waves of immigration stand behind the government’s involvement in housing investment.

Another point of interest regarding government intervention in economic activity, which may serve as a source of information as to its causes, is the gradual transition from government investment grants to government subsidization of interest rates in investment projects of the private sector which is documented by Halevi and Klinov. In spite of its contribution to the misallocation of resources, the government subsidization of private investment supports the idea that the government's intervention in the investment process did not arise out of ideological considerations only. Had the latter been the reason, then the government would not have channeled funds to the private sector at all. The mere fact of capital subsidization by the government implies that according to its assessment the private sector required a higher rate of return on its investment than could be otherwise obtained, a fact which indicates the requirement, actual or perceived, of a relatively high risk premium by the private sector to undertake investment. This line of interpretation of the information contained in the books surveyed raises a question about the government motives of heavy investment in agriculture also documented in Halevi and Klinov. Under these circumstances a possible way of reconciling the weaker ideological motive than previously thought for government involvement in the investment process with the heavy investment in agriculture and agricultural settlements is to attribute to this activity political considerations aiming to prevent claims disputing Jewish ownership of the land.

The economic implications of the government's intervention as the latter was perceived by the various authors was covered only partially by Michael. The high government intervention in economic activity and the need to finance it against the background of inflation, led, according to Patinkin, to the institutionalization of government debt indexation. The latter together with the subsequent expansion of financial indexation considerably weakened nominal frictions transmitting nominal shocks to prices with very limited stabilizing real effects [Bruno and Fischer(1986)].

The financial repression was also reflected in a gradual increase in the concentration in the banking sector as a result of the decreasing number of profitable intermediation activities that could be undertaken by Israeli commercial banks [Djivre and Tsiddon (2002)]. The Bank of Israel intervention in the stock exchange to smoothen the yields of government indexed bonds, especially on the down side, rendered monetary policy ineffective on the one hand [Ben Bassat (2002)] and triggered on the other hand the ill-conceived and ill-fated manipulation by commercial banks of their share prices, on the other. The loss of effectiveness of monetary policy arose in this case from the fact that monetary tightening which was reflected in higher bond yields and lower bond prices triggered the intervention of the Bank of Israel in the stock exchange to absorb the excess supply of bonds, thereby increasing liquidity and neutralizing any tightening of monetary policy. The share-price manipulation by commercial banks consisted in securing a positive rate of return to share holders by absorbing any excess supply in the market using bank funds, limiting in this way the extent of negative share-price fluctuations. This share-price manipulation led to a bubble in the Tel-Aviv stock exchange in whose aftermath in October 1983 the banks involved would have become bankrupt in the absence of a government bail-out. The bail-out scheme led to the practical nationalization of those banks which were involved in the manipulation scheme, after the government purchase of the bank shares held by the public, who were offered a fixed dollar return and full redemption of bank shares at their dollar market value on the eve of the crash and the closure of the stock exchange [Blass and Yosha (2002)]. This arrangement

turned the bank shares held by the public into government bonds overnight, raising the public sector's debt and contributing thereby to the creation of a diverging path for public debt. The overnight increase of government debt and the creation of Patam were factors instrumental to the increase of the steady state inflation as will be explained below.

a.3 Israel in the world economy

In this section Michael examined the import surplus issue and the exchange rate as a mechanism of altering the relative prices of traded goods.

The import surplus is a term used first by Patinkin, and it refers to the excess of imports of goods and services over exports. It falls short of that part of the balance of payments which has to be financed by capital inflows -the current account- by the amount of unilateral transfers. The import surplus is consequently the wrong variable to be looking at to gauge the sustainability of the deficit, because sustainability depends on the accumulation of foreign debt, which reflects the balance in the current account and not the import surplus.

Why then did Patinkin look at the import surplus? The reason for doing so lies in the transitory character, in his opinion, of transfer payments from abroad (unilateral transfers). Their slowing down would imply, in the extreme case, that the current account deficit would coincide with the import surplus. This justification for the focusing on the import surplus as a proxy for the potential or future current account deficit is also justified by Patinkin's analysis based on comparing investments to savings in the Israeli economy, an approach which is characteristic of the macroeconomic analysis of the current account. This methodology of analysis allowed Patinkin to identify the source of potential changes in Israel's external balance. On the side of investments he identified the slowing down of investment in housing as one of the factors which could lead to a smaller deficit, while on the side of savings a similar role could be played by the slowing down in the rate of increase in consumption per capita after the absorption of the new immigrants. Under different assumptions concerning the aforementioned variables he reached the conclusion (Chapter 5) that a substantial reduction of the import surplus during the next three to five years was not to be excluded. This analysis, which mitigated his initial preoccupation with the size of the import surplus, was overlooked by Michael who adopted the position expressed also in Halevi and Klinov that Patinkin had been pessimistic without cause. In spite of the fact that Patinkin's short-term preoccupations did not materialize in the sense that Israel did not find itself short of foreign funds in the medium term, his analysis identified potential sources of unsustainability in the savings of the public sector especially as a result of the defense burden, which hit the economy with a vengeance in the longer run.

Another point not mentioned by Michael is that after Patinkin, perhaps because of him, the discussion on the import surplus focused only on the availability of funds. Attention was thus diverted from the evolution of stocks (foreign debt) and concentrated on the flows. As a result the unsustainability of the economy's debt in general and of the public sector's in particular received professional attention only belatedly. Moreover, the analysis was in general in terms of exports and imports and did not relate to savings and to investment as factors affecting the current account deficit, an additional factor distracting attention from the core issue of sustainability [Halevi and Klinov (1976) and Halevi (1986)]. Bruno (1986) examined the current account deficit to GDP ratio [Table 14-1 in Ben-Porath (1986)]. He mentioned though

that in spite of the fall in the rate of investment, the rate of accumulation of foreign debt, due to the fall of private savings and the increasingly negative savings of the public sector, was faster than the rate of growth of domestic product. At that time however this disparity in growth rates did not seem to him to be alarming.

The section on the effect of exchange-rate policy on the relative prices of goods seems better suited to the section dealing with government intervention and its interference with market mechanisms. In spite of the fact that Michael stated his intention to limit the discussion to this aspect of the exchange-rate policy, I think that his doing so constitutes a shortcoming of his paper. This is because the exchange-rate regime and its periodical collapses, characterized by runs on the foreign exchange reserves of the Bank of Israel, constituted an integral part of the inflationary process and the recurrent balance of payments crises. An analysis of the exchange-rate regime would have thus improved the readers' understanding of the interdependence between balance of payments crises and the inflationary process. This is especially true since as a result of the gradual endogenous financial indexation, the exchange-rate channel constituted one of the channels of the automatic adjustment of monetary financial aggregates to inflationary pressures [Bruno and Fischer (1986)]. By the same token the evolution of the exchange-rate regime after the stabilization program, as the latter transpires form the books surveyed, would have thrown some light on the process of the gradual convergence to a floating exchange-rate regime from the introduction of a horizontal exchange-rate band to a crawling band which at a later stage widened gradually. The transition to a regime of exchange-rate bands was the outcome of an effort to overcome the inconsistency arising from the rate of the nominal exchange-rate depreciation consistent with the exchange rate regime and the relatively higher rate of the underlying inflation which brought about an unsustainable real exchange-rate appreciation. The latter gave rise to devaluation expectations creating periodical waves of destabilizing speculation in the foreign exchange market. Moreover the convergence to a floating exchange rate increased the anti-inflationary efficacy of monetary policy by activating the nominal exchange rate channel and thus facilitated the adoption of inflation targets. It also promoted stability by imposing fiscal discipline on the government through the threat of rapid nominal exchange-rate reaction to unsustainable fiscal policies and was instrumental in the gradual liberalization of capital flows because it mitigated their propensity to cause runs on the foreign exchange reserves [Djivre and Tsiddon (2002)]. In this context, reference should also be made to the gradual liberalization of capital flows and the logic behind its sequencing from long-term capital inflows of the business sector to short-term capital outflows of households [Ben-Bassat (2002), Djivre and Tsiddon (2002) and Gotlieb and Blejer (2002)]. This is true on the one hand because of the contribution of this liberalization to the efficient allocation of capital in the Israeli economy and to its competition-enhancing effect in the domestic capital market, pointed also out by Michael, and on the other hand because a different sequencing led to the failure of the previous liberalization attempt in 1997.

a.4 Inflation and crisis

This section concentrates on the explanations provided in the various books for the chronic inflation which characterized the Israeli economy during the first fifty years of its existence. These explanations range, according to Michael, from pure money printing in Patinkin,

through a Phillips-curve explanation of inflation in Halevi and Klinov, a government-budget-deficit financing explanation in Bruno and Fischer (1986), and an exchange-rate-devaluation shock policy in Liviatan and Piterman (1986), aiming to redress the deteriorating deficit in the balance of payments current account.

A more careful examination of the arguments presented by Halevi and Klinov p.252 reveals that they too considered the partial monetization of the government budget deficit to be responsible for the observed inflation. In this respect the Phillips-Curve explanation may be considered as an attempt to explain deviations from the steady-state inflation rate consistent with the financing of the budget deficit in the long run. The arguments put forward by Halevi and Klinov reveal, however, a rather confused conception of the inflation process which does not differentiate between steady-state and current inflation and their interdependence. This conception is based on the de-coupling of fiscal factors from financial factors in the analysis of the budget deficit, the latter giving rise to money printing, and the former exerting inflation pressures though excess demand for goods.

According to Bruno and Fischer(1986), who concentrated on the analysis of steady-state inflation, the increasing budget deficit was not the unique reason behind inflationary acceleration. The shift out of money because of the creation of the aforementioned foreign-currency-linked money substitutes (Patam) alongside the slowdown in the rate of growth of the Israeli economy led to higher inflation by increasing the weight of the inflationary component in money printing in steady-state equilibrium.

An interesting issue which could have been addressed by Michael in this section is whether the steady-state approach to inflation of Bruno and Fischer can be reconciled with the devaluation- shock approach of Liviatan and Piterman on the basis of the written material in the books surveyed. The answer is implicitly given by Bruno (1986) and is formulated in the Barro-Gordon (1983) type of model. According to Bruno (p. 283) "The inflation from the end of 1977 onward may be viewed as an expectations-driven monetary " bubble," resulting from a change in the monetary regime. It seems to have relatively little to do either with external worldwide shocks or with real developments in the rest of the economy." This "bubble" view of inflation is consistent with the "inflation bias" component of inflation present in the Barro-Gordon type of model which measures inflation in excess of the core steady-state rate, and is an increasing function of the policymaker's pro-employment stance. It has been shown elsewhere that a similar bias can be obtained if wage erosion through devaluations is used to reduce the current account deficit.[3] In this case too the inflation-bias constitutes an increasing function of the size of the deficits and of the urgency given by the policymaker to reducing the current account deficit relatively to deviating from the steady- state inflation rate. It could be claimed in this respect that the devaluation shocks of Liviatan and Piterman allowed the public to update upwards after each devaluation shock the relative weight it perceived as given by the policymaker to the reduction of the current account, raising thereby the inflation bias and pushing the long-run inflation rate to increasingly higher levels beyond its benchmark steady-state level.

No explanation has been provided in the paper for the frequent identification of the period of high inflation with balance of payments crises. The link between the two is to be found in

[3] See for instance Cukierman and Liviatan (1990).

a process of real exchange-rate appreciation similar to that described earlier in the context of the transition to a crawling exchange-rate band.

b. The Arab-Israeli conflict as a common link

The two basic channels through which the Israeli-Arab conflict has affected the evolution of the Israeli economy during the first fifty years of its existence is the need for fast growth and high defense expenditure with all the direct and indirect economic implications which have been already analyzed at length.

The importance of the Arab-Israeli conflict as a force affecting the development of the Israeli economy is explicitly stated by Ben-Porath (1986) according to whom one of the distinguishing characteristics of the Israeli economy is the hostile environment that imposed a heavy burden on the economy and required the conduct of social and economic activities by the government (page 3). Ben-Porath succinctly acknowledged the fiscal burden of defense expenditure (page 5) by writing: "In the late 1950s half of the net taxes collected by the government financed defense; in the 1970s total taxes could not finance even the domestic component of defense expenditure."

Indeed in view of the Israeli-Arab conflict the survival of the State required the immediate provision of the economic and physical resources. Both purposes were served by supporting and attracting immigration to Israel and by securing its absorption, a prerequisite for the necessary for survival fast economic growth. The priority given to fast growth lies -together with the private sector unwillingness and inability to undertake substantial investments, also connected to the regional conflict- behind the massive government intervention in investment activities and government interference with market mechanisms explained extensively above. The need to secure minimum levels of consumption of basic goods and services so as to preserve, in view of the conflict, the appeal of the newborn state to destitute immigrants, whose weight in the country's population was substantial, was instrumental in the establishment of Israel as a welfare state. This affected the structure of the government budget, and led to the imposition of price controls and rationing of goods. It is very probable that the living conditions of a large share of the population would have become rather precarious had the allocation of goods and services been left to the market mechanism.

The Arab-Israeli conflict affected the structure of the government budget also through defense expenditure. Its burden began to be felt only close to the end of the second decade of Israel's existence. Indeed, the build-up in defense expenditures started after the 1967 war [Berglas (1986a)]. Even though the first signs of a deficit were noticed as early as 1968 [Figure 2.1 in Strawczynski and Zeira (2002)], the ballooning of the budget deficit was felt with a delay, when the defense expenditure increased even further, accompanied by an increase in transfer payments in the 1970's and by the absorption of redundant labor from the business sector into the public sector in the aftermath of the two oil shocks [Berglas(b)].[4] When defense expenditure started decreasing relatively to GDP in the mid 1970's, a trend supported by the

[4] The increase in transfer payments attests to the existence of problems of equity and distribution of income about which Patinkin (1960) expressed his concern at a much earlier date, especially because of the association of inequality with the country of origin of the new immigrants.

signing of a peace agreement with Egypt, the ratio of public debt to GDP had exceeded the level of 100 percent, defense expenditure stabilizing over the 20 percent level with respect to GDP up until the stabilization plan in the mid-e1980's [Table 5 in Strawczynski and Zeira (2002)].

I have dealt extensively in the preceding sections with the interdependence between defense expenditure and the size of the budget deficit on the one hand and between the latter and macroeconomic stability, the structure of financial markets and the government's interference with market mechanisms, on the other. I will just add that this interdependence is supported not only by the developments accompanying the ascending path of government expenditure. Disinflation after the stabilization plan in 1985 and the gradual elimination of financial repression were supported by a decreasing budget deficit reflecting the fall in public expenditure from 39 percent of GDP in the mid 1980's to around 28 percent in the second half of the 1990's, mainly as a result of a relative fall in defense expenditure from 20 percent of GDP to around 9 percent and by a parallel fall in transfer payments [Strawczynski and Zeira (2002), Djivre and Tsiddon (2002)].

3. PRODUCTIVITY AND ECONOMIC GROWTH

The issue of productivity constitutes the only issue preoccupying Israeli economists during all the five decades covered by the books surveyed. The issue appears already in Patinkin who provides calculations in the second chapter of his book of what came to be known as TFP. Michael refers only indirectly to the issue in Table 1 which contains data on the fast growth of per capita output, reflecting the high productivity growth rate to which he referred as the Israeli miracle. However no particular attention is paid to it in the following sections.

After growing fast during the two first decades of statehood, productivity rose more slowly in the 1970's, made a considerable recovery after the stabilization program, and fell again to nearly zero after 1990 [Ben-Bassat (2002)].

High rates of productivity growth were the gradual outcome of waves of immigration arising, among other things, from the gradual exploitation of the full labor capacity of the working force [Halevi and Klinov (1976) and Metzer (1986)]. In the same vein Eckstein and Weiss (2002) show that "immigrants adapt gradually to the Israeli labor market and become closer substitutes to comparable Israeli workers with similar schooling and work experience as they spend more time in Israel" (p. 353-354). This argument implies, of course, that productivity growth should slow down with the full absorption of immigrants in the labor force.

According to Hercowitz (2002) high productivity growth during the first decades of statehood was the result "of increasing returns to scale stemming from the process of constructing a new economy…" According to his calculations business sector output grew 350 percent between 1960 and 1975 while inputs grew by 200 percent and TFP by 175 percent. A similar picture arises from the data during the slowdown in economic activity. According to Metzer (1986) the slowdown in productivity growth between 1961-1972 and 1973-1981 explains 57 percent of the slowdown in the average growth rate of the business sector GDP (Table 3-2). This slowdown can be attributed not only to the full absorption of past immigration waves in the labor force but also to the oil shocks as a result of which

some of the capital stock became obsolete, and to high inflation which adversely affected labor effort. After correcting for capital utilization and capital vintages Metzer reaches the conclusion that the fall in productivity growth was less sharp but still contributed substantially to the slowdown of output growth. The slowdown in productivity after 1990 is attributed by Hercowitz (2002) to the initially low productivity after the adoption of new of capital augmenting technological change after the new wave of immigration in the 1990's.

The issue of productivity growth is important for the Israeli economy not only because of its direct contribution to the rate of growth of the economy and to its subsequent slowdown but also because the latter's effect on the macroeconomic stability of the Israeli economy. More precisely, according to the arguments presented in the previous sections, the growth-slowdown gave rise to unemployment pressures. These were mitigated by the public-expenditure enhancing absorption of labor in the public sector. The latter while preventing the deterioration of income distribution, aggravated the existing fiscal imbalances. These contributed, together with the increasing weight of the inflationary component of money printing–because of the growth slowdown–to the transition of the economy to a higher steady-state inflation rate.

I must stress that the above comments are in no way intended to detract from the contribution of Michael Klein's paper. Their purpose is to demonstrate the benefits that would arise from further analysis of the issues presented there.

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