Israel Economic Review Vol. 4, No. 1 (2006), 7–11

THE DEVELOPMENT IN ISRAEL OF THE CONCEPT OF ECONOMIC INDEPENDENCE

NADAV HALEVI

Among Don Patinkin's contributions was his research on the economy of Israel. In his path-breaking survey, The Israel Economy: The First Decade, Don stressed the question of movement towards economic independence. It is therefore fitting that we devote some time this evening to a review of the development of this concept among Israeli economists over the years. Many economists dealt with this idea. In the brief time at my disposal, I can only mention some of them, and certainly cannot do justice to their contributions.

1. BEFORE THE APPEARANCE OF DON'S BOOK

In an important sense, economic independence came with political independence: gaining statehood, Israel was now able to decide on the economic policy it thought fit. However, when Israeli economists used this concept – or its converse, economic dependence – they were voicing concerns about Israel's balance of payments.

From the outset Israel policy makers included "balance in the balance of payments" among its economic objectives, and for many years economic policy fostered import substitution; however, the main emphasis for many years was on finding funds to finance an import surplus. The funds included the sterling assets, backing the currency, frozen in Great Britain; the loan from the Export-Import Bank; Reparations and Restitutions from Germany; State of Israel Bonds; and U.S. grants and loans, all additional to contributions from World Jewry.

From 1953, articles discussing, defining and measuring progress towards economic independence began appearing. Among the economists dealing with the subject were Abramovitz, Bonne, Ginor, Gaathon, Horowitz, Lerner and Creamer. All of them acknowledged that international trade involved dependence on foreign countries; however, they understood that the advantages of foreign trade justified this dependence. Thus, it was not trade itself that concerned them, but the deficit in the balance of payments.

Lerner, in diagrammatic form, and Creamer, using national accounts data estimated by the Falk Project and the Central Bureau of Statistics, developed what became the most widely used measure of economic dependence: the ratio of the import surplus to the total resources available for use in the economy.

2. DEFINITIONS OF THE DEFICIT

The various concepts regarding what defines or measures economic dependence match, in large part, the definitions used to define a deficit in the balance of payments during the 20^{th}

century. Being a double–entry recording of international economic transactions, each transaction having both a credit and a debit side, the balance of payments must balance, by definition. (When the totals do not match, an "errors" item is added to make them match.) Consequently, a deficit can only mean a lack of balance in one or more sub-categories of the balance of payments. Because the word "deficit" has a negative connotation, economists have selected those items in which an excess of debits over credits points up what they consider to be an economic problem.

Thus, it was at first common to consider the "trade balance"; when data on international trade in service became available they were included: this was called the current account. In Israel the most common term for a deficit in the goods and services account is "the import surplus". (Only after the tremendous increase in unilateral transfers after World War II, transfers that do not entail any future repayment, were these included in the current account.) Between the two world wars, it was usual to define a deficit as that part of the import surplus not covered by long-term capital; that is, that part which was finance by short-term loans or loss of gold and foreign exchange reserves. After all, the tremendous growth of the U.S. economy in over a century was aided by investments financed by capital inflow from Europe.

There was a brief, unsuccessful, attempt by the IMF to distinguish between long-term capital which led to domestic investment, thus contributing to economic growth, and flows solely for balance of payments purposes. And there were various other definitions of deficits, for example, the U.S. distinction between short-term capital that threatened its gold reserves and other short-term capital.

These various definitions point out the need to examine not only the size of an import surplus, but how it is financed, and its implications for the future of the economy. This need underlies the discussions in Israel, and up to the present time there are those that define "economic independence" in various ways: as balance in the goods and services account; as balance in the current account; as an import surplus financed entirely by secure capital inflow; or as positive domestic savings.

3. PATINKIN'S VIEWS

In his "First Decade" book, and in an article in the Economic Quarterly, which appeared earlier, Don dealt at length with the question of economic independence. Although most of the ideas he discussed had been raised, in one form or another, by economists who preceded him, the depth of his analysis, the emphasis he gave to the subject in a book surveying ten years of development, and his prestige as Israel's premier economist, combined to give the subject of economic independence major importance.

Where earlier writers had chosen to show the weight of the import surplus as a fraction of the total resources available to the economy; i.e., domestic product plus the import surplus, Don preferred to stress the inverse: the share of product in resources. A second major measure focused on the size of domestic savings. In other data and in the text Don pointed out the dangers for the future of financing the import surplus by long-term loans.He concluded that Israel had neither progressed toward economic independence, nor had used the import surplus of the past to prepare itself for the future decline in capital inflow. He proposed policy changes necessary to prepare the economy for the future balance of payments situation.

Thus, Don was not among those who called for eliminating entirely the import surplus, but rather with those who defined as a goal limiting the import surplus to an amount equal to the expected secure capital inflow. (As an aside, it is interesting to note that for many years the annual National Budget prepared by the Bank of Israel and the Ministry of Finance was based an estimates of the expected capital inflow.)

4. THE EARLY 1960s

Patinkin's book elicited spirited and extensive discussions and research on the subject of economic dependence. Among the additional economists dealing with the issue were Golomb, Michaely, Pines, Ronen and Zandberg (Zanbar).

Pines and Michaely, in separate works, disagreed with the way Don measured the share of the import surplus: whereas he used current prices as weights, they showed that using fixed prices was a more accurate way of showing changes in economic dependence.

Although many years later, in a survey of the subject, Michaely showed that the differences between the two ways of measuring were not very significant for comparisons of progress over time, the current price weights badly underestimated the decline in economic dependence during the first half of the 1950s.

Michaely also presented a number of additional measures, designed to show different aspects of economic dependence. Actually, the use of various measures pointed up two separate problems: The first is the dangers to the economy arising from a sudden sharp drop in capital inflow: this would not only mean a decrease in total resources available to the economy, but also, by curtailing needed imports, lead to a fall in product. The second problem concerned the future burden, in terms of interest payments and capital repatriation, arising from building up massive foreign debt. This problem required looking both at the balance of payments, which is an annual flow, and at the stock of foreign debt and its composition.

5. THE LATE 1960s AND THE 1970s

Discussions on the question of economic independence continued in the second half of the decade, and with less emphasis thereafter. Among the additional economists taking part were: Arnon, Barkai, Bigman, Bruno, Gafni, Oded Liviatan, Fraenkel and Rubin. I myself wrote two surveys of the contributions to the subject. Two ideas received particular emphasis. The first concerned the timing of adjustments. Assuming that the import surplus would decline in the near future – generally a four or five year period was assumed – what is the optimum path of adjustment of the economy: should the import surplus make use of the maximum present capital inflow to build up the economy, or should the economy be gradually weaned from dependence on a large import surplus? A second issue was how to best measure the future burden created by past and present import surpluses. It was clear that the data presented for this purpose were macro measures used as substitutes for micro measures more suited for cost-benefit analysis.

The optimal time path question was considered by those economists preparing long-term plans. The first long-term plan, by Gaathon, appeared in 1949, and others were prepared in the 1950s by Kochav and Merhav. In the 1960s, more sophisticated models were made, import-output models by Bruno and Chenery, and an econometric model by Evens.

Bruno and Fraenkel also dealt with the second issue, building a model to evaluate the marginal product of foreign lending. This issue of future burden became more dominant than that of sudden decrease because, time and again, the pessimists who predicted a decrease in capital inflow were proven wrong: capital inflows did not fall, and when certain sources decreased, others replaced them.

The issue of economic dependence received increased attention whenever there as a balance of payments crisis, such as in the mid 1960s and after the Yom Kippur War.

Surveys of Israel's development and problems that appeared in the 1980s, such as those by Arnon, Kondor, and a Survey by the Falk Institute, edited by Ben-Porath, devoted chapters to the issue, but it is fair to say that in the last thirty years the question of economic independence has declined in importance. Many important studies on various balance of payments components and issues have appeared, but without stressing the issue of dependence.

One aspect of dependence received greater emphasis: the reliance on a particular source of financing. During the banking crisis of the mid 80s, Michaely feared that the erosion of foreign confidence in the Israel economy could lead to a drastic sudden drop in foreign exchange deposits and in short-term loans, a drop that could cause a severe depression. Similar fears lay behind the decision of policy makers to first arrange for U.S. financial support before embarking on major policy changes.

The objection against too-many-eggs-in-one-basket was particular strong as regards U.S. aid, and was raised as early as the 1960s and reemerged thereafter by a number of economists, among them Arnon, Barkai and Rubin. Two types of fears should be distinguished. The first sees in too much reliance on U.S. a problem no different than reliance on any other single source: for economic reasons, the U.S. taxpayer may decide to cut down on foreign aid. The other focuses on the political influence given to the U.S. by reliance on its economic generosity.

6. THE PRESENT SITUATION

Concern with the issue of economic independence has declined. Evidence for this can be seen from the fact that the first symposium in honor of Don Patinkin, almost a decade ago, almost the entire evening was devoted to the question of economic independence, with presentations by Bruno and Michaely and comments by Gronau, Fischer, Fraenkel, Meridor and Sussman, whereas tonight we reserved for it half an hour at most. A recent article, by Kop, on Israel's fifth decade, which, in tribute to Don, is organized along the lines of the "First Decade", gives the subject scarce attention.

At that symposium, Michaely suggested two reasons for the decline in interest in the subject: a decrease in the actual dependence, as a result of improved economic policy, and the relative increase in autonomous capital inflow. Developments since then have strengthened his conclusions.

In the last decade, the import surplus has ranged between 7 and 10 billion dollars. It is hard to believe that we were once worried that the surplus would remain as high as $250 million! But, as said by one of the Hunt brothers when asked, after they failed to corner the silver market in the 1970s, how it feels to lose a couple of billion dollars: "A billion dollars isn't what is used to be".

In relative terms, the import surplus has ranged between 5 and 9 percent of total available resources, similar to the ratios in most of the 1980s, and lower than in the early 1990s. Most of the import surplus is covered by unilateral transfers – in the last two years transfers exceeded the surplus, and decreased outstanding debt. Almost all of domestic investment is financed by domestic savings. Whereas total foreign liabilities exceed total foreign assets, net foreign debts are negative, and foreign exchange reserves are equal to about half of annual imports.

U.S. grants are still extremely important sources for financing defense expenditure; however, as expressed in by Sadan in a recent book, whereas such aid was of crucial significance in the mid 1970s, economic development since then has converted it to one of convenience. Moreover, the political influence of the U.S. neither arises nor is limited to its financial aid to Israel.

Thus, the conventional measures of economic dependence, those expressing concern for a sudden decrease in capital inflows and those stressing the future burden, all show significant decline.

7. CONCLUDING REMARKS

The historical concerns about the balance of payments are now less relevant, and therefore the measures of economic dependence are of lesser interest than in the past. Have we finally arrived at economic independence? I myself hesitate to define that term, but I offer a definition proposed by Fischer at the aforementioned symposium: "The ability of the economy to carry out economic affairs without crisis and without recourse to foreign assistance". In my opinion, we have not yet arrived at this stage.

The Israel economy is an extremely open one, closely integrated into the global economy. This exposes it to disturbances from abroad. Consequently, as suggested by Bruno at that same symposium, this calls for extreme caution in economic policy. I doubt very much that any economy, let alone a small one, can be economically independent. In fact, the desire and attempts by various countries to join in larger economic unions reflect the belief that the economic benefits of such integration are worth even giving up some independence in economic policy.