

STUDYING TEXTS:
A GEMARA OF THE ISRAELI ECONOMY

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This paper reviews six English-language books on the economy of Israel. Each book was written or edited by Israelis, and each is from a different decade. The earliest book, Don Patinkin's *The Israel Economy: The First Decade*, was written in the late 1950s, and the most recent volume, *The Israeli Economy, 1985 – 1998: From Government Intervention to Market Economics* (edited by Avi Ben-Bassat), was published in 2002. While each book considers the Israeli economy at a different stage of its development, five common themes appear: (i) the relevant comparison group for considering the Israeli economy, (ii) the challenges of immigration, integration and inequality, (iii) the appropriate roles of the government and markets, (iv) openness and dependence, and (v) inflation, crisis, and stabilization. Overall, the chronology of economic views presented in these books corresponds to an increasing acceptance of the role of markets and an increasing desire for open trade in goods and assets.

Books discussed in this review:

Don Patinkin, *The Israel Economy: The First Decade*, Jerusalem: Maurice Falk Project for Economic Research in Israel, c. 1959.

Nadav Halevi and Ruth Klinov-Malul, *The Economic Development of Israel*, Praeger Special Studies in International Economics and Development, Published in cooperation with the Bank of Israel, Frederick A. Praeger, Publishers, NY, Washington, London, c. 1968.

Michael Michaely, *Foreign Trade Regimes and Economic Development: Israel*, National Bureau of Economic Research, Columbia University Press, NY, c. 1975.

Yoram Ben-Porath, ed., *The Israeli Economy: Maturing Through Crises*, Harvard University Press, Cambridge, Massachusetts, c. 1986

Assaf Razin and Efraim Sadka, *The Economy of Modern Israel: Malaise and Promise*, University of Chicago Press, Chicago, c. 1993.

Avi Ben-Bassat, editor, *The Israeli Economy, 1985 – 1998: From Government Intervention to Market Economics*, MIT Press, Cambridge, Mass., c. 2002.

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Debate is deeply embedded in the Jewish tradition. Perhaps the best example of this is the Talmud, one of the great intellectual achievements of Jewish thought. The Talmud consists of the Mishnah, the oral tradition that was compiled in the 2nd century of the Common Era, and the Gemara, subsequent commentaries on the Mishnah that were written over the next few centuries. The Gemara records conversations and arguments across generations on the proper interpretation of Jewish law.

This essay presents something like a Gemara of economic policies and economic challenges for the State of Israel. In this essay, I review six books on the Israeli economy, all of which were either written or edited by Israeli economists. Each of these six books was published in a different decade, with the earliest one written in the late 1950s and the most recent one published in 2002. While each book reflects the main challenges of the time that it was written, there is, nevertheless, a conversation that takes place across time. Thus, the goal of this essay is to use these Israeli sources to construct a type of economic Gemara that, like the Talmud, records intergenerational conversations, although, in this case, the conversations take place over decades, not centuries, and the subjects include topics like the role of government and the promises and pitfalls of international trade and investment.

This essay, like the Talmud, is divided into six sections, each of which concerns a particular topic. The first section sets each of the six books reviewed here in its historical context. The economic development of Israel, since its founding in 1948, is marked by great achievement, but also by periods of great challenges. The books, as products of their respective eras, focus on the most noteworthy achievements, and the most compelling problems, of the times in which they were written. Thus, an understanding of the evolution of the topics discussed in these books must refer to the chronology of events facing the Israeli economy.

A chronology of the Israeli economy shows its remarkable transformation across the decades. But, despite this transformation, certain topics are addressed time and again across these volumes. Sections 2 through 6 of this review develop the conversations, across books, on five topics;

- (i) the relevant comparison group for considering the Israeli economy
- (ii) the challenges of immigration, integration and inequality
- (iii) the appropriate roles of the government and markets
- (iv) openness and dependence
- (v) inflation, crises and stabilization

As will be discussed below, the emphasis placed on each of these themes varies across the six books, both because of the variation in the events that most commanded attention at the times the books were written, and because of differences in authors' interests. Nevertheless, issues such as the integration of new immigrants, which was a dominant theme in the first years of Israel's existence and, accordingly, has a place of prominence in Patinkin's 1959 book, reappeared in the 1990s with the influx of *olim* (immigrants) from the former Soviet Union. The conversation across decades evident in these books, on topics like immigration, openness, the role of markets, and stabilization, reveals much about both changes in the Israeli economy and the evolution of economic thought in Israel from the early 1950s to the present day.

1. THE BOOKS AND THEIR TIMES

The economy of the State of Israel in its first few years of existence reflected a range of influences, including the economy of the preceding *yeshuv* (the period of British mandate), the collectivist tradition of Zionism, the waves of immigration before and immediately after the founding of the State, the effects of the war declared on Israel at the moment of its birth, the impact of aid from the diaspora and from foreign governments, and the consequences of the displacement of the Arab population of Palestine. This was a time when the unsettled and rapidly changing economy reflected a general situation of change and uncertainty.

Once the ongoing fighting in the War of Independence ended in 1949, the government undertook efforts to develop the economy. These included, during the first few years of the State's existence, pervasive price controls and rationing. Government spending at this time was largely financed by a monetary expansion; credit to the central government increased at a rate of 75 percent per annum between December 1948 and September 1951 (Patinkin, pp. 112 – 113) and, as a consequence of this, the money supply grew at an annual rate of 36 percent during this period (Patinkin, p. 108). The price controls, coupled with the monetary expansion, led to widespread shortages, the development of a black market, and, ultimately, a crisis that began in the autumn of 1951.

From the perspective of the late 1950s, the crisis of 1951 appeared as a watershed to Don Patinkin. In his book, *The Israel Economy: The First Decade*, he wrote that the 1951 crisis led to a greater understanding, among government officials, of the role of the price mechanism. Accordingly, the “New Economic Plan” introduced in 1952 scrapped much of the rationing in the economy. The plan's increased use of the price mechanism, however, did not represent a full embrace of a free market since, for example, multiple exchange rates were maintained and there continued to be pervasive import duties. Nevertheless, Patinkin predicted that the lasting legacy of the 1951 crisis was that no government would again try to impose comprehensive non-market controls.

The dominant economic event of the first years of Israel's existence, one that left a permanent legacy, was the mass migration to the country of Jews from Europe and Asia.¹ It is noteworthy that the first of the five chapters of Patinkin's *The Israel Economy: The First Decade* is entitled “Labor and Immigration.” Immigration in the 1950s occurred in waves, as has been the case throughout the State's history, with more than half of the 250,000 immigrants who arrived in Israel in the years 1953 – 1959 making *aliya* in either 1956 from Egypt, in the wake of the Sinai crisis, or in 1957 from Hungary and Poland, after civil unrest in those countries.

These waves of immigration made the task of providing jobs for its citizens a major challenge facing Israel during this period. Fortunately, after poor economic performance in 1953 and 1954, the economy began the so-called “Israel Miracle” with rapid growth in the rest of the 1950s and into the 1960s. As shown in Table 1, real annual GDP growth between

¹ Although one could easily argue that the dominant event, economic or otherwise, was the continued existence of the State in the face of the onslaught of its neighbors' armies.

Table 1
Israel Macroeconomic Data

Years	GDP growth rate (%)	Business sector product per capita growth rate (%)	Unemployment rate (percent)	Inflation rate (percent)	Net overall public sector debt (% of GDP)	Total public sector expenditures (% of GDP)
1954 – 1959	11.8	8.4	6.8 ¹	5.4 ¹		
1960 – 1972	9.2	6.4	4.7	6.9 ²	70.2	39.7 ³
1973 – 1985	3.5	1.0	4.2	117.9	138.8	74.5 ³
1986 – 1991	4.6	3.0	8.1	18.1	128.8	59.0
1992 – 2000	5.3	3.5	8.5	7.9	87.4	53.8
2001 – 2004	1.0	-1.3	10.2	1.8	86.5	53.0

Data are from Bank of Israel.

¹ = 1954 – 1958, unemployment data from Patinkin (Table 7).

² = 1962 – 1972.

³ = old System of National Account for 1960 – 1979 data.

1954 and 1959 averaged 11.8 percent and per-capita business-sector product grew an average of 8.4 percent per annum during this period, even as population increased over 22 percent.

Patinkin offers some calculations to address the source of this impressive growth performance. His conclusion is that “the growth since 1953 has to a significant degree been the result of the increasing efficiency with which the economy operated.” (p. 79). A somewhat different opinion, one that gives less weight to efficiency gains and more to labor and capital accumulation, is presented by Moshe Syrquin in his contribution to the 1986 Ben-Porath book. Syrquin attributes 40 percent of the growth in output to total factor productivity growth over the period 1950 – 1970. But he also notes that “The relatively low contribution of increases in efficiency to output growth conceals the magnitude of the achievement of having incorporated into the productive process the vast increase in inputs while improving their efficiency.” (p. 49)

As Syrquin’s calculations suggest, the “Israel miracle” continued to be the context for the Israeli economy when Nadav Halevi and Ruth Klinov wrote *The Economic Development of Israel*, which was published in 1968.² As shown in Table 1, the average rate of GDP growth from 1960 to 1972 remained high, at 9.2 percent per annum. But, during the mid-1960s when Halevi and Klinov wrote their book, there were signs that things might have started to go awry. Inflationary pressures in the late 1950s and early 1960s, coupled with balance of payments difficulties, led to a second New Economic Policy in February 1962. One component of this policy was a devaluation of the Israel Lira from IL1.8 / US\$1 to IL3.0 / US\$1. This devaluation was accompanied by an agreement by the Histadrut, the organization that oversaw a widespread cooperative movement, to a two-year freeze in real wages (but not nominal wages) which Halevi and Klinov characterize as a “complete failure.” Inflation pressures continued in the wake of the devaluation, and, in 1965, the Israeli economy entered its first recession since 1953.³ One might date the end of the Israel economic miracle at

² Halevi and Klinov were assigned to teach a course at Hebrew University on the Israeli economy, but finding a lack of sources useful for the classroom, wrote *The Economic Development of Israel*.

³ The inflation rate rose from 4.5 percent in 1964 to 7.0 percent in 1965 and 7.8 percent in 1966. The business sector growth rate per capita fell from 5.7 percent in 1965 to -3.1 percent in 1966 and -2.9 percent in 1967. Unemployment rose from 3.6 percent in 1965 to 7.4 percent and 10.4 percent in 1966 and 1967, respectively.

the time of the onset of this recession. Alternatively, since the economy entered a renewed period of growth in the wake of its victory in the 1967 Six-Day War, one might date the end of the Israel economic miracle at the time of the Yom Kippur War in 1973.⁴

The shift in the macroeconomic environment in the mid-1960s described above was accompanied by an important change in the microeconomic environment with respect to trade. The second “New Economic Policy” represented an effort to decrease the distortions in the markets for exports and imports that arose due to multiple exchange rates, export premiums and subsidies, and import tariffs and controls. Michael Michaely describes the distortions in place before 1963, and the goals and accomplishments of the second New Economic Policy, in his 1975 book *Foreign Trade Regimes and Economic Development: Israel*. Michaely’s book is more narrowly focused than the other five reviewed here since he was contributing to a National Bureau of Economic Research series that published books on foreign trade regimes and economic development in ten different countries. Nevertheless, in its description of efforts to foster the role of the market with respect to international trade, it provides valuable insights into efforts to liberalize Israeli economy.

The dominant economic challenges facing Israel for more than a dozen years after the 1973 Yom Kippur war, however, involved macroeconomic instability rather than microeconomic liberalization. The average annual inflation rate was 40 percent between 1974 and 1977. This was partly a response to the worldwide energy and food price shocks of this era. But a more specific shock for Israel was the defense build-up after the Yom Kippur War. Eitan Berglas, in his chapter “Defense and the Economy” in the Yoram Ben-Porath volume, presents statistics that show that defense expenditures represented about 10 percent of GNP during the 1962 – 1966 period, 21 percent of GNP during the 1968 – 1972 period, and about 29 percent of GNP in the 1974 – 1980 period. This increase is consistent with the overall fiscal situation, as indicated by the statistics in Table 1 showing that both total public expenditures and public-sector debt between 1973 and 1985 were about twice the levels (as a percent of national income) as in the 1960 to 1972 period.

In an effort to combat inflation, the government undertook contractionary monetary and fiscal policies beginning in 1974. Partly due to the unpopularity of these policies, as well as dissatisfaction with the general economic conditions, the 1977 election resulted in the so-called “political upheaval” in which the Likud party outpolled the Labor party and, for the first time in the history of Israel, Labor was not a part of the ruling coalition.⁵ The policies of the Likud government did not stem inflationary pressures, however, and the rate of inflation continued to rise, reaching 133 percent in 1980.

A series of failed stabilization efforts in the first half of the 1980s contributed to the growing concern about the fate of the Israeli economy. This concern, as well as a persistent hope in the face of difficult circumstances, is reflected in the title of the 1986 book edited by Yoram Ben-Porath, *The Israeli Economy: Maturing Through Crises*. As an edited volume, this book is more wide-ranging in the topics it covers than the earlier books reviewed here. Some of the chapters in Ben-Porath’s book, which was completed in the summer of 1985

⁴ In the five years from 1968 to 1972, the average growth rate of business sector growth per capita was 10.1 percent and the average unemployment rate was 4.1 percent.

⁵ Other reasons that 1977 election saw the Labor party failing to head a coalition government for the first time in Israel’s history include dissatisfaction with the conduct of the Yom Kippur War, a series of financial scandals, and a shift to the right of the National Religious Party as well as a large segment of the Sephardi electorate.

just as the successful stabilization process of the economy was beginning, described the antecedents to this macroeconomic crisis, and the first, unsuccessful, attempts to resolve it.⁶ Other chapters in this book focused on other, more long-standing, challenges facing the economy of Israel in the mid-1980s, including inequality and the redistribution of income, the balance of payments, and the role of defense in the economy.

The focus of economic policy in the mid-1980s, however, was not on these chronic, long-standing challenges, but, instead, on the acute macroeconomic crisis facing Israel at that time. The uneven, but ultimately successful, path to the resolution of this macroeconomic crisis is chronicled in the 1993 book by Assaf Razin and Efraim Sadka, *The Economy of Modern Israel: Malaise and Promise*. They pointed out the importance of the political commitment to stabilization, a commitment that was made more credible both by the formation of a national unity government in which Labor and Likud shared power after the 1984 election, and by the severity of the circumstances by the summer of 1985.

After several failed efforts, the successful phase of the stabilization of the Israeli economy began with the heterodox program introduced in July 1985. The initial success of the stabilization program included a decrease in inflation, from 445 percent in 1984 to 185 percent in 1985 and 20 percent in 1986. There was also an increase in real economic activity, with the annual growth in business sector product per capita rising from 0.4 percent in 1984 to 4.3 percent in 1985 and 3.6 percent in 1986. But, in the second-half of 1987, the economy slid into recession, an event that Razin and Sadka maintained was “the inevitable outcome of the economic policy of 1986 – 1988.” (p. 49) Ultimately, however, the economy did recover in the late 1980s and early 1990s, a time when there was a new wave of immigrants from the former Soviet Union. As with previous waves of immigration, this one both presented challenges for integrating the *olim* into the economy and offered opportunities in terms of greater macroeconomic demand and enriching the economy with skilled citizens.

Another challenge facing Israel at the time Razin and Sadka wrote their book was the Intifada in the West Bank and the Gaza Strip, which began in December 1987. These two areas had been occupied by Israel since the Six Day War in 1967. As Razin and Sadka point out, the Intifada began at a time when Israel was already entering a recession, but they argue that “The Intifada, by itself, could not have pulled the Israeli economy into a severe slump because the economies of the West Bank and Gaza are very small relative to the Israeli economy.” (p. 71) They do show, however, that the Intifada contributed to economic distress in the West Bank and, to a greater extent, in Gaza. At the time Sadka and Razin completed their book, the first Intifada was “still intense” (p. 96), although its intensity had waned by time the book was published in 1993.⁷

The use of the word “Modern” by Razin and Sadka in the title of their 1993 book implicitly refers to the post-1985 period, a time when there was a greater consensus behind, and movement towards, liberalization and free markets than in earlier periods. The macroeconomic crisis of the early 1980s helped forge this consensus for economic reform. Another crisis in this period, the October 1983 Bank Share Crisis, also helped forge opinion in favor of a greater role of markets and less government intervention. With almost a decade’s perspective, Razin

⁶ This distinction between the date of completion of this book and its copyright date is important because the book’s contents do not reflect the watershed events of the summer of 1985.

⁷ The contributions to the Ben-Bassat volume, *The Israel Economy, 1985 – 1998*, were completed before the beginning of the second intifada in the autumn of 2000.

and Sadka discussed the Bank Share Crisis in *The Economy of Modern Israel: Malaise and Promise*, writing “The mechanisms through which banks raised their share capital was by far the greatest scandal in Israel’s financial history.” (pp. 189 – 190). Banks ‘regulated’ the price of their own shares, and this led to annual returns on bank equities of 30 percent to 40 percent per annum. These kinds of returns are clearly unsustainable and, since something that can’t go on forever won’t, there was a crash. This market manipulation also shows the lack of a deep, well-functioning capital market in Israel at that time. The banks actions were undertaken, according to Razin and Sadka “with the full knowledge (though not always with the explicit consent) of the government, the Knesset, and the Bank of Israel. Occasionally, the authorities even approved of the process.” (p. 190) In the wake of this crisis, after the government bailed out the banks by committing to buy their shares, “the need for a major reform was self-evident!” (p. 191).

The pressure for reform and liberalization that emerged out of the events of the early 1980s, and which continued through the 1990s, is reflected in the title of the most recent book reviewed here, *The Israeli Economy, 1985 – 1998: From Government Intervention to Market Economics*, edited by Avi Ben-Bassat. Both the title and the contents of this 2002 volume would lead a reader to date the beginning of the “modern” phase of the Israeli economy in the mid-1980s, a view consistent with that of Razin and Sadka. But, as evident from the title of the introductory chapter by Ben-Bassat, “The Obstacle Course to a Market Economy in Israel,” the general trend towards free markets and liberalization masks fits and starts in that process.

The volume edited by Ben-Bassat, like the 1986 book edited by Ben-Porath, is more wide-ranging in its scope than the four other books reviewed here. Both the Ben-Porath and Ben-Bassat volumes include chapters on overall macroeconomic performance, fiscal policy, monetary policy, and income distribution. But a quick examination of differences between topics covered in the 17 chapters of the 1986 volume and the 15 chapters of the 2002 volume reveals interesting insights about changes in the Israeli economy over this period. For example, the earlier book has a chapter entitled “Indexation in the Labor Market,” a topic of less relevance in the first decade of the 21st century than in the middle of the 1980s. There is not a separate chapter on defense spending in the Ben-Bassat volume, unlike the Ben-Porath volume, possibly because, as pointed out in the chapters by Moshe Justman and by Michel Strawczynski and Joseph Zeira in the Ben-Bassat volume, domestic purchases of defense goods and services dropped from 9.1 percent of GDP in 1982 to 3.5 percent by 1995. Justman’s chapter, in fact, is on the high-tech sector, one not mentioned in the 1986 volume, and he refers to defense spending to make the point that its reduction in the 1990s “...may have been the most important contribution of fiscal policy to the development of Israel’s high-tech industry...” (p. 457) The fact that financial market reform is the subject of the three chapters that constitute Part III of the Ben-Bassat volume, while not appearing as the topic of a distinct chapter in the Ben-Porath volume, tells much about the timing of this form of liberalization. Likewise, the presence of a chapter on the integration of *olim* from the former Soviet Union in the Ben-Bassat book (and the presence of a chapter on the same topic in the earlier book by Razin and Sadka), and the absence of any separate chapter on immigration in the earlier Ben-Porath book, reflects the timing of this latest wave of immigration.

About one million people emigrated from the former Soviet Union to Israel in the 1990s. A large Russian-speaking presence is evident in Israel these days in the conversations one

hears on the streets, and also because of the Cyrillic characters one sees on billboards and in markets. But these immigrants are integrating into the Israeli economy and, like *olim* before them, both changing the country and being changed by it. Zvi Eckstein and Yoram Weiss, in their chapter in the Ben-Bassat volume, noted that immigrants from the former Soviet Union had an exceptionally high level of education and, as a group, rose up through the occupational ladder after beginning at low-skilled occupations. They also noted that, in the 1990s, economic growth benefited from the wave of immigration.⁸ The statistics in Table 1 show that the growth rate of both GDP and business sector product per capita were higher in the 1992 – 2000 period than during the other post-1972 periods listed in that table.

As the new century began, however, the Israeli economy entered a difficult period. The growth in GDP averaged -0.8 percent in 2001 and 2002, and business sector product growth per capita was -4.6 percent in each of these two years. Many other industrial countries also suffered an economic slowdown at this time, and the spillover effects of a worldwide slump were felt in Israel. But other factors, such as the bust in the high-tech sector, and the contractionary effects on tourism and investment from the second intifada, also had an effect. There has been some recovery lately, with 4.3 percent growth in both GDP and business sector product per capita in 2004. Unemployment has remained high, however, with the 10.4 percent rate in 2004 marking the third year in a row that it exceeded 10 percent. The manner in which these challenges are addressed will, no doubt, be the subject of the next important book on the Israeli economy which, at the time of this writing, remains an ambition of its yet unknown author.

This review of the books and their times shows how the five common themes discussed in the introduction appear across these books, each of which was published in a different decade. I next shift focus and discuss, in turn, each of these five specific themes.

2. COMPARED TO WHOM?

The perfectly competitive economy presented in textbooks does not appear in the real world. Therefore, while some may take this ideal as a useful guide for dictating direction, it does not serve as a helpful benchmark for judging position. A discussion of a country's actual economic performance, and gauging the evolution of its economic structure, require some reference to the performance and structure of other countries' economies.

The question arises as to which countries Israel should be compared. Every country has its own peculiar circumstances, but those of Israel are, in important ways, distinct from that of other countries. Ben-Porath, at the beginning of the introductory chapter of the book he edited, mentioned some distinctive aspects of the Israeli economy, including its small size, its lack of natural resources, and its exceptionally highly educated labor force. In the second chapter of that same book, Syrquin noted that the antecedents to the modern Israeli economy, unlike that of many other semi-industrial countries, did not include strong internal

⁸ This positive correlation between immigration and economic growth is a long-standing characteristic of the Israeli economy, and even the earlier yeshuv economy, as noted by Ben-Porath in the introduction to his 1986 volume.

institutional barriers arising from entrenched interest groups (e.g. large landholders in a semifeudal agricultural system). But the key distinctions of the Israeli economy are provided succinctly in Ben-Porath's statement towards the beginning of his introduction, "The major distinguishing characteristics of Israel's economy ... are tied to its existence as a Jewish state in a hostile environment." (p. 2).

In its role as the Jewish state, Israel, unique among nations, has the goal of attracting immigrants and making one nation of them.⁹ The economic implications of the effort to attract and retain immigrants include a strong commitment to full employment and job security, as well as a high level of civilian public consumption and a large investment in the quality of housing which, as Ben-Porath wrote, reflects "... a tendency to mobilize an increasing share of resources to the immediate, direct and indirect, improvement of living standards." (p. 8)

Along with the responsibility of being the world's sole Jewish state, Israel's link to world Jewry also offers it some financial opportunities similar to that of other countries with a large diaspora community (e.g. Ireland, Armenia, and the Philippines). In its early years, financial assistance was also provided through German reparations. And, like many other countries, Israel receives foreign aid from the United States although, on a per capita basis, Israel heads the list of recipient countries.

The aid from the United States reflects, at least in part, the other point raised by Ben-Porath, of Israel's existence in a hostile environment. Much of the foreign aid given to Israel is directed towards its defense. But the defense needs of the country run far ahead of what is covered by aid and, consequently, a relatively large proportion of the expenditures of the government (as compared to other countries) is devoted to the military.¹⁰ Beyond this, ubiquitous security concerns also impose an effective tax on Israeli businesses and households.

While it is easy to focus on the distinctive aspects of Israel, and the manner in which those aspects have forged its economy, it is also important to place the country within a context of other nations in order to gauge its economic performance. But which nations should serve as a comparison group? Patinkin, writing in the late 1950s, boldly asserted "Israel is a modern economy." This statement, which begins the second chapter of his book, is reflected by the reference group he selected. Patinkin distinguished Israel from "...Egypt, India, China, and the like..." (p. 43) because, at that time, it did not have the population and educational challenges facing these countries, and also because of the level and growth of its national income by the end of its first decade. At the end of the 1950s, the national income of Israel was comparable to that of richer South American countries like Argentina and Chile, and to poorer European countries, like Ireland, Austria and Italy. Patinkin's expectations of a continued advance of Israel's economic standing among nations was also likely influenced by its rapid growth at the time he wrote his book, a growth rate that exceeded that of rich European countries like the Netherlands, West Germany and France.¹¹

⁹ Of course, this "one nation" also includes a substantial non-Jewish Arab population and Israel, like some other countries, faces the potential challenge of bifurcation into a dual economy.

¹⁰ However, as mentioned in Section 1, the share of defense expenditures has been decreasing over time.

¹¹ As mentioned in Section 1, the growth of Israel during its "miracle" years was exceptional; but European countries also enjoyed high rates of growth in the 1950s.

Halevi and Klinov, writing almost a decade after Patinkin, employed a somewhat less ambitious comparison group for Israel. Placing the economy of Israel, in 1968, in the context of other countries, they wrote that it is “well above the ‘underdeveloped’ level...[but] still below most of the developed countries of Europe and America.” (p. 93). They also noted that the national income of Israel “has grown unusually fast, but a number of other countries, particularly those showing rapid post-war recovery, have matched its per capita rate of growth.” (p. 93) Some sixteen years later, when Ben-Porath was writing the introductory chapter of the book he edited, he noted that Israel headed the World Bank list of “Upper Middle Income countries” and that it ranked 30th (out of 118 countries) as an exporter of manufactured goods.

The set of countries that one chooses for a comparison group depends upon the issue of concern. In the 1980s, the dominant concern for the Israeli economy was stabilization and, accordingly, Razin and Sadka, in their 1992 book, compared the performance of the stabilization efforts in Israel to those of other countries with an experience of efforts to halt high inflation; Argentina, Bolivia, Brazil, Chile, and Mexico. A decade later, Stan Fischer and David W. H. Orsmond, who also wrote on inflation in Israel, compared its experience to the experiences in nine other countries; Argentina, Brazil, and Croatia, which moved from high to low inflation; Chile, Egypt and Greece, which went from a period of moderate inflation to low inflation; and Colombia, Hungary and Mexico, which also had moderate inflation but did not reduce inflation as much as the previous set of three countries. The fact that Egypt, eschewed by Patinkin for one type of comparison, is selected by Fischer and Ormand for another type, illustrates the point that context determines the relevant set of comparison countries.

A third dimension along which Israel is compared to other countries, along with level of income and experience with macroeconomic instability, is the role of government in the economy. Patinkin, voicing concern with the solvency of the economy, argued that the Israeli government should generate a surplus, or at least stop running a deficit, which, he noted, “...are characteristics of European countries.” (p. 105). Of course, one could argue that the economic structure of Israel at the end of the 1950s was quite distinct from that of European countries. This comparison with industrial countries in the context of government spending continued with Halevi and Klinov, when they noted that the Israeli government’s level of consumption, at 15 to 20 percent of overall consumption, was comparable to levels in the United States, the United Kingdom, and Sweden. By the time Ben-Bassat’s book was published, the metric for measuring the role of the government was broadened beyond government consumption to a broader index of regulation and liberalization. Ben-Bassat, in the introductory chapter of his book, cites Israel’s standing in the Economic Freedom Index and notes that its position in that index indicates that, at the end of the 1990s, Israel was less liberalized than South American and semi-industrial countries.

Thus, overall, there has been a shifting set of countries to which Israel was compared in these books. One reason for the differences across time in the reference set is because of a change in the focus of concern. Another reason is that early aspirations gave way to a more circumspect analysis. It is also probably the case that the comparison group used by a particular author says something about that person’s own visions, hopes and concerns as well as Israel’s economic standing in the community of nations.

3. IMMIGRATION, INTEGRATION AND INEQUALITY

“All happy families are alike; each unhappy family is unhappy in its own way.”

“Call me Ishmael.” “It was the best of times, it was the worst of times...” “I am an American, Chicago born.”¹²

Sometimes the beginning of a book reveals much of its essence. The first words of the first major book on the Israeli economy, Patinkin's *The Israeli Economy: The First Decade* (1959), are “Ingathering of the exiles.” He went on to write, in the first paragraph of the book, “The ultimate criterion by which the Israel economy must be judged is its success in ... integrating these new immigrants into its productive labor force.” The new immigrants to which Patinkin referred were those from Egypt, in the wake of the 1956 Sinai campaign, and, those who came a year later, primarily from Hungary and Poland.

Patinkin's opening words reflect a uniform view across these books concerning the centrality of immigration for Israel. For example, Ben-Porath, at the beginning of the introductory chapter of the book he edited, wrote “Israel is a country established for and run by immigrants from diverse countries and backgrounds. Its *raison d'être* is to gather, retain and forge these immigrants into one nation.” (p. 2) In the midst of the large-scale immigration from the former Soviet Union, when there was still a great amount of uncertainty as to its effects, Razin and Sadka were hopeful as to its consequences for the nation. They close their book with the statement, in the last paragraph of the epilogue, “After many years, Israel is again blessed with a massive wave of *aliya*, the gathering of the exiled, the very soul of existence of Israel.” (p. 225)

Immigration to Israel has occurred in waves, and the degree to which any particular book focuses on immigration partially depends upon the time in which it was written. The absence of a separate chapter on immigration in the Ben-Porath volume may reflect the opinion voiced by Jacob Metzger in that book that “... the major sources of potential large-scale immigration seem to have run dry.” (p. 100) Like virtually everyone else at that time, Metzger did not anticipate the collapse of the Soviet Union and the implications of this event for the population of Israel. But, by the time Razin and Sadka published their book, in which one of its five parts is devoted to the issue of immigration, the *aliya* from the former Soviet Union was well underway. By the beginning of the 21st century, Zvi Eckstein and Yoram Weiss were able to look back at the immigration experience of the 1990s and analyze the extent to which immigrants integrated into the economy in their chapter in the Ben-Bassat volume.

Table 2 presents data on the population of Israel, its net immigration, and the proportion of population growth due to immigration, for seven periods from the time of the founding of the state until the first years of the 21st century. This table shows that Patinkin wrote at the end of a decade when net immigration contributed to two-thirds of the country's population growth. The role of immigration remained strong for the next two decades, but its contribution to population growth decreased to 6 percent in the mid-1980s when Metzger wrote of the depletion of potential sources of immigration. A few years on, immigration was

¹² These are the opening words of *Anna Karenina* by Leo Tolstoy, *Moby Dick* by Herman Melville, *A Tale of Two Cities* by Charles Dickens, and *The Adventures of Augie March* by Saul Bellow, respectively.

Table 2
Israeli Population and Immigration

Period	Population, Beginning of Period	Net Immigration	Immigration / (Total Population Growth)
1948 – 1960	805.6	869.4	0.65
1961 – 1971	2,150.4	339.8	0.38 ¹
1972 – 1982	3,115.6 ³	183.5	0.20 ²
1983 – 1989	4,033.7 ³	31.1	0.06
1990 – 1995	4,559.6	593.5	0.56
1996 – 2000	5,612.3 ³	296.2	0.39
2001 – 2003	6,369.3	72.3	0.19

¹ Excluding the addition of the Arab population from East Jerusalem in 1967.

² Excluding the addition of the Arab population from the Golan Sub-District in 1982.

³ Discontinuity due to Census results: see website.

Source: *Statistical Abstract of Israel, 2004*, Central Bureau of Statistics, www1.cbs.gov.il

again ascendant and responsible for more than half of the population growth of the country in the first half of the 1990s. Immigrants had increased the population of Israel by about one-fifth by the end of that decade. After this huge inflow, the beginning of the 21st century saw a decrease in immigration, both in absolute terms and in terms of its contribution to the growth of the population of the country.

The vitality of the Israeli economy, and indeed the mission of the State itself, is achieved by the integration of immigrants into the society and the economy. Therefore, the topic of the economic integration of immigrants appears across the books reviewed here. For example, Patinkin, following his statement on the ingathering of exiles, continued in that same first paragraph “The ultimate criterion by which the Israel economy must be judged is its success in ... integrating these new immigrants into its productive labor force.”(p. 1) He was particularly concerned that the 7 percent unemployment rate at the time he was writing would be an impediment to the absorption of the new immigrants. But, despite these concerns, he wrote “Nevertheless, the integration of most of the increased population into its productive labor force has been one of the significant accomplishments of the Israel economy in the first decade of its existence.” (p. 42)

But almost a decade after Patinkin wrote of significant accomplishment in this area, Halevi and Klinov observed “Far from having been solved, the problem of integration is perhaps the main challenge facing Israel in the future.” (p. 5). One source of concern was unemployment, which rose from an average of 3.6 percent between 1961 and 1965 to 7.4 percent in 1966 and 10.4 percent in 1967. Halevi and Klinov viewed attaining a low unemployment rate “an economic achievement of prime importance.” (p. 67) They also noted that the adequacy of housing was an important issue for attracting and retaining immigrants, a point that was also mentioned by Ben-Porath in the introduction to his 1985 book.

A different type of concern about the integration of Soviet immigrants was voiced by Razin and Sadka. While acknowledging the high endowment of human capital of these *olim*, they worried that “Because their training and work experience come from the Soviet Union, it may take time to train and fit them into the relatively modern, Western-style techniques and rigors of the market economy of Israel.” (p. 109) To some extent, Eckstein and Weiss allay these fears in their contribution to the Ben-Bassat volume since they found “...immigrants

adapt *gradually* to the Israeli labor market ... This process is reflected in the initially low wages of immigrants, about half the wages of comparable natives, followed by a sharp increase in wages with time spent in Israel.” (pp. 353 – 354)

The steep wage profile of Soviet immigrants may eventually eliminate wage differentials between them and natives. But the issue of inequality, especially with respect to country of origin, is one that has been present since the founding of the State. Patinkin anticipated this early on, noting that the unemployment rate in the 1950s was higher among immigrants from Asia and Africa than among those from Europe and the Americas. Halevi and Klinov also voiced concern with increasing inequality between North African and European immigrants, even though they noted that the income distribution in Israel was “more equal than other [countries]” and “is as close to equality as that of any other nation for which data are available.” (p. 117). To these authors, however, the relative standing of Israel among nations was less important to them than the ideal of more complete equality.

A decade after Halevi and Klinov published their book, one might have been buoyed by the diminished level of inequality in Israel. The Gini coefficient (for income inclusive of transfers) decreased from 0.358 in 1968 to 0.337 in 1979. But, as noted by Yehuda Geva and Jack Habib, in their chapter in the Ben-Porath volume, inequality had begun to rise in the second half of the 1970s; the lowest value of the Gini coefficient, 0.314, was in 1975. (p. 213) This trend towards increased inequality continued more or less unabated for the rest of the century, as mentioned by Momi Dahan in his chapter in the Ben-Bassat volume. Transfers and taxes somewhat ameliorated this; the Gini coefficient inclusive of transfers rose from 0.339 in 1980 to 0.362 in 2002, while the coefficient excluding transfers rose from 0.434 to 0.532 over this period. Like Klinov and Halevi almost forty years before, Dahan considered the context for this change and noted that “Israel’s level of net income inequality is not exceptional given its level of economic development.” and that Israel is “...not unique in evidencing an upturn in earnings inequality.” (p. 495) Nevertheless, the current rise in inequality is troubling and attracting increasing attention; for example, the Bank of Israel included a chapter entitled “Welfare,” which focuses on poverty, for the first time in its 2004 *Annual Report*.

4. THE ROLE OF MARKETS AND THE GOVERNMENT IN THE ECONOMY

There is a view that the absorption of immigrants from the former Soviet Union went more smoothly than would have been the case had Israel not undertaken a commitment to greater economic liberalization, beginning in the late 1980s. In the chapter in the 2002 Ben-Bassat volume on import liberalization, one facet of this move towards the market, Yoram Gabai and Rafael Rob wrote “Because Israel invoked its import liberalization at a time of mass immigration from the former Soviet Union, its economy absorbed the extra increment of labor in industries that were making efficiency efforts. The liberalization and immigration processes converged, and unemployment rates declined from 12 percent to 6 percent and the additional labor integrated into all industries.” (p. 305)

The liberalization process referred to by Gabai and Rob had its earliest antecedents in the 1952 New Economic Policy program. Some insights as to the state of the economy before

this program are provided by Halevi and Klinov, as well as by Michaely. Michaely noted that, during the 1920 – 1947 *yeshuv* period, the Jewish sector of Palestine began to develop a “state in the making.” The Jewish Agency, recognized as political representative of Jews in Palestine, channeled aid from diaspora, establishing agricultural settlements and promoting certain industries. Halevi and Klinov argued that this experience during the *yeshuv* period set the stage for the subsequent period after the Mandate, writing “Unlike the Government of Palestine, the Jewish national institutions adopted an attitude towards public responsibility for economic development that was foreign to most of the non-Communist world until the 1950s. ... With the advent of the State of Israel, the stage was set for a meeting of two strands of policy for economic development: the acceptance of economic development as a primary goal of government economic policy in all its forms and the continuation of the national institutions’ activities in channeling the contributions of world Jewry towards the development of Israel.” (p. 39).

These “national institutions” referred to by Halevi and Klinov include uniquely Israeli non-government actors that influenced economic outcomes in a way that was not necessarily consistent with the market, such as the Histadrut (which was established in 1921), the Jewish Agency, and the Jewish National Fund. Michaely pointed out that, at the time he was writing in the early 1970s, the basic statistics on the Israeli economy overstated the role of the market since, while only one-fifth of the economy was explicitly governmental, another fifth was within the dominion of the Histadrut. He distinguished, however, between Israeli-style government management and more *dirigiste* government-planning. Nevertheless, he stated “Ever since the establishment of the state, economic policy has been conducted in a strong spirit of governmental interventionism.” (p. 5) He also noted that the existence of profits in an industry would give rise to the suspicion that the national cause was being subverted by that sector, especially since there was the view that “economic laws do not hold in Israel.” (p. 5) In the time since Michaely wrote these words, however, the influence of groups like the Histadrut and the Jewish agency have diminished.¹³

The first moves away from government intervention in the economy, as mentioned in Section 1, came in the wake of the 1951 crisis. This crisis marked a turning point for the Israeli economy by de-legitimizing comprehensive non-market controls as a policy tool. But there is a vast gulf between an absence of comprehensive non-market controls and a fully liberalized economy. The discussion in Section 1 describes how the process of liberalization continued, albeit somewhat unevenly, across the decades. In this section, I discuss the evolution of thought, across these books, in two particular areas; the general role of government, and the role of government in the important arena of investment. The topic of the role of the government in the economy, however, is inexorably linked to the topics discussed in the next two sections as well, openness and macroeconomic management. Therefore, the discussion on the role of government in this section is taken up again in Sections 5 and 6.

4.1 The overall role of government in the Israeli economy

The appropriate role of government in the Israeli economy is not an explicit focus of Patinkin in his book *The Israel Economy: The First Decade*. In the second chapter of his book,

¹³ The power once commanded by the Histadrut is reflected by the remark of Professor Abba Lerner, who said “The workers have a Histadrut and Histadrut has a government.” (quoted by Halevi and Klinov)

“The Growth of National Product and Income,” he did note that, by international standards, government played a big role in the Israeli economy in the 1950s. Patinkin attributed this to the importance of defense spending, as well as to issues of measurement. He also briefly mentioned the pattern of ownership, raising the point of the role of the Histadrut. But, overall, there is only a small amount of discussion in this book on the appropriate role of government in investment or in export promotion, and that discussion does not point strongly towards a view that government evidenced too big, or too small, a role in the economy.

One can interpret the institution of the second New Economic Policy in the early 1960s, however, as evidence of a strengthening view that the role of government in the economy should be scaled back.¹⁴ Halevi and Klinov gave voice to this view in the introductory chapter of their 1968 book. They argued that policy administration and planning had been of poor quality, and the most severe problems in the economy were found in places that had the greatest government intervention. They conceded that government controls were warranted in some instances, but also mention that mistakes were made. They also distinguished between direct intervention by the government in response to events like waves of immigration or reversals in capital flows, and other, more ideologically-driven roles. In this latter category, they documented and anticipated difficulties in persistent government involvement. For example, discussing efforts to promote agriculture, they write “settlement activity gradually abated and then came to a virtual stop as economic problems countered the ideological desire to increase the relative importance of agriculture.” (p. 105)

Concerns that the hand of government remained too prevalent in the economy continued to be voiced almost two decades after Halevi and Klinov wrote these words, by Ben-Porath in the introductory chapter to his book, and by Gur Ofer in his chapter on the provision of public services in that book. Ofer wrote “It is generally agreed in Israel that the public sector is too big ...” but he also mentioned that “On the other hand, it must be generally accepted that the social value and the value for the individual of most medical and educational services provided by the public sector is higher than the value of many goods and services consumed as private consumption.” (p. 208) Ben-Porath characterized the Israeli economy of the mid-1980s as one with a high level of civilian public consumption, government control of the capital markets, pervasive subsidies, and policies that tended to disconnect economic incentives facing individuals from economic reality. He also argued that excessive economic activity took place in organizations motivated by complex objective functions (including responding to vested interests), with cost-accomodating budgets uncontrolled by market pressures. Ben-Porath concluded the introductory chapter to his book warning

“The country as a whole must achieve self-reliance and change its economic and social structure, bringing about a convergence of standards of living, effort and productivity. This task involves reassessing the role of the public sector and abandoning many of the modes of behavior that characterize both a private sector that has grown under the protective canopy of government and an entire economy that has grown under the protective shield of another country.... the longer the delay, the higher the price paid. Whether the political system will muster the strength to effect a change before some major catastrophe occurs, and whether it can design an equitable way to do so, remains to be seen.” (pp. 22 – 23)

The urgency in Ben-Porath’s words no doubt reflected the growing crisis at the time he penned them in 1984. One of the legacies of this crisis, as was the case with the crisis

¹⁴ This was especially true in the role of government in export promotion and import control, a focus of Michaely in his book, and a point that discussed in the next section.

in 1951, was a re-evaluation of the role of the government in the economy. Once the acute macroeconomic problem of runaway inflation was vanquished, attention turned to microeconomic issues including that of the appropriate role of the government. This point is made by Razin and Sadka, who wrote in the early 1990s “The stabilization program drastically changed the focus of attention of policymakers, economists, members of the business community, and the public at large from the problem of how to cope with high and rising inflation back to the real issues of market structure, international competitiveness, savings and investments, productivity, and growth.” (p. 3)

Razin and Sadka argued, however, that the role of the market was more pervasive in the economy of Israel than commonly thought. For example, in the introductory chapter of their book, they write “Over its brief history, ...several myths were built around [the Israeli economy including that it] is an Eastern Bloc – type socialist economy, the ‘last bastion’ of Stalin – type planned economy.” (p. 5 – 6) In particular, Razin and Sadka made the point that the tax burden in Israel was not especially onerous, writing in the introduction “Israel’s corporate tax rate...is among the *lowest* rates among industrial countries.” (p. 5 – 6, emphasis in original) and, in their chapter “Tax Structure,” they wrote “The total tax burden in Israel, when measured by total tax revenue as a percentage of GDP, is significantly higher than in the United States, Canada and Japan, but about ‘average’ or slightly higher than in the Western European countries.” (pp. 136 – 137) Nonetheless, they conceded “...the indirect tax burden in Israel is very high, in fact, much higher than in [Belgium, Canada, France, Germany, Italy, Sweden, US, UK, Japan, and is due to] the many excise taxes that are levied at extremely high rates.” (p. 137 – 138) Furthermore, they also wrote that “A persistent problem of the Israeli economy is the excessive level of government ownership of commercial companies. Despite the declared policy of privatization, very little progress has been made.” (p. 7)

The title of the most recent book reviewed here, the 2002 volume edited by Avi Ben-Bassat *The Israeli Economy, 1985 – 1998: From Government Intervention to Market Economics*, is consistent with the points made by Razin and Sadka on both the time the most recent round of structural change in the Israeli economy commenced and its direction. Strawczynski and Zeira, in their chapter on fiscal policy in this book, wrote “Prior to 1985, the relative size of the public sector was the highest in the world.” (p. 65) but they noted that, in the 1990s, the size of the public sector became comparable to that of many European countries. They also noted that “one of the most dramatic processes since 1985 has been a gradual privatization, both of public companies and public services and activities.” (p. 66) In the introduction to this book, Ben-Bassat wrote “The economy is structured much differently today than it was on the eve of the stabilization program. Government involvement in the various markets has decreased perceptibly, and economic competitiveness has risen.” (p. 54)

The decrease in government involvement is evident in many sectors of the economy. I next turn to one in particular, the capital markets, and discuss how views on government involvement in this market, and in directing investment, have evolved over time, as evidenced by the discussion in the books reviewed here.

4.2 The Government and the Israeli Capital Market

In its early years, the national government and the Jewish Agency had a big role in directing investment in Israel towards areas thought important for the country’s development.

Reflecting on this, Patinkin asked the rhetorical question “Could the role of private investment been greater, or was it directly or indirectly restricted by government activity?” (p. 91) His conclusion was that the government caused little crowding out of private investment because, in his view, the financing it obtained in the 1950s would have been unavailable to the private sector. He did not focus on the question, however, of the allocation of investment and whether government investment was well directed.

The 1960s saw the beginnings of a shift away from the prevalence of non-market investment decisions. Halevi and Klinov made this point at the beginning of their 1968 book when they wrote “The degree of intervention [in the capital market] and its form are therefore in flux.” (p. 4), although, towards the end of the book, they stated “...it is difficult to see any clear trend indicating a reduction in public initiatives or control of investment activity.” (p. 210) The issue of the allocation of investment is mentioned several times by Halevi and Klinov, and their views on this are reflected in the sentences “There is no clear connection between the rate of return and trends in investment. This probably reflects the prominent role of government in directing investment by undertaking it directly, as well as by financing private enterprises at preferred terms.” (p. 132) The policy conclusion drawn from this view, if not already evident, is captured by the statement at the conclusion of their chapter on public finance “... we have no doubt that much resource misallocation could have been avoided if the effects on allocation had been fully taken into account when the various government growth incentives were considered and implemented.” (p. 223)

The appropriate allocation of investment continued to be a concern in the decades following the publication of Halevi and Klinov’s book. In the mid-1980s, Joram Mayshar concluded his chapter “Investment Patterns” in the volume edited by Ben-Porath with the words “... one may note the ever more pressing need to allocate investment resources efficiently in a period of reduced growth and increased pressure on resources. So far, the Israeli economy does not seem to have met this challenge successfully.” (p. 118)

As mentioned above, the crises of the 1980s were a turning point for the Israeli economy in many ways, including the role played by the government in the capital market and in allocating investment. Razin and Sadka, writing in the early 1990s, acknowledged that “For years, the government’s hand and foot were very much visible in the capital market.” (p. 186) but went on to argue that “Much freer financial markets have started to play their natural role as a meeting place between savers and investors.” (p. 186)

Joseph Djivre and Daniel Tsiddon, in their chapter on the conduct of monetary policy in the Ben-Bassat volume, provided a date when financial markets began to play their natural role; April 1987, when the government began to phase out capital market restrictions that maintained its role as a monopsonist. They argued that this liberalization led to the development of the private capital markets in Israel. They also argued that the liberalization of international capital flows into Israel, was “... a necessary step for enforcing the competition pricing of the cost of capital in Israel, thereby achieving an efficient allocation of resources in the domestic capital market.” (p. 102) In fact, Djivre and Tsiddon “... identify the liberalization process as the major competition-enhancing factor in financial markets.” (p. 123) The importance of capital account liberalization for enhancing the productive allocation of investment is also discussed in a later chapter in the Ben-Bassat volume. The authors of that chapter, Gottlieb and Blejer, wrote “With the benefit of hindsight, we conclude that in spite of temporary setbacks the strategy of gradual but adamant pursuit of liberalization-cum-stabilization has been a successful approach.” (p. 273)

4.3 Looking Forward: The Durability of Reform in Israel

Will the “gradual but adamant pursuit of liberalization” continue in Israel? What will a future reader of a book reviewing the first few decades of the 21st century conclude about the evolution of the roles of the government and the market in the Israeli economy?

There are reasons to think that, at least over a reasonable time horizon, the movement towards a greater role for the market will prove durable. This is especially true if, both in the halls of government of Israel and, more broadly, worldwide, the current tendency to favor markets over planning continues. Ben-Bassat, in the first chapter of his book, wrote that the structural reform of the 1990s was “the result of a profound change in the economic thinking of policymakers and has also been influenced by regional and global geopolitical processes.” (p. 1) He characterized the broad public consensus in Israel at the end of the century as one that sees economic vitality originating with the private sector.

Another reason for the durability of these reforms is that they have, to some degree, been locked in through legislation. Strawczynski and Zeira cite two important acts, 1985 Law of No Printing that prohibited the Bank of Israel from lending money to the government to finance its deficit, and the 1991 Budget Reduction Law, that set a future path for diminishing deficits, as important policy tools for realizing the goals of reducing the size of the government. They argued that “...the reduction of subsidies to the business sector was not motivated by fiscal prudence only, but can also be viewed as part of an ongoing process of liberalization, in which the government reduces its active role in production and allocation.” (p. 79)

But views can change, and laws can be repealed. Ultimately, the durability of reform depends upon its success. Of course, the success of reform, especially over a long horizon, remains uncertain. Nevertheless, Ben-Bassat, while acknowledging the slow pace of reform, and its still incomplete nature, wrote of his confidence in its durability because of the potential it unleashes. In the final section of the introductory chapter to his volume, entitled “Summary and Lessons,” he wrote “After the stabilization program was implemented, a new economic approach took shape, was applied in most years since then, and has achieved a success worth imitating. There have been deviations from the path, for which a heavy price was paid, but these are exceptions that prove the rule.” (p. 52)

5. ISRAEL IN THE WORLD ECONOMY

Golda Meir once remarked “Let me tell you something that we Israelis have against Moses. He took us 40 years through the desert in order to bring us to the one spot in the Middle East that has no oil!” She might have added that this spot also had insufficient fresh water, malarial swamps and very little in the way of any natural resources.

Michaely reported that, in the first few years of the existence of the State of Israel, this lack of resources, combined with sparse industrial skills, led to a government policy that leaned toward autarkic development. This quickly proved untenable, however, and the government altered its view. The extent to which trade was embraced early on in the State’s existence led Razin and Sadka to write, in 1993, “Israel has never been an economic enclave, isolated by trade barriers from the rest of the world. Its volume of trade has always been remarkably high.” (p. 175) They continued “Over the forty-five years since its birth, Israel has gradually,

although with many ups and downs, undergone a process of liberalization both on the trade side and on the capital side.” (p. 175) Updating this view, Gabai and Rob concluded their chapter on import liberalization in the 2002 Ben-Bassat volume with a paragraph that includes the sentence “During those years [1989 – 1995], Israel completed the process of opening its economy and became one of the most open economies in the world, in which its comparative advantage industries would blossom.” (p. 306).

But the “many ups and downs” in the trade liberalization process were not incidental. Razin and Sadka also wrote of the “government’s heavy involvement in Israel’s external economic relations” (p. 175), although they maintained this “was not intended as much to constrain the volume of trade as to control its composition”. In this section, I first discuss the evolution of thought about the overall volume of trade. The swings in views on this point are more pronounced than those on any other topic discussed in this review. I then turn to a discussion of the evolution of thought on efforts to control the composition of trade, as well as its volume, through the use of prices and exchange rates.

5.1 The Import Surplus

Notwithstanding the claim by Razin and Sadka concerning the Israeli government’s focus on the composition of trade rather than its overall volume, the net trade position of the country, somewhat euphemistically termed its “import surplus,” was, according to Ben-Porath in 1985, “a central economic issue since Israel was established” (p. 8) Indeed, the import surplus was a major preoccupation and concern of Patinkin in his 1959 book. Modern international macroeconomic theory shows that funding investment through foreign borrowing can be optimal for an economy with good growth prospects. This was not the view of Patinkin, however, as demonstrated by his statement “The stress on domestic dissaving is the result of our underlying assumption that the continued development of the Israel economy in the future is vitally dependent on the emergence of private savings.” (p. 100) This point is reiterated in the concluding chapter of his book, where Patinkin wrote “It is taken as axiomatic that a decline in this degree of dependence is one of the goals of the economy: indeed, a necessary goal, in view of the anticipated decline over the next few years of those sources which have so far financed the import surplus.” (p. 126) Patinkin acknowledged that the goal of economic independence may conflict with other goals like integrating immigrants, providing for the national defense, and promoting development and a rising standard of living. But, despite this, Patinkin viewed the continuing dependence on foreign financing in the 1950s, especially with the prospect of the end of German reparation payments in the 1960s, as “...the major failure of Israel economic policy in its first decade.” (p. 132)

In response to this perceived failure, Patinkin called upon the government to act. He thought that there was scope for a positive policy response to what he viewed as the major challenge for the Israeli economy, writing “...the size of the import surplus can be significantly affected by the policy decisions of the economic authorities...”. (p. 127) This policy would induce producers “...to direct their efforts toward new commodities, new productive techniques, and new markets.” (p. 137) He also felt that there would be dire consequences if his advice were not heeded. A reader of Patinkin’s book in 1959 would have finished this work, by the most prominent Israeli academic economist of the day, sobered by the warning in the concluding chapter of the book “Unless definite policies are adopted to change the relative structure

of the economy's production in favor of import-substitution and exports, the economy will once again be in danger of failing to exploit its growing GNP for the purpose of significantly increasing its degree of economic independence." (p. 139 – 140)

A decade on, this same reader might have wondered why Patinkin's worst concerns had not been realized. An answer was provided by Halevi and Klinov. Halevi and Klinov were, of course, aware of Patinkin's warnings, noting "The existence of zero or even negative savings in the Israeli economy has frequently been viewed with alarm." (p. 97) But they pointed out that much of the foreign financing was concessional, with unilateral transfers representing 70 percent of the import surplus. They also were optimistic about the ability of the Israeli economy to attract foreign funds. These funds would be beneficial, rather than a source of concern, since "...the import surplus served the important goal of providing savings to economy." and "... whether saving is positive or negative is important only to the extent that it determines investment and thus the rate of economic growth." (p. 97) The most direct answer provided by Halevi and Klinov on the source of the import surplus, one that also reflects the difference between their concern about this issue and that of Patinkin a decade earlier, is given in their statement "Thus, the simplest answer to the question why Israel failed to generate much domestic saving is that it was not necessary!" (p. 97)

Concern with the import surplus, however, persisted over the next few decades. Berglas, in his contribution to the 1985 Ben-Porath book, wrote "So far, it can be said that the government has still not found an economic policy that would reconcile a large defense expenditure, price stability, and a manageable import surplus." (p. 191) Both Klinov and Halevi, in their separate contributions to this volume, also revisited this issue that they discussed almost two decades earlier. Halevi wrote "Although the import surplus has not increased in relative importance, it has grown tremendously in absolute dollar terms, especially since 1972." (p. 243 – 244) Of course, Klinov and Halevi could not have forecast this growth in their 1968 book. Given an opportunity to reflect on the large increases in foreign debt since the early 1970s, Halevi concluded his chapter with "Israel's failure to prevent increases in the import surplus in recent years and the concomitant growth of foreign indebtedness and increased reliance on short-term obligations have brought it to a precarious position." (p. 263) while Klinov began her contribution to that book with "Although unilateral transfers finance 60 to 75 percent of the import surplus, the cumulative debt resulting from the residual, loan-financed part has become increasingly burdensome, and the prospect of a future decline in unilateral transfers is a further source of worry." (p. 119)

But once again, the passage of time saw a change in the view of the implications of the import surplus. The term "import surplus" does not appear in the 1992 book by Razin and Sadka. Their one reference to foreign financing in that book is in the context of the wave of immigration from the former Soviet Union, when they wrote that the "*aliya* produced massive investments, both in residential structures and in nonresidential capital...It is noteworthy that in general the massive investments in physical capital were financed by capital imports, as the *olim* themselves fled their former homes almost penniless." (p. 105)

Likewise, the term "import surplus" is absent from the 2002 book edited by Ben-Bassat. This most likely reflects the relative contraction of Israel's external debt in the 1990s, as well as the fact, noted by Justman in his contribution to that book, that the increase in investment by the business sector in the 1990s "...was made possible by far-reaching changes in Israel's capital markets, which enabled it to take part in the worldwide trend toward globalization of financial markets and opened up new channels for foreign investment." (p. 451) Evidence

of the liberalization of Israel's traded goods and international capital market in the 1990s is provided in that same volume in the chapter by Gottlieb and Blejer. They noted that an acceleration of liberalization efforts in 1998 led to an increase in Israel's ranking in an IMF index of the freedom of movement of goods and assets across borders from the 60th percentile in 1996 to the 75th percentile in 1998. (pp. 269 – 271)

The policy response to the concerns about the import surplus was often an effort to alter the relative price of traded goods in order to promote Israeli exports and to shield Israel's industries from international competition. As these concerns waxed and waned, so did the role of the government in its efforts to alter the relative price of traded goods. But, as will be seen in the next section, the authors of the books reviewed here, even when concerned about the import surplus, were generally not in favor of a strong government presence in managing relative prices.

5.2 Exchange Rates and Prices

Belief in the benefits of free trade is one of the hallmarks of a mainstream economist. Thus, it is not surprising that the authors of the books reviewed here tend to be concerned with distortions associated with import protection or export promotion. It is also not surprising, in light of both anxiety about the import surplus and the views in policy making circles in Israel on the role of government in development, that Israeli economic policy has given these writers much to be concerned about.

The exchange rate has always had an important role in Israeli economic policy.

The centrality of the concern about the import surplus in Israel from the time of the founding of the state until the mid-1980s focused attention on the exchange rate, as well as other policy variables that affected the availability and the relative price of imports and exports. Subsequently, efforts to combat high inflation, beginning with the "Hamesh-Hamesh" (5 – 5) plan of 1982, and continuing with the more successful stabilization plans in the mid-1980s, used the exchange rate a nominal anchor. As discussed by Razin and Sadka, "Initially, as the country adopted severe restrictions on international capital flows, the exchange rate served mainly to regulate aggregate real demands and supplies (and, consequently, external imbalances). Gradually, as the economy became more open to international capital flows, the exchange rate policy became interrelated with monetary and inflation policies." (p. 9) In this section, I focus on the role the exchange rate and other policy instruments played in altering the relative prices of traded goods. The role of the exchange rate as a nominal anchor in macroeconomic stabilization plans is addressed in Section 6.

The quote by Razin and Sadka illustrates both the uses of the exchange rate as a policy instrument and the environment (regarding capital mobility) in which that instrument was deployed. It is important to note that the change in the environment from capital account restrictions to greater liberalization was not particular to Israel. Perhaps more than any other topic in this review, a discussion of the change in thinking about exchange rate policy must take into account the worldwide context of that policy rather than just events in Israel. For example, when Halevi and Klinov wrote in 1968 "...virtually all policy makers and many local economists do not yet consider ...[flexible exchange rates] appropriate for Israel." (p. 224), one should recall that, at that time, this opinion was widely shared by economists and policy makers in other countries as well.

Nevertheless, exchange rate policy in Israel did not just mimic exchange rate policy in other countries, but responded to specific national issues. For example, we have seen that the focus of concern of Patinkin was the import surplus and, consequently, he called for “definite policies ... to change the relative structure of the economy’s production in favor of import-substitution and exports...”. (p. 140) While acknowledging that “The market mechanism could probably be used here to greater advantage than it has been heretofore.” he continued “But even with its aid, the shifting of resources takes time...Furthermore – if the past is any indication – this process will not take place of itself.” (p. 139 – 140).

The way in which the government did not wait for “the process to take place of itself” is documented by Michaely (1975). Michaely detailed the ways in which the government attempted to influence the pattern of production in the economy and affect the composition and volume of imports and exports through the use of restrictions on imports, policies to promote exports, subsidies, tariffs, and the use of multiple exchange rates.¹⁵

Michaely painted a picture of a Byzantine system of restrictions, subsidies, and tariffs in the 1950s and the early 1960s. This system was, through its efforts at micromanagement, effectively an industrial policy. Its components included multiple exchange rates (from 1952 to 1954), premiums for certain types of output (until 1962), the Pamaz plan under which exporters could use their proceeds to purchase intermediate inputs (in effect from 1953 to 1959), and beginning in 1959, Branch funds to foster exports. The consequence of these policies was a wide dispersion in rates of effective protection. As an example of the effect of these policies, Michaely noted that the 67 percent devaluation in 1962 resulted in an effective increase in the price of exports by only 13 percent.

A focus of Michaely’s book is the distortions introduced by this patchwork of controls and intervention in the economy. He reported that, by the early 1960s, most policymakers were convinced that quantitative restrictions had led to a costly misallocation of resources (e.g. Michaely offered the example of subsidies that led to feeding chickens with bread). A concern about this, as well as a concern about the implications of the cessation of German reparation payments for the import surplus, led to the introduction of the Second New Economic Policy in 1962. The goal of this policy was to rationalize the system of controls on traded goods and to move from quantity restrictions to more transparent price controls.

But the distributional costs of the Second New Economic Policy made its implementation difficult. Michaely wrote “Once an economy has been subjected to exchange controls and import prohibitions for a long period, its whole industrial structure has been determined accordingly, and it is very difficult to introduce changes that open the economy to import competition, if that competition lowers effective protection.” (p. 80) Furthermore, the implementation of this policy made apparent a controversy between those who favored the use of the price mechanism to determine the long-run exchange rate, and to let the allocations respond to this (economists at Hebrew University, the Bank of Israel, and the Ministry of Finance), and those who wanted to use discriminatory policies to foster development (members of the Ministry of Commerce and Industry).

¹⁵ As mentioned, Michaely’s book is more narrowly focused on foreign trade than the other books reviewed here. This is reflected in the titles of its seven chapters; “The Israeli Economy: An Overview,” “Comprehensive Controls and Partial Liberalization: the 1950s,” “Liberalization of Protective Restrictions: the 1960s,” “Protection Through the Price Mechanism,” “The Process of Devaluation,” “The Exchange Rate System and the Growth of the Economy,” and “Concluding Note: Increasing Reliance on Price Mechanism.”

The Second New Economic Policy was implemented by a public commission with representatives of the Ministry of Finance, the Ministry of Commerce and Industry, Histadrut and the Manufacturers' Association. The commission operated from 1962 to 1966 and decided whether and how to shift from quantity restrictions to price intervention on a case-by-case basis. The distinction between the avowed goals of this policy, and its actual effects, were discussed by Halevi and Klinov in their 1968 book:

"It might be supposed that this controversy was resolved [in favor of the price mechanism] with the New Economic Policy in 1962 when the principle of multiple exchange rates was rejected in official statements. But the implementation of the New Economic Policy, and subsequent developments, suggest that a fundamental controversy still remains, with little, if any, weakening of the Commerce and Industry approach." (p. 248) Seven years later, a similar view was provided by Michaely when he wrote that the commission demonstrated a bias against liberalization with its goal of "efficiency, not elimination," and often the amount of protection afforded an industry depended upon its promised intentions rather than its actual performance.

The process of liberalization that began in 1962 with the Second New Economic Policy remained incomplete at the time Michaely published his book thirteen years later. The first stage of this process, of a switch from quantitative restrictions to tariff protection, was largely completed by 1969. But, by the time Michaely completed his book in the mid-1970s, he still looked forward to the abolition of tariff protection, which he expected to occur by 1975 or 1976 (see p. 79). In fact, the wait for the abolition of protection would be much longer still. Gabai and Rob, in their chapter of the 2002 Ben-Bassat volume, wrote that "the 1980s were typified by vagueness in regard to trade policy... Overall, the main effects of the policy were two – exacerbation of economic distortions and vast empowerment of the professional and political bureaucracy to prefer domestic manufacturers and importers and to enrich close and less-close associates by providing favored parties with import licenses at no charge..." (p. 289). They stated that it was only in the 1990s that "...pro-openness forces won the day..." (p. 290), and the quote from them that began this section, in which they call Israel "...one of the most open economies in the world..." (p. 306), represents a situation that only emerged after a very protracted process.

The discussion in this section has shown that the liberalization process that culminated in the openness of the Israeli economy might have foundered but for the crises and challenges that spurred it on. More generally, as mentioned in previous sections, the response to crises and acute challenges often led to fundamental shifts in policy. Perhaps the major economic crisis that Israel faced was the protracted battle with inflation in the 1970s and 1980s. In the next section, I consider the discussion of this episode in the books reviewed here.

6. INFLATION AND CRISIS

It is often remarked upon that, during its short existence, the State of Israel has been severely challenged by its engagement in numerous wars and military conflicts. Less often cited, but also important, is the fact that the State has also had more than its share of economic crises since its founding. These crises have helped forge the country's economic system, as suggested in the subtitle of the book edited by Ben-Porath, *Maturing Through Crises*.

The crisis that may have had the largest effect on the economy of Israel, at least since the early 1950s, was the inflation crisis of the 1970s and 1980s. As mentioned in Section 1, the resolution of this crisis is viewed as the beginning of the “modern” Israeli economy. In this section I review the discussion of this crisis in the three most recent books and, in the two books written before its onset, the view of inflation.

Inflation was of some concern in Israel before the late 1970s. Soon after the founding of the State, rapid monetary growth led to incipient inflation, and an effort to suppress it through price controls and rationing. These efforts ultimately failed in 1951, and the government abandoned its comprehensive price controls. Patinkin wrote that this episode gave members of the Israeli government a much greater appreciation and understanding of the role of the price mechanism. But Patinkin viewed the 5.4% average rate of annual inflation in the 1954 to 1958 period with a certain amount of equanimity. He wrote that Israel, “... like many other economies in which inflation has become part of everyday life and considerations – has shown much greater stability in this process than might have been thought possible at one time.” (p. 115).¹⁶

Halevi and Klinov devoted the last chapter of their book to the topic of inflation. In a private conversation, Klinov indicated that she and Halevi “had to include” this chapter because, by the time of the book’s publication, inflation had started to become a topic of concern. The view expressed in the chapter on inflation in their book is consistent with a prevailing view at that time concerning the Philips curve, as evidenced by the passage “The benefits of inflation may be that it helps reduce unemployment, enhances growth, and is an administratively cheap way of taxation. Its adverse effects are mainly apt to occur in the fields of saving and investment, balance of payments position, and income distribution.” (p. 279)

This somewhat benign view of inflation, not uncommon in many countries in the 1960s, was swept away in the 1970s with the rapid increase in prices worldwide. A much less sanguine view of inflation took hold in Israel as prices rapidly rose and inflation became more virulent. The volume edited by Ben-Porath appeared after several failed attempts at stabilization, and just before the ultimately successful policy was undertaken. In the first paragraph of the introduction to that volume, Ben-Porath wrote that during the 1970s “... Israel has become synonymous with running inflation and balance-of-payments crises.” (p. 1)

A variety of views on the causes of the run-up in inflation are advanced in the Ben-Porath volume. In one chapter of that book, Michael Bruno argued that “The opening up of the economy to short-term external capital flows (and the unnecessarily large devaluation that signaled its start) without any accompanying fiscal or liberalization measures, locked the economy into a new inflation-cum-low-growth pattern...” (p. 301) In a later chapter that Bruno co-authored with Stanley Fischer, the theme of weak institutions is continued with the statement “Our view is that institutional adaptations and accommodating monetary and fiscal policies have left the stabilizing forces in the economy very weak...” (p. 347) Bruno and Fischer considered the expansionary fiscal policies in 1978, as well as those under Finance Minister Yoram Aridor in 1981 and 1982, and in the pre-election period in 1984, as central

¹⁶ While 5.4% inflation might seem low in light of subsequent experience in Israel, the appropriate context is cross-sectional; for example, during this period, the average CPI inflation in the US was about 1%.

sources for the explosion in the inflation rate (see pp. 361 – 367). In another chapter in that volume, Nissan Liviatan and Sylvia Piterman instead blamed the balance of payments crises in 1974, 1979, and 1983 as the driving forces behind the run-up in inflation, writing “The transformation of the price-level shock into a new level of inflation is caused by an interaction of lags in the adjustment process and by a general feeling that the BOP problem is being given priority over stabilization of the inflation level.” (p. 321) In the introduction to the volume, Ben-Porath argues that “All of the various explanations of the acceleration of inflation and the growing balance-of-payments deficit reflect the conflict, indeed the schizophrenia, affecting the government as it wavered between its obligation to deal with pressing economic problems and what it perceived as the constraints imposed by the public and the political process.” (p. 18)

Ben-Porath’s point, on the importance of a political commitment to stabilization, is supported by the post-mortem of 1985 heterodox plan by Razin and Sadka in their 1994 book. Razin and Sadka wrote that, in 1985, “The active and authoritative role played by Shimon Peres was a remarkable contrast to the passive, unenthusiastic role played by Prime Minister Menachem Begin in 1983...” (p. 30n) and emphasized efforts to build support for the plan among various constituencies including “the pillars of the political economic system: the government, the Histadrut, and the Private Employers Association.” (p. 23) They also noted that public support for this program, that emerged “as soon as it was implemented, clearly played a role in its success.” (p. 30). The importance of this support, and the political backing of the program, is stressed by Razin and Sadka because they believe that a cause of the crisis was “...a weak government, which lacked resolve and had at best a poor understanding and awareness of the real seriousness of these problems.” (p. 26)

Razin and Sadka also discussed the recession that occurred in the wake of the stabilization plan, beginning in the second half of 1987. They see this recession as “the inevitable outcome of the economic policy of 1986 – 1988.” (p. 49) More specifically, they viewed the fixed exchange rate component of the policy as tying the hands of the central bank in a way that caused distortions in the real exchange rate and in interest rates, writing that “In the spring of 1988, well before the general elections held in November, it became evident that the stubborn policy of freezing the exchange rate, in effect since January of 1987, inflicted a heavy toll on the economy.” (p. 99)

The use of the exchange rate as a nominal anchor, and the subsequent appreciation of the real exchange rate, is a common feature of stabilization programs, as pointed out by Fischer and Orsmond in their contribution to the 2002 Ben-Bassat volume. Looking at nine other countries’ experiences, they wrote “Virtually every country that tried to disinflate initially relied on the exchange rate as the nominal anchor.” (p. 173) In all but two of these countries, once the stabilization plan was enacted, “...the real exchange rate appreciated, typically by around 30 – 50 percent, which soon called into question the sustainability of the current account position.” (p. 177) Evaluating the experience of Israel, Fischer and Orsmond concluded that “Although the far-ranging and bold initial stabilization program led to a sharp reduction in inflation from very high levels in 1985, the effort to continue the disinflation effort – meaning, in practice, persistence with tight fiscal and monetary policies – waned thereafter.” (p. 179) Thus, Fischer and Orsmond might take issue with the contention of Razin and Sadka concerning the “*stubborn* policy of freezing the exchange rate” since, across countries that attempted stabilization, a real exchange rate appreciation was common.

Furthermore, Fischer and Orsmond wrote that “Reinflationary pressures were evident after mid-1986. In large part, these were caused by the nominal and real wage increases conceded in the early phases of the program and their accommodation by monetary policy...”. (p. 160)

Another post-mortem on the stabilization of the mid-1980s in the Ben-Bassat volume is provided by Djivre and Tsiddon. Like Razin and Sadka, they also mentioned the role of politics in the stabilization plan, although they focused on the 1985 Law of No Printing, writing that “Up until the 1985 stabilization program, monetary policy had been subordinated to the budget deficit financing requirements.” (p. 85). Djivre and Tsiddon also considered the role of stabilization in contributing to the development of the financial markets in Israel. Financial markets remained underdeveloped in the first half of the 1980s both because of high inflation and because financial repression served the goal of lowering the government’s cost of funds. But after 1987, with inflation largely tamed and a reduced public sector budget deficit weakening the government’s motivation to repress financial markets, liberalization allowed greater competition in financial markets. Thus, the development of financial markets in the late 1980s and early 1990s represents a case where reforms that were part of a response to an acute crisis led to structural changes that fostered development of the Israeli economy.

7. CONCLUSION: THE SEVENTH BOOK

Perhaps the only (and certainly the oldest) long-term economic forecast that proved accurate was “Immediately ahead are seven years of great abundance in all the land of Egypt. After them will come seven years of famine...” (Exodus, 41: 29 – 30). While acknowledging the very real difficulties in peering more than a few quarters into the future, what will the next major book on the Israeli economy, the one that is published after 2010, have to say about developments during the present decade?

If the arc of the discussion in the six books reviewed here is any guide, the Israeli economy will likely maintain its level of liberalization, and perhaps even become more open to the world economy and more oriented towards markets. The shadow of the crisis of the mid-1980s still seems to hang over thinking about the proper structure and conduct of the economy. The reforms set in place since that crisis do not show evidence of being reversed. And, as pointed out by Ben-Bassat, a continued success of the liberalization program will help to maintain its policy goals.

But economic policy may be altered in response to the fate of an influential group, rather than the performance of the economy as a whole. If efforts to move Israel towards a more free-market economy are not accompanied by policies that mitigate the costs to those disadvantaged by these reforms, the policies may be challenged. Of course, those who are disadvantaged by reforms can include the wealthy as well as the poor, and in most countries political clout is correlated with economic success. Therefore, the success and maintenance of reforms is linked to issues of economic equality. The political process, along with economic outcomes, will ultimately determine how durable reforms prove to be.

But the most important political calculus for the Israeli economy involves the conflicts between Israel and her neighboring countries, as well as between Israel and the Palestinians. It is unfortunate that the one continuing theme, across all of the volumes reviewed here, is that Israel has remained a country characterized by a constant struggle for its existence against forces aligned against it. The real difficulty in forecasting the economy of Israel over the next decade arises because of the impossibility in forecasting the international political environment in which that economy will either thrive or struggle. The most beneficial change in the environment for the Israeli economy, and, more broadly, for Israeli society in general, would be a stable, lasting, and meaningful peace.