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DISCUSSION ON THE DEVELOPMENT IN ISRAEL OF THE CONCEPT OF ECONOMIC INDEPENDENCE

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I would like to say a few words in honor of Don Patinkin, who taught and was mentor to all of us, a man who made the discipline of economics in Israel into one of the best in the world.

This discipline has yielded one Nobel Prize to date. I would like to point out that over the years Don himself was an almost regular candidate for that prize. I heard this from an important member of the prize committee, and I'm afraid that it was not merely professional considerations that prevented him from getting the prize.

I would like to say to Nadav, my teacher, that I enjoyed his lecture very much. As always, this time too I learned something new from him. There are things that only Nadav knows. His tremendous experience in the spheres of the Israeli economy and international trade have made him an endless source of information and knowledge in those spheres.

Because of pressure of time, I will make just a few main points.

The concept of economic independence emerged in Israel in the 1950s in the following context:

1. The existential threat to the State (the possibility of withstanding a blockade).
2. The sense that unilateral transfers (restitution payments from Germany) would not continue indefinitely.
3. A mercantilist approach combined with autarchic ideas (import substitutes).
4. The concept of sovereignty: there can be no political independence without economic independence.
5. The belief that dependence harms spiritual health and social development (e.g., the decline of Spain after the discovery of America because of the inflow of gold). This contention also incorporated economic ideas reminiscent of the concept of the Dutch disease.

It was necessary to establish a trade-off between economic independence and the standard of living. Don proposed dealing with the problem of the trade deficit by reducing the growth rate of both consumption and investment.

The concept of economic independence has to be examined in terms of the *Zeitgeist*, the spirit of the time, and the conditions which prevailed then:

- An economy with a fixed exchange rate, and foreign-currency reserves which played an important role.
- The foreign-currency reserves constituted a safety-net in both economic and security terms. They were regarded as an existential factor which ensured the country's survival.

As Nadav stated, the definition of the balance of payments has changed over time, and this symbolizes more than anything else the shifts in the philosophy of economic independence.

Here are a few definitions of the balance of payments, as it has evolved over time:

Balance of trade = (goods only);

Current account = balance of trade (goods and services);

Current account = balance of trade (goods and services) *plus* unilateral transfers;

Basic balance = current account as above *plus* long-term capital.

At a later stage, as Micha Michaeli pointed out, the definition was extended to include autonomous and accommodating transactions. If there is balance in total autonomous transactions, i.e., those that are motivated by market forces, the balance of payments is considered to be balanced.

Concurrent with the change in these definitions, the exchange-rate regime changed in the following way:

Fixed exchange rate with devaluations.

Floating exchange rate.

Return to controlled floating exchange rate.

Floating exchange rate within a horizontal band.

Floating exchange rate within a crawling (diagonal) band.

Floating exchange rate again.

The balance of payments was managed via monetary instruments, i.e., the interest rate.

In the last few years there has been a huge increase in nonfinancial capital inflow for investment.

The foreign-currency reserves have ceased to be a means of balancing the balance of payments.

The interest rate was used as the main instrument for managing the exchange rate and the balance of payments, alongside the maintenance of stability in general, and financial stability in particular.

Financial stability has become more important as a target than economic independence, and the same has happened with other economic targets, such as the restraint of inflation. The desire to keep inflation down has led to the existence of high interest rates, which with increased globalization have given rise to the over-valuation of the local currency and may have harmed the balance of trade, a variable which has been defined as an indicator of economic independence.

Although the principle of economic independence has been abandoned as the prime target of economic policy, it is worth noting that dangers still exist. The high concentration of Israel's exports in high-tech products, an industry which is highly volatile, creates other dangers. These threaten the stability of employment, GDP and growth, the exchange rate, and financial stability, and in extreme cases can harm the foreign-currency reserves which constitute a safety-net in an emergency.

Attention should be paid to this.