Introduction

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For twenty-five years after its establishment in 1948, Israel was considered an economic miracle, with one of the highest rates of growth in the world. For the twenty-five years before 1948, the same was true for the Jewish economy of Palestine. Throughout these years there was a remarkable rapid increase in population through immigration, increase in per capita income, and increase in total product. During the 1970s, however, immigration slowed down, the economy almost stagnated, and Israel has become synonymous with running inflation and balance-of-payments crises.

The immediate sources of the turnabout were the energy crises and the escalation of defense expenditures following the 1973 war. These coincided with a long-term shift from growth based on immigration and a need to develop an alternative growth strategy. For the most part the government’s economic policies failed to cope with these challenges: the standard of living continued to improve despite the cessation of growth, the public sector increased its claim over resources, investment declined, and economic dependence on the United States became greater. Inflation can be interpreted as the manifestation of the conflict between attempts to solve the real economic problems and the social and political constraints that weakened the government. These constraints may reflect in part the ideologies and institutions forged during the earlier period of growth based on immigration but ill suited to cope with the crises facing a maturing economy. It appears that if Israel is to heal its economy, it will have to undergo a basic structural change.

Distinguishing Characteristics

Israel, with per capita income of $5,090 in 1982, headed a 1984 World Bank list of "upper middle income countries." It is a major exporter of manufactured goods,
together with the industrializing countries of Asia, some southern European countries, Argentina, and Brazil. Among the 118 countries surveyed in that year’s World Table (which does not include the nonmarket Eastern European economies), Israel ranked thirty-first in per capita income, surpassed only by the rich oil exporters, the “industrialized market economies” (the developed countries of North America and Western Europe plus Japan), and Italy, Spain, and Ireland.

With population of 4.1 million, Israel is a small open economy, smaller than most individual states of the United States. It is not well endowed with natural resources, but it has an exceptionally highly educated population and labor force. The major distinguishing characteristics of Israel’s economy, however, are tied to its existence as a Jewish state in a hostile environment.

The Jewish population of Palestine was built up by successive waves of immigration, starting in the last quarter of the nineteenth century. As the Jewish community grew, conflict with the Arab population escalated. In 1948, when independence was declared, the new state was already engaged in the first of a series of wars (1948, 1967, 1970, 1973, and 1982) with neighboring Arab countries. The war of independence established the borders of the new state and caused the departure of a significant part of the Arab population. However, the proportion of Jews in Israel’s population declined from 89 percent in the early 1950s to 83 percent in 1984 as a result of higher Arab fertility and the incorporation of East Jerusalem into Israel in 1967. Most of the non-Jews in Israel are Muslim Arabs, with smaller communities of Christian Arabs and of Druze.

The Jewish sector in Palestine developed as a separate economic entity in terms of institutional structure and patterns of trade with the non-Jewish community. From 1948 on, the economy of Israel coincided to a large extent with the economy of the Jewish population. The 1967 occupation of the remaining areas of British Mandatory Palestine, with a population of over a million Arabs, brought the proportion of Jews in the whole of Palestine (including the occupied territories) down to 65 percent. These territories are not treated as an integral part of the economy of Israel.

Israel’s position as a Jewish state has four main manifestations.

A country of immigrants: 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. Preventing social and economic splits along lines of origin has been a major objective in Israel’s development as a welfare state, and the discouragement of emigration is an important constraint on economic policy. The early immigrants’ ideologies and aspirations and the institutions created to achieve them have had a lasting effect on the country’s social and economic structure. In particular, they shaped the role assumed by Israeli governments.

Strong ties with world Jewry. Immigration is one aspect of a broader affinity with Jews worldwide. This strong and lasting relationship has concrete implications for the country’s resources and its balance of payments. As a haven for survivors of the Holocaust, Israel received German reparations at a crucial stage in its economic development. Transfers from world Jewry have been Israel’s most consistent source of external financing. This aid, which is especially responsive to emergencies (as in the 1967 war), provides a unique economic safety net. These ties were of course instrumental in forming the close economic links between Israel and the United States, which have affected economic life in Israel in many ways.

The hostile environment. To ensure its survival Israel has had to devote an increasingly large share of its resources to defense and to conducting economic and social activities in a context of constant preparedness for overt or covert hostilities. With certain historical variations, existence in a hostile environment isolates Israel from adjacent economies and obstructs economic relations with countries in the Eastern bloc and the Third World.

Dualism: The Jewish state and the Arab minority. The tension between the national aspirations of indigenous Arabs and the objective of forming and maintaining a Jewish state based on principles of equality and democracy has introduced elements of dualism into Israel’s economic structure, both in its 1948 borders and much more so in the larger territory controlled by Israel since 1967. This dualism is apparent in the standard of living, education levels, occupational structure, government services, and institutional structure.

Immigration and Product

Immigration and the Growth of Product

Immigration drove the growth of the Jewish economy sector of Mandatory Palestine and of Israel for the fifty years or so ending in the early 1970s. From 1922 to 1948 the Jewish population increased eightfold, and total product increased twenty-fivefold, allowing a 4.8 percent annual increase in per capita income. In the years of mass immigration, 1948-1951, the population doubled again and per capita income continued to grow. Over the next two decades GNP rose 9 percent annually, while the population increased by 4 percent and 3 percent respectively; per capita income thus grew more than 5 percent each year. In the 1970s population growth slowed to an annual rate of 2 percent, the annual growth of total product to 3.2 percent, and that of per capita product to less than 1 percent (see Chapter 1).

Population and product growth underwent three long swings, with peaks in the
mid-1920s, mid-1930s, and early 1950s. Though largely caused by noneconomic forces, immigration also responded to economic fluctuations in Israel. It stimulated economic growth both by pushing demand and by increasing productive capacity through the provision of labor; through capital imports, which financed the increase in the stock of productive capital; and through productivity change. Productivity depended both on the quality of labor and on the institutional structure. The high education level of the pre-1948 population—one of the highest in the world—and the institutional structure formed during the Mandate period enabled Israel to absorb the mass immigration of 1948–1951, largely composed of Jews from less developed countries in Asia and Africa and from war-ravaged Europe. Their entry initially reduced the population's average level of schooling and skills; their economic absorption and the improvement in their skills were significant elements in the productivity increase that lasted until the mid-1960s or early 1970s.

**Labor, Capital, and the Decline in Growth of Productivity**

More than half of the 6 percent decline in the business sector's growth of productivity after 1973 from that of the preceding decade was caused by a sharp drop in the improvement of productivity. The other half was caused by a slower rate of growth for both labor and capital. Although the stock of capital continued to grow faster than both labor and output, the energy crises and other price changes probably rendered a significant fraction of the pre-1973 stock obsolete. Increased government subsidization of investment in the 1970s may also have bred misallocations of investment. For this reason, or because of changes in demand, capital stock utilization has declined appreciably, rendering the effective growth of capital services inputs in the 1970s negligible (see Chapter 3).

The composition of the Israeli labor force also underwent several changes. The share of men decreased (from 76 percent in 1965 to 63 percent in 1982) and that of women increased (from 29 to 36 percent); women now make up two-fifths of the Israeli labor force. The share of highly educated workers increased significantly—faster than population, output, and the stock of capital (see Chapter 5). Educated men entered the business sector in large numbers with no decline in their relative wage, but educated women experienced a wage decline (see Chapters 6 and 7). Since 1967 significant numbers of manual laborers from the occupied territories have entered the Israeli labor force, slightly offsetting the effect of reduced participation by Israeli men.

Changes in labor utilization, as reflected in unemployment rates, were relatively small. Unemployment fluctuated between 4 and 5 percent. The significance of full employment and its relation to the industrial structure of employment are discussed in later sections.

**External Shocks**

**The Energy Crises**

Besides a slowdown in immigration—a long-term phenomenon—Israel underwent external shocks: the energy crises of 1973–74 and 1979, with associated changes in world prices and world trade. These developments made the 1970s a period of worldwide slow growth and stagnation (see, for example, Matthews 1982). As an open economy with a large import surplus, Israel was particularly hard hit. Rising defense expenditures after the 1973 war (discussed below) and the return of the Sinai oil fields to Egypt as part of the Camp David accord exacerbated the problem.

Israel's commodity terms of trade declined 17 percent between 1972 and 1975, improved briefly, and then declined again from 1978 to 1982. A loss on the current account was partly offset by a capital gain on the outstanding foreign debt, which was unindexed and still bore relatively low interest rates (see Chapter 12). Israel's energy bill grew from less than 1 percent of GNP in the 1960s to 7.3 percent after the first oil shock and to 11 percent after the second shock (see Chapter 13). At least 30 percent of the increase in the balance-of-payments deficit in the 1970s can be attributed to these price changes. Chapter 14 traces the consequences of the shocks in Israel and compares them with the effects in the OECD countries.

**Defense Expenditures: Escalation of a Persistent Problem**

What distinguishes resource use in Israel is the growing share of its defense expenditures. From 8 to 10 percent of GNP before the 1967 war, it rose to approximately 22 percent in 1968–1972 and to 28–29 percent in 1974–1980. Berglas suggests in Chapter 8 that a more complete accounting of the defense burden would have added approximately another 8 percent of GNP to these figures.

The defense burden is directly, though not exclusively, responsible for many of the oddities in the rest of Israel's national accounts. Between the late 1950s and the 1970s expenditures rose from less than 50 percent of government consumption to more than 70 percent, accounting for almost the entire increase in the share of government consumption in GNP, from less than one fifth to two-fifths. In the late 1950s half of the net taxes collected by the government financed defense; in the 1970s total taxes could not finance even the domestic component of defense expenditure.

Another dimension of the defense burden is reflected in the balance of payments. About half of all defense outlays in the 1970s went for imports, even though substantial foreign aid financed a rising share of those imports. Post-1973
military imports account for much of Israel's current debt. Military preparedness also has some favorable effects: the development of a sophisticated domestic military industry contributed to exports, and possibly to technological development as well.

The size of the defense expenditure interacts both with actual and expected military buildup in the confrontation states surrounding Israel and with the short- and long-term availability of resources. Since 1973, increased oil revenues have improved the Arab countries' ability to sustain an expensive arms race, while the oil crises and the economic slowdown have hindered Israel's ability to do so. The competition for resources between defense and investment, together with the danger that the economy may someday not be large enough to support higher levels of defense expenditures, has been a persistent dilemma. These conditions have also made U.S. aid of crucial importance.

Defense expenditures increased in stages associated with the wars. Berglas (see Chapter 8) explores the relationship between the change in defense expenditures and in consumption, investment, and the import surplus. The steep rise associated with the 1967 war was absorbed by a sharp reduction in the share of consumption and a decline in domestic investment. Relative to GNP, public consumption did not decline and the import surplus hardly rose from that of the full-employment years 1963 and 1964. When the postwar period is compared with the depressed years 1965 and 1966, the increase in the defense share is associated with an increase in the import surplus and the investment share and a decline in both civilian public and private consumption. In contrast, the post-1973 increase in defense expenditures was accompanied by a significant increase in the share of private consumption and by some increase in public civilian consumption, at the expense of a sharp rise in the average import surplus and a decline in investment. The wars, of course, were not the only factors in these trends: the 1967 war followed a recession and was followed by a boom; the 1973 war came after a boom and was followed by a long recession.

The Uses and Misuses of Resources: Preferring the Present to the Future

After 1973 Israel experienced structural problems both in the use of resources and in production. The increasing defense burden was not the only cause: higher standards of living, added to government expenditures on public services, squeezed out investment and forced dependence on a growing foreign debt. Correspondingly, the key prices in the economy—-the real wage, the real interest rate, and the exchange rate—were maintained at levels that supported this undesirable allocation of resources.

Private Consumption

Private consumption as a share of GNP went through a long swing. From absorbing approximately three-quarters of GNP in the 1950s, it declined to 57 percent of GNP in 1972, increasing again to 66 percent in 1982. Over successive decades starting in 1952 the annual growth rates of per capita GNP were 5.7, 5.5, and 0.8 respectively, while the growth rates of per capita consumption were 5.3, 3.8, and 3.2.

The resilience of private consumption to deceleration in growth is not merely a delayed adjustment of consumption to short-term variations in income: the figures cited above are decadal averages. Moreover, annual data show that consumption could sometimes adjust downward fairly rapidly (in the 1965-1967 recession, in 1975, and in 1980).

The Civilian Public Sector

Israel has a relatively high level of civilian public consumption — that is, education, health, and administration services provided by the government. Like private consumption, civilian public consumption went through a long swing with some cycles—a decline from approximately 12 percent of GNP in the mid-1950s to 10-11 percent in 1961-1975 (interrupted by an upswing in 1965-1968, associated with the recession). Then public consumption rose to an all-time peak of approximately 13 percent in the late 1970s, sliding back in the early 1980s. If the services provided by nonprofit institutions, which are largely and increasingly financed by the government, are included, then public civilian consumption increased from approximately 17 percent of GNP in the early 1960s to 20 percent in the early 1980s (see Chapter 9).

The contraction from the 1950s to the 1960s probably reflects the public sector's gradual shedding of functions associated with large-scale immigration waves and with the costs of establishing Israel's infrastructure. There was also a change in the way the government intervened in and managed the economy — from direct administrative allocation of goods to taxes, subsidies, and control of the capital market (see, for example, Chapter 12). The share of economic and general services in government expenditures declined, perhaps reflecting part of this change, but there was also an increase in the share of government expenditure on education and health. The latter items, which serve the public as consumption or as investment in human capital, are responsible for the increase in the share of public services in the 1970s. Not only did the public sector increase production of these services, but also the public was paying less and less for them.

The puzzling upswing in both private and public civilian consumption in a
period of external shocks and stagflation is discussed below, in the first subsection of “Economic Policy.”

Domestic Investment

The share of investment in GNP declined from close to 30 percent until 1977 to around 25 percent in 1978-1982 (see Chapter 4). This change, when viewed in relation to trends in other countries, represents a convergence to a normal ratio after a long period of exceptional growth (see Chapters 2 and 4). What is striking is the composition of investment. Israel devotes one-tenth of its GNP to investment in housing. There seems to have been a swing here too—the share of residential investment was lower in the 1960s than in the preceding and following decades. The high demand for housing since the late 1960s is less a consequence of population growth than of a higher standard of living. Another factor is the high and rising share of capital in services. Thus, there is a tendency to mobilize an increasing share of resources to the immediate, direct and indirect, improvement of living standards (see Chapter 4).

In sharp contrast, the entire share of gross business investment in fixed investment was only one-third of total investment, and that of manufacturing only 14 percent, or approximately 4 percent of GNP. Even this level was achieved only through massive government intervention and subsidization, which in the late 1970s mostly took the form of inflation-induced gains to firms and households on their unindexed debt to the government (and to the extent that some of the acceleration of inflation was unexpected this was an ex-post transfer). The gross capital-output ratio seems quite high, but the degree of government intervention may have rendered much of the investment inefficient. Thus, in evaluating the position at the end of the period, Chapter 4 considers not only the level of productive, or tradable-oriented, investment, but also the extent of government intermediation.

The Import Surplus

An import surplus, defined as the excess of imports over exports of goods and services, represents an addition to a country's resources. To the extent that it is financed by loans or unilateral transfers from abroad that make the country dependent on another (in Israel's case, on the United States), it raises both economic and political questions. The import surplus has been a central economic issue since Israel was established.

In absolute terms Israel's import surplus was $4.7 billion in 1982. In terms of 1982 U.S. producer prices, the import surplus was less than $1.5 billion in 1960, $2.5 billion in 1970, and $4.1 billion in 1975. The size of the import surplus relative to GNP fluctuated around 20 percent. The worst years were 1973–1975, when it exceeded 36 percent. This long-term stability of the import surplus level combines two trends: a rapidly growing ratio of imports to GNP (from less than 30 percent in the early 1950s to approximately 70 percent in recent years) and a growth in the ratio of exports to imports, from 22 percent in 1952 to 68 percent in 1982 (see Chapter 12).

Long-term financing, including both borrowing and unilateral transfers, covered the deficit in the period 1958–1973. Long-term loans accounted for between one-third and one-half of the deficit. Unilateral transfers consist mainly of transfers from Jewish communities abroad; German reparations; and U.S. government aid, which was important in the 1950s and became important again in the 1970s. The accumulation of debt has become a serious problem. The net national external debt increased from $0.5 billion in 1964 to over $15 billion in 1982. A serious consequence in recent years was Israel's need to resort to short-term financing, with a corresponding deterioration in its short-term net asset position (see Chapter 12).

In earlier decades the import surplus reflected mainly the availability of long-term financing, and foreign borrowing could be viewed as a means of financing domestic capital formation. In the past decade, the import surplus has grown in response to aggregate demand and the constraints on GNP. Chapter 5 interprets the growth of the nontradable (mostly public) sector in response to factor supplies and attributes the import surplus to the structure of production.

Another way of saying that the import surplus is too large is to say that the real rate of exchange is too low. Much of the debate over the inflationary process is linked to the feasibility of effecting changes in this rate through nominal devaluations. Under full-employment conditions, which have prevailed in Israel for most of the period since 1968, the resilience of domestic demand makes nominal devaluations ineffective.

Implications for the Structure of Production

Although many specific features of Israel's structure of production merit elaboration, the focus here is how the structure of production reflected the major macroeconomic problems: the conflict between the need to improve the balance of payments and countervailing pressures on the structure of production, caused either by the structure of demand or by problems associated with factor supplies.

In its early years Israel pursued a strategy of import substitution (see Chapter 2). In the late 1960s it accomplished a major shift, spectacularly expanding exports and retreating somewhat from import substitution. But because imports grew from 38 to 65 percent of GNP, the growth of exports was far from sufficient. In the 1970s the rise in exports accounted for most of the growth of the business sector.
Much of this growth was based on sophisticated industries’ greater use of the growing supply of educated manpower in the manufacture of electrical and electronic products, metal products, and chemicals. In the same period skill content of locally marketed output declined (see Chapter 12). The demand generated by defense needs also helped promote the development of sophisticated manufacturing (see Chapter 8). Trade relationships with the European community and intangible learning gains in marketing and innovation seem to have played an important role in the process. Export expansion, based on an ample supply of educated manpower and backed by Israel’s research and science infrastructure, seems a likely alternative basis for economic growth.

But other developments have thwarted this transformation. The entire business sector has been squeezed by the growth of the public sector. The share of manufacturing failed to grow over several decades because Israel prematurely deindustrialized along with the developed countries (see Chapter 2). The growth rate of worker hours in the public sector accelerated from 4.3 percent in 1961–1972 to 4.6 percent in 1973–1981, in sharp contrast to the deceleration (to 1 percent) in the business sector (see Chapter 3). Inputs were diverted to public services and to nontradable sectors: the share of the public sector in civilian employment rose from 18 percent in 1951 to a relatively stable 22 percent in the 1960s and to 28 percent in 1981 (see Chapter 5). Over the same period the share of financial and business services increased from 6 to 10.8 percent.

Several related hypotheses link the adverse structural problem to the labor market: both Klinov (Chapter 5) and Amir (Chapter 6) note a remarkable increase in the education level of the labor force in the 1970s, coupled with a large increase in the share of (educated) women. Klinov maintains that the deviations of the growth of the public sector served as a solution to the excess supply of educated labor in general. The excess supply may have been more of an issue of educated women (see Chapter 7). The growth of the public sector may have been part of a general attempt to prevent unemployment.

The Decline of National Savings

With private and public consumption increasing and GNP almost stationary, national savings, which by definition are equal to domestic investment minus the import surplus, had to decline. The national saving rate, which was 6.1 percent in 1953–1962 and 7.1 percent in 1963–1972, averaged 1.1 percent in 1973–1982 (see Chapter 4). This calculation regards the entire import surplus as negative investment abroad. If unilateral transfers are deducted from the import surplus, national savings do not turn negative, but the decline remains very steep.

National savings are generated in both the private sector (households and firms) and the public sector. By international standards the rate of private savings as a share of disposable income remains very high—around 30 percent in 1978–1982. This share grew from approximately 20 percent in the late 1950s to a high of 40 percent in 1972, fell to 35 percent in 1973–1977, and declined further to a still respectable 26 percent in 1982. The sharp decline in national savings in the 1970s was a result of the decline in private savings and the steep rise in the government’s negative savings. Budget deficits ran at roughly 4 percent of GNP before the 1967 war, jumped to 15 percent in 1967–1972, declined to 30 percent in 1973–1975, and have remained at around 25 percent since then (see Chapter 4). By an alternative definition of the deficit that deducts foreign unilateral transfers, the numbers are smaller but the trend is similar: no deficit in the early 1960s, a peak deficit of close to 18 percent of GNP after the 1973 war, and a deficit of approximately 15 percent in recent years (see Chapters 16 and 17).

Policy Dimensions of High Consumption

The increase in the standard of living of the population, both directly and through improved government services, rested on the following factors.

Use of full employment. Unemployment did not exceed 5.1 percent in 1968–1983. This low rate was achieved not only through measures affecting aggregate demand but also through the government’s direct role as an employer.

Increase in real wages. In 1968–1973 real wages increased 18.7 percent, per capita GNP 35 percent, and per capita consumption 22.4 percent. In 1973–1976 real wages declined 2.8 percent, per capita GNP increased only 3.3 percent, and per capita consumption increased 5 percent. Most striking are the figures for 1976–1983, when real wages increased 24.1 percent, per capita GNP 5.6 percent, and per capita consumption 30 percent. In only four years since 1968 did the real wage actually decline (the sharpest decline was in 1980—6.9 percent; in the same year per capita consumption declined 5 percent, and per capita GNP hardly changed). Thus there was no short-term rigidity of real wages. This fact disproves the widespread belief that wage indexation prevents declines in real wages. Chapter 15 demonstrates that the indexation of wages to the cost of living would not have been an effective barrier to declines in real wages. Hence the observed increase in real wages must have been caused by real forces.

Decline in net taxation. A decline in net taxation was associated with a large increase in gross taxation and an even larger increase in transfers. Gross taxation rose from 28 percent of GNP in 1960–1965 to nearly 50 percent in the early 1980s. Net taxes, which were 19 percent of GNP in the 1960s, certainly did not rise, and according to some definitions even declined (see Chapters 9 and 11).

The growth of gross taxation and of subsidies was associated with increased
inefficiencies. In fact the sum of the two rather than their difference is a better indication of the excess burden of the tax system. The high rate of personal income tax bred various tax exemptions and distortions in the wage system. Also, the tax administration found it increasingly difficult to collect taxes from nonwage income. A tax reform in 1975 eliminated many of the tax exemptions, expanded the tax base, and reduced the formal rates, but it failed to solve the problem of tax evasion. In the early 1980s, tax collection from corporations also eroded steeply.

An important component in the rise of both taxes and transfers was the expansion of the National Insurance Institute, which levied heavy payroll taxes as well as taxes on the self-employed. These taxes, which have become known as “Income Tax B,” widened the gap between the cost of labor to employers and the net reward to labor, with associated inefficiencies. The expansion of transfers to households started in the late 1960s and, despite the 1973 crisis, was not reversed until 1976. The expansion occurred first in child allowances, then in old-age assistance, and later in disability insurance (see Chapter 10). Owing to the low rate of unemployment, the rise in transfers was not a result of growth in unemployment insurance, as in many European countries. Households also benefited from intensive subsidization of basic foods.

As inflation accelerated, a new source of transfers emerged — capital gains by the private sector on its unindexed debt to the government. As the domestic (indexed) government debt to the public increased, the real interest it bore became an increasingly important component in the public’s income and in the government’s deficit. Domestic debt finance grew from nil in the mid-1960s to approximately 5 percent of GNP in the mid-1970s and to over 7 percent of GNP in 1978–1983 (see Chapter 17).

**Sharp increase in financial assets of the private sector.** The net financial assets of the public sector grew from 60 percent of disposable income in 1973 to 150 percent of disposable income in 1982 (a blow to the stock exchange in 1982 reduced the share to 130 percent). This growth reflects the increase in the domestic debt, which has become larger than GNP and is largely indexed. The government and the Central Bank had to stabilize the real rate of interest in order to sell more bonds to the public. They also avoided short-term rises in interest rates to prevent the value of existing stocks from falling. Government financing and monetary policy were thus constrained by both the level and the variability of the interest rate. The combination of inflation and the complex form of government intervention in the capital market produced odd, sometimes exotic, phenomena. For no good reason as far as the real performance of the economy was concerned, the Tel Aviv stock exchange was booming, providing in 1982 an average real return of 73 percent on stocks and 29 percent on what were then considered to be blue chips, the stocks of the banks. This bubble, based on a chain effect, eventually burst in 1983.

**Maintenance of too low an exchange rate and growth of the public foreign debt.** Israel’s low exchange rate is made possible by and supports the import surplus and external aid and borrowing. Until recently the population did not take full account of the collectively assumed liability and therefore overestimated its true wealth.

Exchange policies may have affected private consumption more directly through relative prices. The purchase of durables contributed one-third of the growth of consumption in 1980–1982 (compared with one-quarter in the preceding five years). This higher share may have been the result of exchange-rate policies and reduced taxation on durables, pursued in the early 1980s, and may have caused part of the decline in private savings (as conventionally measured).

Budget cuts proved unfeasible both because some budgeted expenditures (public employment, debt servicing, and, to some extent, transfers to households) were inflexible and because some budgeted items (notably subsidies) were designed to counteract the detrimental effects of other policy measures (such as subsidies to investment and to exports). But the crucial constraints on the budget were political.

All these policies disconnected the economic incentives facing the individual from the realities confronting the national economy. This separation was probably made possible to a large extent by the safety net provided by external support. Direct responsibility lies with the government; but the government itself operates in a social and political context. The next section describes some of the constraints on government policies and examines the post-1973 macroeconomic policies and acceleration of inflation in this perspective.

**The Constraints: The Institutional Heritage**

Older, richer countries have developed rigidities that prevent rapid growth and adjustment to change. Olson (1982) attributes them to the emergence and cumulative impact of special-interest groups. The “sclerosis” of the developed countries became apparent from their slow response to the energy crises and the resultant sharp fluctuations in their terms of trade and was reflected in rigidities in the real wage, prolonged periods of unemployment, and oversized public sectors. This pattern contrasts with that in some of the successful developing countries of Asia—Taiwan, Korea, Hong Kong, Singapore. Israel, which until recently seemed to belong to the latter group, displays symptoms of premature aging, combining the structural problems of some of the richer and older European countries with the inflation, balance-of-payments crises, and foreign indebtedness observed in some Latin American countries.

Some of the difficulties confronting Israel in the 1970s originated in the period
of rapid inflation and in the institutional structure that evolved in earlier decades to foster growth based on immigration. Recently political and social constraints have curtailed the country's ability to cope with crises and to shift to a new mode of economic growth. The major relevant elements in this context are as follows:

The prominence of collective activity. Israel's organizational infrastructure was established in the Mandate period, when the leadership of the Jewish community was voluntarily recognized as the quasi-government of the state-to-be. The Jewish Agency was a government in the making. The Hagana was its military arm. The Histadrut (the national federation of labor) developed in a unique form alongside the Jewish Agency, combining the role of trade union with the establishment of a developed system of social and health insurance. It fostered entrepreneurship in economic development by creating a large labor-owned economic sector consisting of communal rural settlements (kibbutzim, moshavim), large transportation cooperatives, and huge enterprises in construction and industry.

The preference for collective action rested on the Zionist version of socialism that evolved in Palestine from eastern and central European ideologies of the late nineteenth and early twentieth centuries. Throughout the Mandate period and its first twenty-nine years of statehood, Israel was led by the labor movement, which laid down the norms and the organizational modes for running the economy and society. Collective action was a natural and probably necessary way to achieve specific national goals of organizing and absorbing immigration and securing a foothold in a disputed land. The socialist ideology included a distrust of the market, a view of profits as mere rewards to parasitism, and (paradoxically) a view of services as unproductive.

With the establishment of Israel the government's dominant role in economic affairs reflected both the éstatist bias of the socialist ideology and the new needs and opportunities: only the state could cope with the combined (and differently weighted) challenges of defense, immigration, and economic development. Foreign aid, which was necessary to achieve those goals, flowed to the government. As the recipient of these funds and arbiter of their distribution, it gained enormous power. Secure in the knowledge that aid was forthcoming, it could embark on economic ventures without having to bear the political consequences of making the taxing public foot the bill. Government intervention has changed form, shifting from quantity allocations, administrative controls, and ad hoc decisions to greater reliance on general taxes, transfers, and subsidies. Compared with the U.S. government, Israel's government seems to have less regulation of and fewer legal confrontations with business. It is the control of the capital market and of subsidization that provides it with so much power.

Over the years there has been a major change in the government's attitude toward the private sector. From socialist ideals and strong preferential treatment of the Histadrut sector in the 1950s, it moved in the 1960s to a development drive that relied on private entrepreneurs, or would-be entrepreneurs, who used mostly government money. Thus the labor-led government created a new "quasi-private," government-dependent class. In the 1970s this quasi-private sector reorganized around large corporations associated with the banks and cooperating with the Histadrut sector. These large enterprises not only depended on the government but also exerted considerable influence on it.

The government's prominent role has several important effects. First, excessive economic activity takes place in budgeted organizations motivated by complex objective functions, uncontrolled by market pressures, facing budget constraints that in the long run tend to be cost accommodating. Second, vested-interest groups apply for government aid instead of relying on efficiency and market forces to ensure their survival. These groups include labor unions in the public and semipublic sectors and their employers, as well as labor and management in the private sector. Although these phenomena are fairly common in many developed countries, the size of the public sector in Israel makes this trend a particularly severe problem there.

Strong commitment to full employment and to job security. Israel's policy regarding unemployment and job security is related to its status as a country of immigrants. Both immigration and emigration are responsive to the level of unemployment (see Chapter 1 and Landau, 1982). One of the traumatic lessons of the 1965-1967 recession was the ensuing wave of emigration. The threat of emigration also influenced economic policy in the 1970s, thwarting the adoption of sustained deflationary policies.

At the microeconomic level, the commitment to job security makes mobility expensive and dismissal difficult. It also makes the level of employment remarkably resilient to demand conditions. Whereas in the period of rapid immigration additions to the labor force provided flexibility, the costs of immobility to the economy increased when the growth of the labor force slowed down (see Klinov, 1976).

Preservation of wages and financial assets. A norm of economic security that became entrenched in the labor market is the preservation of both the level of real wages and of the relative earnings of different groups. Although relative wages did in fact fluctuate during collective bargaining, this norm did have an independent effect in pushing up real wages, particularly in the budgeted sector.

It is interesting to note that more recently the norm of income security previously applied to labor has also been extended to private wealth and in particular to the financial assets of households (see below).

The ethnic gap, the welfare state, and the growth of consumption. The wide social differences between immigrants of European origin and immigrants from Arab countries helped shape the Israeli welfare state. Government efforts in the 1950s concentrated on providing shelter and employment. The rapid rise in the
standard of living made social and economic gaps easier to tolerate. But in the late 1960s the tensions created by the ethnic gaps became acute political and social issues. The growth of the social security system, particularly the expansion of child allowances (building on wide differences in fertility by continent of origin), was a response to that concern.

During the 1970s ethnic gaps became more a middle-class issue than a poverty-line one. The earning gap between Jews from Asia and Africa and Jews from Europe and America has narrowed, owing to the elimination of differentials that could not be explained by schooling or age. Some of the pressure on real wages may have been a result of competition between these groups. Gaps in consumption, in housing density, and in ownership of durable goods were narrowing too. Among the more basic variables, fertility differentials narrowed considerably, promising a possible long-term convergence. Despite the expansion of the education system, gaps in education and in other indicators of social status persisted into the second generation. Jews of Western origin dominated the white-collar occupations, Jews from Arab countries the blue-collar ones (see Chapter 7).

The rapid growth of per capita consumption helped Israel cope with the social tensions associated with its ethnic divisions in the early period. Such growth was then both inevitable and feasible. But in the 1970s the price to the economy became too high. The translation of ethnic cleavages into political life became overt. Deflationary policies or increased unemployment would have widened the ethnic gap. The Labor party, which led the Jewish community before 1948 and ruled the country, in coalition with other parties, from then until 1977, had such a wide margin of strength that elections did not threaten its primacy. The strong connection between economics and politics was structural. The government could afford to maintain a reasonable balance among long-term needs, available resources, and pressures for higher standards of living. After 1973, political competition intensified as a change of government became feasible. The immigrants of the 1950s had become more assertive; many had moved into the middle class and were striving for the standards of living and the durable consumption goods enjoyed by the more affluent. The political competition had a strong—though not exclusive—ethnic dimension, expressed in affiliation with one of the two major political parties. The populist line pursued during most of the period 1977–1983, reflecting consumers' aspirations and the government's sensitivity to them, determined the nature of Israel's crisis in the early 1980s.

Stop-Go Macro Policies and Failure to Resolve Conflicting Constraints

Israel has a long history of inflationary experiences. But the period 1968–1972, marking the recovery from the 1965–1967 recession, began with no inflation. With the first supply shock, the rate of inflation accelerated from 14 percent in 1970–1973 to 36 percent in 1973–1977. In 1974–1976 deflationary fiscal and monetary policies achieved some success at the cost of a small increase in unemployment. As noted earlier, this period was also marked by cessation of growth in real wages and private consumption (Chapters 14 and 17).

In 1977 the Likud party gained control of the government. Although many factors contributed to this change, the preceding years of contractionary policy must have been part of the reason. The new government liberalized the exchange rate, allowed the possession of foreign exchange and dollar-indexed money, and pursued expansionary policies. In 1977–1979 the rate of inflation increased to 71 percent. Bruno and Fischer in Chapter 17 attribute this increase to the decline in the demand for money associated with this innovation, as well as to the monetary and fiscal expansion. During this period subsidies for basic food items were increased, and a package deal with the Histadrut went into effect as part of an effort to deal with inflation from the cost-push side.

From the end of 1979 to 1983 the average rate of inflation was 123 percent. In a sharp policy reversal at the beginning of this period, a new minister of finance, Yigael Hurwitz, made the balance of payments a priority. Both policy and rhetoric emphasized the need to reduce the government budget deficit and private standards of living. Real wages and consumption declined, and the balance-of-payments deficit was kept in check despite the second oil crisis and the loss of the Sinai oil fields following the Camp David accord. The new level of inflation was precipitated by the sharp cut in subsidies. This time, however, the deflationary policies lasted less than a year. Mindful of the approaching elections and the dire predictions of the polls, the finance minister was replaced again.

In the pre-election period Yoram Aridor, the new minister of finance, restored and increased subsidies, reduced taxes on household durables, and reversed some of the erosion in transfers. The Likud was returned to power.

The declared shift in economic policy gave first priority to fighting inflation. Inflation was viewed as a bubble, a consequence of a cost-push-expectations mechanism. Starting in the autumn of 1982 the government raised the prices it controlled, including the exchange rate, at a constant rate of 5 percent a month, in the hope that expectations and other prices would converge down to this rate. This policy was initiated during the war in Lebanon, when domestic defense expenditure increased. At the same time other large projects were continued (such as the massive settlement effort in the West Bank; the planning of Israel's new military airplane, the Lav; and Project Renewal, the rehabilitation of low-income neighborhoods) and new ones planned (such as the Mediterranean–Dead Sea canal). Despite increased taxation, private consumption kept rising. The "5 percent policy" was a grand failure. Actual prices rose by more than 5 percent, requiring increased expenditures on subsidies and causing progressive overvaluation of the currency. Anticipating the imminent collapse of the policy, people
accumulated dollars, sold their free stocks, and then tried to sell government bonds and bank stocks. To prevent a total collapse, the banks borrowed abroad and reportedly asked the government to pump money into the stock exchange. This glaring paradox demonstrates the conflict between policy objectives.

In October 1983 a crash of the banks' stocks brought a collapse of the policy, a sharp devaluation, and a new minister of finance, Yigal Cohen-Orgad. The balance-of-payments deficit again became the priority. The acceleration of inflation to an annual rate of 400 percent produced a real wage cut, and subsidies were reduced. But within a few months a call for early elections reversed policies again. During the election campaign a new two-year wage agreement was signed, restoring the earlier cut in real wages, and a law was passed guaranteeing the value of the public's financial assets, thus further restricting the government's ability to pursue economic policy.

Yet 1984 was different. The civilian import surplus and public and private consumption declined because of a cut in real wages induced by the price shocks of late 1983 and a decline in the real financial wealth of the public. In the fall of 1984 a Unity government, composed of the two major blocs, was established with the express purpose of reforming the economy. Early in 1985 a package deal sharply reduced the monthly rate of inflation, subsidies were increased again, and foreign exchange reserves rapidly declined. Political considerations (including elections for the Histadrut, held in mid-1985) again constrained economic policy. In the summer of 1985 a new economic policy was announced. It was based on a sharp cut in real wages, a cut in subsidies, a price freeze, and a cut in government expenditure and manpower. It was accompanied by a special emergency grant by the United States.

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. These tensions led to short-term policy reversals, with shorter and shorter intervals of restraint.

Inflation accelerated in steps, with a rapid increase followed by a period of quasi-stability. Typically, the upward step was associated with an innovation in government policy, reflecting worry about the budget, the balance of payments, or foreign reserves. The initial effect of devaluation or subsidy cuts is higher prices. With partial indexation of wages, there was an immediate decline in real wages. Built-in asymmetry prevented the translation of the deflationary spell into quick price deceleration. Only at the end of a sustained period of restraint (1974–1976) did inflation show signs of yielding. Since then, the periods of restraint have been shorter. After the short-term setbacks real wages tended to rise through formal and informal bargaining rather than automatic mechanisms; subsidies were restored and devaluations started lagging behind prices.

Monetary policy has played an important part in Israel's inflation. It became increasingly accommodating, adjusting to the higher rate of inflation. As the real stock of domestic money held by the public shrank because of increased inflation, the monetary injections became more potent. Also, as the growth in product slowed, less of the growth in the money base could be absorbed in a noninflationary way. With most of the public's financial assets linked to the price index or to the dollar, there was an automatic increase in an important component of the money supply, as well as automatic protection of households' wealth. Thus the system was deprived of any self-correcting mechanism with which to combat inflation by relying on the real balance or real wealth of effects (see Chapter 17).

When the consequences of these policies were felt in the balance of payments, the public, aware of the inevitable need for correction, accumulated dollars. Increasingly in recent times, such waves of speculation have prompted devaluations. It became clear that the stop-go policies fueled rather than quenched the inflationary process.

Interpretations of the role of the government deficit differ. Bruno and Fischer (Chapter 17) emphasize the roles of the large deficit (15 percent of GNP) and the accumulation of an intolerably large national debt in contributing to inflexibility in the budget and in money creation. Liviatan and Piterman (Chapter 16) emphasize the lack of any short- or even medium-term correspondence between the size of the deficit and the rate of inflation. They attach importance to the link between expenditures and the import surplus, which induced inflationary measures.

The issue of Israel's inflation tax is particularly interesting because of the asymmetry in indexation between the government's assets and obligations. In the late 1970s and early 1980s, when the public sector still had a sizable outstanding indexed debt to the government, it was not even clear whether the inflation tax was positive. It was, at any rate, fairly small. Does this mean, as Liviatan and Piterman suggest, that such a small tax could not have been responsible for inflation of such magnitude, or could it be that it takes a great deal of inflation fueling in Israel to obtain even a modest tax?

This is only one aspect of indexation. In a sustained inflationary environment, institutional adjustments become ingrained (and some of the indexation arrangements date back to World War II). Every advance in inflation creates a short-term shock, because the old formulas are not tight enough to handle it; then the public views inflation as intolerable, and real wages fluctuate violently. Eventually, however, institutions and habits adjust: indexation formulas are revised, prices are adjusted often, and prices and contracts come to be quoted in dollars, resulting in a daily price adjustment. In fact, by the early 1980s the dollar had become a unit of account as well as a partial means of payment, and certainly an important store of value. Inflation has increasingly become a function of itself.

Obviously the indexation system is not perfect. It may be argued that it is close enough to perfection, so that in fact it makes the price level indeterminate, and
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<tr>
<td>Population (1000s)</td>
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<td>Women</td>
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<td>Consumer price index (1973 = 1.0)</td>
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<td>Inflation rate b</td>
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<td>Money supply/GNP</td>
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Source: CBS, Statistical Abstracts, various years.
a. Calculated relative to preceding column.
thus allows an unbounded acceleration of inflation. Certainly the automatic indexation of financial assets and the existence of "indexed money" is an important element. On the other hand, Chapter 15 demonstrates that the formal indexation agreements for wages would have allowed significant erosion in the real wage. In fact these imperfections may have created short-term fluctuations in real wages that sought compensation in other components of the wage structure and thus may have had an inflationary bias.

It is clear that the indexation system, interpreted in a broad sense to include many informal practices, allowed people to survive inflation and thereby made it impossible to muster the political coalition to combat it, and to bear the costs and the risks of doing so. Inflation, like the balance-of-payments deficit, has become an externality. This fact raises the question whether inflation entails real costs and whether it is necessary to fight it.

With imperfect indexation the price system is subject to "noise" and uncertainties. The indicators for the cost of inflation, though fragmentary, are very telling: an excessive share of the financial sector in employment, the collapse of the tax system, perhaps the high share of dwelling in investment, plus much anecdotal evidence that people spend their time looking after their assets, pursuing "bubbly" profits or searching for the lowest price. It is hard to believe that both the public and private sectors operate efficiently in such an environment. It is not established at what rate inflation in Israel can be defined as hyperinflation. It may well be that a balance-of-payments crisis, with associated mass unemployment, is a more acute threat. In either case a collapse of the economic system also has frightening implications for the political democratic system.

**Epilogue: Problem and Promise**

Many of Israel's economic problems are related to its heavy defense burden. Several of the structural features that have handicapped Israel's transition to a new growth path and its ability to cope with external shocks resemble the rigidities that have plagued other economies during the past decade. Other features—such as the strong aversion to unemployment, the overprotection of individual welfare, and the role of government in the economy—derive from the period of large-scale immigration and rapid economic growth. In Israel's case they may have been necessary to meet the economic and social challenges of that phase. Thus there may be a dialectic connection between the height of past achievements and the depth of the recent fall.

If Israel's present economic straits do involve not only the fortuitous conjunction of bad luck and erroneous policies but also basic structural problems, the required remedies may necessitate an operation as drastic as the problems. 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. There is no simple formula for such a change, because some of the circumstances that produced the current situation still exist. The concern that many elements of such a change, though desirable in the long run, would have an immediate adverse effect on inflation, unemployment, and equity, is a legitimate one. However, 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, remain to be seen.

The title of this section is borrowed from a pioneering study, *Palestine: Problem and Promise*, by Nathan, Gass, and Creamer (1946), written before the establishment of the state of Israel in the face of what seemed to be insurmountable economic problems and vaulting hopes. In the midst of today's crisis, too, it is hard to discern the promise. But the potential is there. Israel has a reservoir of human capital and a scientific infrastructure that can be used to increase productivity and expand exports. Its national determination, used to achieve political independence and self-defense, could also be harnessed to achieve economic independence. Thus, economic maturity may still prove to be a starting point for a new phase of sustained growth.