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Israel's Globalization Episodes: Lessons for Open Economies

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INTRODUCTION AND SCOPE

Anti-globalization sentiment is growing, especially in Europe and the United States, with the increasingly integrated global economy blamed for domestic economic distress. Razin (2018) shows that Israel offers a counterexample to this view, by demonstrating the decisively positive economic effects of globalized finance, trade and immigration. Israel has seen a remarkable development, emerging from a low-income, high-inflation developing economy in the 1970s to a medium to high-income advanced economy in the 2000s, while becoming increasingly integrated into the world economy in trade, supply chains and through financial links. At the same time, the global economy has been buffeted by several unprecedented economic events over the past four decades. This article attempts to provide a brief analysis of the impact of these events on Israel's development, institutions and economic policies.

Globalization is currently facing some challenging political tests that are tougher than in previous decades. Migration is the core of the emerging trend towards economic nationalism. Sachs (2017) puts it succinctly when he says, "if people were told that they could move, no questions asked, probably a billion would shift around the planet within five years, with many coming to Europe and the US. No society would tolerate even a fraction of that flow. Any politician who says, 'let's be generous', without saying 'we're not going to let the doors stand wide open' will lose".[1] Rational and generous policy that also resonates politically will not eliminate national borders altogether. Instead, it will elicit calls for limits on the flow of migrants. The core of the wall-building coalition in the United States consists of white males with low educational attainment. Low-income citizens were also far more likely to support Brexit in Britain. The call for a 'points-based' immigration system from the Brexit campaign was an explicit call to increase the skill composition of UK immigrants. Israel's Law of Return not only enables free immigration, but also grants returnees immediate citizenship. For a researcher, it is like a laboratory experiment on how free migration can function without non-economic forces and anti-migration sentiments. Brexit may have been a leading indicator of anti-globalization and rising economic nationalism. Continental Europe has not followed through to date. There is still the looming problem of settling the Middle East in the EU.

The political backlash against trade treaties in the United States has postponed multilateral trade agreements like the Transatlantic Trade and Investment Partnership (a US-EU trade deal), the Trans-Pacific Partnership (a US-Asia trade deal), and many others. The open-border model, which governed the global economy for over seventy years, is under threat. However, the acceleration of finance, technology and telecommunication and global supply chains makes the reversal from globalization self-defeating. Against this background, it is desirable to bring to the fore how Israel has been able to advance the political-economy process of globalization, notwithstanding domestic and external crises. Israel's globalization story provides a counterexample to the current trends.

Several unprecedented economic episodes have buffeted the global economy the past few decades. These episodes have had transforming effects on Israel's economy: the collapse of the Soviet Union, and the massive wave of high-skill immigration to Israel that followed; the Great Moderation in inflation and decreased employment fluctuations in advanced economies, which helped open emerging economies to converge to world inflation rates; the 2008 global financial crisis, whose epicentre was in the United States, but which spread violently to Europe; the rise of the Asian markets as export targets and as new origins for outward foreign direct investment (FDI); and the global information technology surge and its spill-overs, reinforced by FDI. The brain drain of top talents has also been encouraged, enabled by the pro-skill immigration rules in advanced countries on the demand side; and facilitated by Israel's highly advanced higher education system on the supply side. The Great Moderation in advanced economies occurred from 1985 to 2007, during the low-inflation era when the US Federal Reserve and other advanced economies' central banks provided a broadly stable macroeconomic environment to facilitate rational private-sector choice.

THE HYPER INFLATION CRISIS

The political upheaval in 1977, the so-called *Maapach*, was a game changer for economic policy in Israel. The newly elected government abruptly switched away from a long-running economic regime, which had been able to maintain fiscal discipline in the presence

[1] See http://politicalcritique.org/world/2017/new-abnormal-conversation-sachs-sierakowski/.

of strong external shocks (the Yom Kippur War and the first oil crisis). Monetary policy was moderately accommodative, underpinned by a fixed exchange rate regime and shielded from capital flights by capital controls. Notwithstanding the oil price shock, inflation was in the low double digits.

In the first phase after their policies are enacted, populists tend to be vindicated. Growth and wages do indeed rise, as a combination of profligate spending and intrusive government control does expand the economy. Surging government spending and mandated wage hikes tend to produce a temporary 'sugar high', followed by a crash. Populist policies, because they are unsustainable, encourage people to shift their spending away from an uncertain future to the present, when the economy is temporarily booming. Beneath the surface, however, the country's economic potential deteriorates and financial disorders start to emerge. Rather than make the hard choice of returning to principled economic oversight, the populist leader recommits to harmful policies and steers the country toward decline, capital flight and sometimes debt crises. In all cases, there are disastrous effects for those groups who were supposed to be the beneficiaries of the populistic policies.

CURBING INFLATION

Israel avidly globalized during this period, and its inflation decelerated from three-digit rates in the 1980s to the low single-digit range as its financial sector became more and more globally integrated. Curbing inflation has been a struggle for Israel for many years, since the very beginning of the state. After several failed efforts to stop the five-year-long hyperinflation, Israel's national-unity government implemented a successful stabilization program. The inflation rate nevertheless stuck persistently to the low two-digit levels until spill-overs from the Great Moderation in advanced economies put entrenched inflation off. Israel climbed down from three-digit rates to two-digit rates, and the inflation rate later converged to the advanced countries' rate.

Globalization also affected the conduct of Israel's central bank. Inflation targeting, which was born in New Zealand in 1990, was adopted by Israel's central bank in 1993. Dovetailing the huge wage-depressing immigration flow and taking advantage of it, Israel's central bank gradually moved the inflation rate all the way down to the level seen in industrial countries. Admired for its transparency and accountability, it achieved success there, as well as in Canada, Australia, Britain and Sweden soon after. It subsequently also became popular in Latin America (Brazil, Chile, Mexico, Colombia and Peru) and in other developing countries (South Africa, South Korea, Indonesia, Thailand and Turkey, among others).

HEADING OFF EXTERNAL DEPRESSION PRESSURE

The 2008 global depression crisis came to the world as a surprising outcome. Pre-2008 macroeconomic models did not adequately capture the features of real-world business cycles: small recessions that occur in the interval between deep and long depression-recessions. All this was because traditional macroeconomic models ignored the role of financial intermediaries. These financial institutions were simply treated like a neutral conduit between savers and investors, and not as a source of crisis by themselves. This deficiency may have been remedied, but uncertainties remain. These are crucial to understanding the 2008 global financial crisis and its aftermath. Until they are resolved, Israel and the global economy may generally have difficulty coping with the Great Recession, the Eurozone crisis, and perhaps secular stagnation in some of the advanced economies, and especially in Europe.

ISRAEL'S IMMIGRATION STORY

Migration has become a huge political-economic issue. There are several problems with the argument that immigrants are an unmitigated economic boon. One is that almost any major economic event like a large-scale immigration has far-reaching distributional effects, very much like a big cut in trade barriers. Another is the fiscal burden arising from low-skill immigrants. By contrast, high-skill immigration brings with it fiscal gains, especially for an ageing society. In general, immigration enriches the workforce, allowing for a more finely-graded specialization, which raises average productivity and living standards. Diverse workforces are likely to be more productive, especially in industries in which success depends on specific knowledge, like computing, healthcare or finance. Indeed, Israel's migration episode was accompanied by a rise in labour productivity coupled with an increase in income inequality.

The exodus of Soviet Jews to Israel in the 1990s also had an impact on income inequality and the political balance of power. I recall the extraordinary experience of Israel, which received three-quarter of a million migrants from the former Soviet Union within a short time. This wave was distinctive for its large skilled cohort, which raised disposable income inequality without increasing market income inequality. In other words, the welfare state took a sharp regressive turn. The unique experience of Israel is markedly different from recent immigration experiences in the United States and Europe, where anti-globalization forces reign supreme.

COMPARING ISRAEL AND IRELAND

Ireland entered the 1950s as a very poor postcolonial society. However, it realized major successes thanks to its integration into the EU and reached elite high-tech status. Ireland was able to attract from the rest of the world (excluding the EU) massive FDI, thanks to its status as a tax-sheltered gate to the huge EU markets. However, Ireland regulated its banking sector poorly and allowed the credit bubble to flourish in the wake of the 2008 global financial crash. Its overexposed banking sector subsequently collapsed during the financial crisis. Ireland has continued to be burdened by the Eurozone's nearly secular stagnation. Israel's robust performance during the crisis is partly attributable to its status as a non-member of a single currency area.

ISRAEL'S HIGH-TECH STORY

Dovetailing with immigration in the 1990s, the global information-and-communication-technology (ICT) surge led to the unprecedented growth of Israel's high-tech sector. Innovation requires scale, and scale requires trade. An isolated, small economy cannot be a centre of innovation. The incentives of entrepreneurs to invest effort and resources in generating valuable services are related to their ability to use the resulting knowledge repeatedly, on a large scale, over time. FDI provides critical incentives to be able to use scale economies, so as to leap from the precarious innovation stage at the confines of a small economy to the execution stage, by utilising the world markets. The globalization of an economy is crucial so that its nascent high-tech industry can develop and flourish. While the long-term benefits of the global ICT surge are palpable; in the short run, the simultaneous wave of financial liberalization contributed heavily to the surge in development and global economic growth from 1985 to 2008. However, deregulation turned out to be a two-way street. It spurred entrepreneurship, investment and technological progress, and the global technology surge spread into Israel's nascent high-tech industry. However, the surge also created a fertile environment for asset speculation and leveraging, with dire consequences when the dotcom crisis erupted.

BRAIN DRAIN

Brain drain is evidently the flipside of intensive globalization interactions and skill-biased immigration rules in advanced economies. Talent outflow is reinforced by the top level of Israel's academic institutions, and entrepreneurship increases the supply of skilled workers that is also partly channelled into the state-of-the-art, high-tech industry. Advanced science and technology institutions that are not located in the global centres suffer from a resource squeeze, as they bring to the world a growing supply of Israeli scientists who seek and find their opportunities elsewhere.

RISING INCOME INEQUALITY

Fast technological developments and globalization come in the case of Israel at the cost of rising income inequality. Israel's welfare redistributive policies have deteriorated. Sizeable communities exist with high fertility rates. Indeed, an international ranking of Israel's economy in terms of the population growth rates puts Israel at the very top among advanced economies. The high fertility rate among the Jewish ultra-Orthodox and the Israeli Arabs, and the lack of proper investment in children on the periphery to prepare them for the labour market, raises the dependency ratio, undermines the skill level of the labour force, and raises the fiscal burden of Israel as a welfare state. Even although the skill attainment of the labour force is currently high, demographic trends, if not reversed, could severely lower future GDP growth and weaken Israel's international competitiveness.

COST OF OCCUPATION

An important role played by globalization is in mitigating, not eliminating, the cyclical effects of the Palestinian uprising and points to its uncertain future consequences. However, the inconvenient circumstances of the Israeli-Palestinian conflict boil down to its uncertain long-term implications. The almost intractable conflict comes together with combustible internal conflicts. Concern is mainly over international political-economic isolation and explosive internal conflicts that tear the social and economic fabric. More precisely, the unresolved Palestinian-Israeli conflict poses a serious long-term threat to Israel's economic place in the world due to the danger of its isolation. There is also uncertainty about the possibility of cuts in trade and financial links for an economy that is currently integrated into the world financial and trade networks.

CONCLUSION

Some of the powerful forces of globalization – responsible for the inflection points in the history of the economy of Israel – include immigration waves; inflation-reduction spill-overs from the advanced economies during the Great Moderation; FDI in technology and spill-overs from the global information technology revolution; the effects of the large influx of skilled immigrants from the former Soviet Union; the rise in income inequality; the opening to East Asian large markets;[2] and the rising cost of occupation. These critical driving forces explain how Israel,

[2] The emerging market economies such as China, Vietnam, India and Indonesia abandoned autarky in favor of export-led growth in the mid-1980s. Suddenly, and with little warning, more than a third of the world's population joined the postwar globalization parade, powerfully effecting global demand everywhere, including Israel. Israel has significantly pivoted its trade to the emerging East Asian markets.

within a relatively short period, transformed from a developing to developed economy and gained entry in 2010 into the OECD – the thirty-five-member group of world advanced economies. Israel's fast development, although unique, is not unknown elsewhere. Ireland somewhat parallels Israel in greatly benefitting from globalization.

However, going forward, fundamental challenges are acute. FDI presently amounts to about 4 percent of GDP in Israel, compared to the OECD average of just 1.4 percent: for Israel, the OECD accounted for the lion's share of FDI inflows. Israel's exports of goods and services currently account for about 30 percent of the country's GDP, while imports of goods and services also amount to about 30 percent. For Israel, the OECD also accounts for the lion's share of its trade in goods and services. The uncertainty over the future Israeli economic and financial links to the global economy arises precisely from the potential of Israel being sanctioned by the international community and thereby becoming politically and economically isolated from some world markets due to future regional crises. Both sides of the Palestinian-Israeli conflict are following increasingly more extreme and polarizing trajectories.

These are major tests facing Israel's economy. The high fertility, low labour force participation, and excessive supply of school time to religious non-core studies in the ultra-Orthodox community can be explained in terms of the behaviour of a 'club' that has strengthened its norms of religious stringency, in an attempt to stay excluded from the outside world. In other words, its isolation from society forces this community to be redistributive and develop its own social insurance. Parents tend to endow their children with good skills to help maintain the survival of the club, but poor skills for the labour market outside of the club. Societal transformations that can reverse this trend are hard to come by. The high fertility rate and the low labour-market participation rate among the Jewish ultra-Orthodox, and to a lesser extent the Israeli Arabs, could boost dependency on the welfare state, which will have fewer revenue sources and more transfer to hand out. Furthermore, among the high-fertility groups, the lack of proper investment in education to prepare children for the labour market could create economy-wide productivity regress, which would negatively affect Israel's competitiveness in the global economy. Brain drain may reinforce the productivity-regress process. Overcoming such backward-driving forces that could weaken Israel's competitive power in the world economy is a major task for the future.

REFERENCE

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