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Chapter 7

A Concluding Note: Increasing Reliance on the Price Mechanism

Comprehensive quantitative restrictions of imports, as the major component of a system of price control and rationing, were practiced and intensified in Israel during the years 1949–51. This was the period in which the country, which was just emerging from the War of Independence, about doubled its population through immigration. It was argued then that under such unusual conditions a market mechanism could not be expected adequately to fulfill the tasks of an economic system—the determination of production, consumption, and distribution. In particular, it was believed that establishing equilibrium in the balance of payments by raising the rate of exchange enough to allow freedom in international transactions would lead to a socially unacceptable structure and distribution of imports.

In what way a rationing plan would be more effective than the market mechanism was not usually very well specified. But presumably, the former was intended to fulfill two objectives: One was to achieve a more equal income distribution than a market mechanism would provide; and the other was to increase savings and investment as proportions of income. Since these targets could also be reached by a market mechanism plus taxes and subsidies, it may be inferred that the QR system was judged to be a better, or perhaps more *feasible,* means of implicit taxation than the conventional methods of explicit taxation. For a while, the QR system seemed indeed to achieve some equalization of income, by adding a price in "rationing points," distributed equally among the population, to the conventional money price. It apparently also produced, for some two years, a significant rate of "forced" savings. But the Israeli experience has shown that the QR system could be maintained, and its targets achieved, only for a short while and only insofar as it caused no major deviations from what would have been the result of free market forces. Since the price control and QR systems were combined, during these years, with a very expansionary monetary-fiscal policy, it soon became unsustainable. By 1951, the degree of disequilibrium became high enough to lead to a disintegration of the system—to very intensive shortages and scarcities, widespread absenteeism of labor, and the rapid overtaking of the system by the black market. From a political point of view, too, the system, which was presumably thought to be more acceptable than explicit taxation, became untenable. The Israeli lesson from the period of 1949–51 is clear: a QR system probably fulfills the task of distributing some essential goods from a given stock better than any other system; but a comprehensive scheme of controls and rationing cannot replace the market mechanism, once the degree of disequilibrium in the system becomes substantial, unless a full shift is made toward a centrally planned economic regime.

The degree of failure of administrative controls probably contributed much to the fact that, once a shift to the use of the price mechanism was begun in early 1952, it progressed virtually without any relapse. In this shift, again, the foreign-exchange rate and import prices were the focal points of the system as a whole. The switch was sudden and of overwhelming proportions. Within a period of less than three years, the rate of exchange increased fivefold; and although domestic prices, too, rose very fast, with the gradual relaxation of controls, the PLD-EER more than doubled. By the latter half of 1954, when this process was completed, the exchange rate and the balance of payments were close to equilibrium, as were most other prices and quantities in the economy. During this period of three years, despite a short period of increased unemployment resulting from a restrictive monetary-fiscal policy, the increase in the economy's productivity was particularly high and the economy's growth particularly fast.

Once restriction of imports had been imposed due to balance-of-payments considerations, however, inevitably there were protective effects as well. Thus, when equilibrium in the balance of payments was restored, in the mid-1950s, the economy had already acquired patterns determined by the protection until then afforded to import substitutes. While the correction of a very high degree of balance-of-payments disequilibrium required only a few years, the removal of the protective aspects of the QR system has not been completed even at present, close to twenty years after the balance-of-payments motivation for the restrictions had disappeared. Removal of the QRs proved to be easy, and was performed quite rapidly, for imports of raw materials and semimanufactured intermediate goods. Since these were not produced in Israel, and could not potentially be produced within a relevant price range, liberalization of such imports did not effectively reduce protection to any local industrial branch. Indeed, such liberalization increased the effective protection granted to local industries using these intermediate inputs and was therefore welcomed by those industries. When, however, an import good did compete with a local industry, and the effect of its liberalization was to lower effective protection, the situation was radically different. Such liberalization of imports competing with local industries—mainly imports of finished consumer goods—started only much later, and by a much more gradual and protracted process. In fact, total protection of import substitutes by QRs remained in force some seven or eight years after the restoration of the balance-of-payments equilibrium. Only with the second New Economic Policy, in 1962, did the progressive relaxation of these restrictions start. Even then, for some seven years the change was primarily in the *form* of protection: quantitative restrictions were replaced by the price mechanism, that is, by appropriate tariffs designed to grant each industry roughly the same protection it had enjoyed under the QR regime. In this sense, then, the shift from the use of QRs to reliance on the price mechanism was completed not in 1954 but only some fourteen years later, in 1968. Since 1969, a gradual reduction in the level of effective protection of the industries formerly enjoying QR protection has been underway. And by present forecasts, over twenty years are anticipated to pass between the time the original balance-of-payments motivation for QRs disappeared and the time when most of the protection afforded by this system will have been removed. The lesson drawn from this experience in Israel is that once comprehensive QRs of imports are imposed, and the economy's structure adjusts to them, the protective aspect of the system is not easy to remove. Liberalization of QRs is easy and speedy where it leads to an increase in effective protection to local import-using industries; but when, to the contrary, it lowers protection, the liberalization process must be gradual and protracted. The process is likely to be helped by a shift in the method of protection from QRs to tariffs, even though at first such a shift may be purely a nominal liberalization, leaving the level of protection unaffected.

The degree of protection has throughout been much less uniform, and on the average higher, for import substitutes than for exports. This was obvious under the QR regime, when the importation of almost anything that competed with existing or potentially feasible local production was in fact banned, leading sometimes to extremely high levels of protection in import-substitution industries, whereas no similar policy of producing at "any cost" was applied to exports. When QRs were replaced by tariffs designed to afford each branch the same protection as the QRs, the level and dispersion of protection of import substitutes remained, of course, largely unchanged. But even regardless of the QRs, and abstracting from the tariffs that were designed to replace them, effective protective rates appear to have been higher and, primarily, much more diversified for import substitutes than for exports.

Several factors could explain this difference between import substitutes and exports. One is a tendency toward a policy of autarky, which apparently prevailed during the 1950s. Another is the *size* of the two sectors: exports being, particularly in the earlier years, a very small segment of total trade, they carried relatively little weight in the policymaking process. Still another factor, certainly not one confined to the case of Israel, was that protection to import substitutes could be hidden to some extent: protection afforded not by QRs but by tariffs even yields a revenue to the government, whereas export subsidies are mostly a governmental expenditure. Another factor, apparently specific to the case of Israel, was the early recognition by the government that protection should be measured by its effect on the price of the value added rather than the price of the final good: ever since the mid-1950s this view has been almost universally accepted in Israel and has been applied to exports in particular. Effective protective rates in exports were thus considered and determined *directly,* and not as a chance by-product of decisions about nominal rates of subsidy, a fact which certainly contributed to the uniformity of these rates. In imports this principle was not generally applied, probably because high import duties (unlike export subsidies) had existed before the effective protective principle was recognized, and because tariff duties also fulfill other functions besides protection. In the stage of nominal liberalization of the 1960s the effective protection principle was most probably applied in the determination of import duties; but in this case, it was designed to maintain the nonuniform degrees of protection introduced by the QR system rather than to lead to a uniform level. The progressive lowering of protection since 1969, on the other hand, has been aimed at achieving uniformity of effective protection in import substitution.

The combination of the relatively large size of the import-substituting sector and the large dispersion in the degree of protection granted to the various industries involved must have resulted in a significant loss of productive capacity due to misallocation of resources. The loss from protection of exports, on the other hand, could not be of a substantial size, even in recent years, when the export sector has grown in importance.

The process of devaluation, which started in 1952, has proceeded ever since, either through large-scale formal devaluations or small changes in nonformal components of the exchange rate, such as import tariffs and export subsidies. Both the size of the several devaluations, however, and their degree of success, varied considerably. The formal devaluation of 1952–54 could be termed an unqualified success, and was probably an example rarely repeated in other countries. As mentioned, the PLD-EER more than doubled within less than three years. During this period, not only was the QR system largely scrapped and the severe shortage of imports largely eliminated, but the quantity of imports also declined, while the national product increased at a very fast rate. Exports, too, rose during the period at a record rate. Other devaluations, on the other hand, notably the formal devaluation of 1962, fared much less well, and the benefits were dissipated within only a few years. As discussed in the concluding section of Chapter 5, the major factor which accounts for the difference in performance between the devaluation of 1952–54 and other devaluations was the nature of the accompanying demand policy: this was restrictive during most of the period of 1952–54, and expansionary during other episodes of devaluation.

The contrast in fiscal and monetary policies between 1952–54 and subsequent devaluations may probably be explained mainly on two grounds. One is that the first devaluation was undertaken under emergency conditions, when the country's external reserves were nil and a general feeling of collapse was pervasive, whereas the other devaluations were undertaken in more secure circumstances. The other difference lies in the strong, automatically expansionary impact the later devaluations had on money and liquidity in the economy, owing to the existence and accumulation of external and exchange-rate-linked assets. The lesson which may be drawn from the history of the devaluation process in Israel is that although a restrictive demand policy is essential to the success of a devaluation, it is particularly difficult to undertake when strong automatic forces lead in an expansionary direction and when no sense of emergency prevails in the population or among policy-makers.

One indicator of the success of the various steps in the process of devaluation is the movement of the level of the PPP-adjusted EER, which shows the relative change in the price of tradables (exports and imports) versus other prices. The level of this rate increased considerably (by close to 150 per cent) from the time just before promulgation of the 1952 New Economic Policy to the mid-1950s. Since then, however, the rate has been stable over the long run, with the various acts of devaluation leading only to temporary fluctuations in its level.

Two major forces seem to have motivated the devaluation process, both operating mainly in the early and mid-1950s. One, mentioned earlier, was the need to overcome the consequences of the system of controls and restrictions of 1949–51, and to replace this collapsing system by a workable price mechanism. The other was the need to reduce the dependence of the economy on capital imports, and to provide for the economy's continuous growth in face of a relative decline in the inflow of foreign capital. Indeed, the second target has been achieved just as well as the first: there has been almost continuous full employment and an almost uninterrupted rapid growth; and the dependence of the economy on capital imports, as measured by the ratio of the import surplus to the GNP, has sharply declined. Reduction of this dependence took place almost entirely during the 1950s: in later years, there are large fluctuations, but the long-term trend is only slightly downward.

It is interesting to note that this drastic (relative) reduction of the import surplus altered only slightly the importance of foreign trade for the economy. This may be illustrated by the following comparison of the beginning and end pairs of years of the period under review. In 1950–51, the ratio of the import surplus (excluding imports of military goods) to GNP was about 43 per cent; in 1971–72, it was less than 10 per cent. Yet, the combined ratio of value added in exports and of imports for domestic use (again, excluding military imports) to GNP declined merely from about 50 per cent in 1950–51 to 47 per cent in 1970–71. Despite the overwhelming decline of the import surplus, the economy retained almost the same degree of openness as before; that is, the declining gap between imports and exports was provided chiefly by export expansion rather than by a contraction of imports. This process, again, did not follow a uniform course over the years. During the 1950s, it was primarily a reduction of imports which contributed to the decline in the import surplus. In later years, on the other hand, imports not only ceased declining but even increased slightly, while exports expanded substantially.

This performance stands in sharp contrast to the prevailing view in Israel during the first few years after the establishment of the state, which leaned toward autarkic development. Based on something like an "absolute advantage" theory, the common argument made was that a country in Israel's position, with almost no raw materials and little industrial skill, could become competitive in only a very few goods. Having little to offer to the outside world, it therefore had to turn inward, producing for itself whatever it possibly could. In illustration of the extent to which Israel's actual growth process has deviated from this dim projection, it may be noted that by the early 1970s, value added of Israel's exports exceeded its 1950 GNP. Given the substantial change in relative prices introduced in the 1950s, rapid growth has thus been consistent with the drastic reduction of the economy's dependence on the import surplus and with maintenance of an open economy.