JERUSALEM LETTER / VIEWPOINTS
Jerusalem Center for Public Affairs

No. 359 25 Iyar 5757 / 1 June 1997

FINANCIAL AND HUMAN CAPITAL FLOWS INTO ISRAEL: WHAT ROLE FOR PUBLIC POLICY?

James W. Dean

Patterns of Capital Flow / Why Israel Imports Capital / What Role for Government?: Financial Capital / Human Capital / Should the Israeli State Still Help Absorb Immigrants in the Late 1990s? / Job Creation Via Exports

During the first half of the 1990s, Israel imported more human capital than ever before in its history, and also proportionately more than any country in the world. In the second half of the 1990s, Israel can expect to import more financial capital than ever before in its history.

Absorbing human capital proved problematic, exposed market failures, and called for government intervention. Experiences of other countries suggest that importing financial capital may also prove problematic. However, the need for government intervention is less obvious; in fact, the Israeli authorities are probably already intervening too much. What lessons can be learned from the rest of the world?

Patterns of Capital Flow

From 1973 to 1982, tens of billions in OPEC oil surpluses, as well as funds from America, Europe and Japan, were lent to and invested in the developing world. That process ended abruptly in mid-1982 when Mexico and then dozens of other borrowers, mostly in Latin America, proved unable to service their debts.

From 1982 to 1989, during the "international debt crisis," voluntary private sector lending to developing countries slowed to a trickle. However, the United States and Canada became the world's largest borrowers, and Japan and Germany the world's largest lenders. Although rich, North America was (and still is) a "developing country" in the sense that it imports large amounts of financial capital to finance a steadily growing economy. Most of this appetite for capital derives from a rapidly growing labor force, which in turn derives from immigration. While Europe and Japan created almost no jobs during the 1980s and 1990s, North America has created millions.

Since 1990, private sector lending to developing countries has resumed with a vengeance. It has taken new forms: banks are lending less, while direct investment and portfolio investment has burgeoned. Portfolio investment takes the form of bonds and equity. As part of this process,

Daniel J. Elazar, Editor and Publisher; Zvi R. Marom, Associate Editor; Mark Ami-El, Managing Editor. 13 Tel-Hai St., Jerusalem, Israel; Tel. 02-5619281, Fax. 02-5619112, Internet: elazar@vms.huji.ac.il. In U.S.A.: 1616 Walnut St., Suite 507, Philadelphia, PA 19103; Tel. (215) 204-1459, Fax. (215) 204-7784. © Copyright. All rights reserved. ISSN: 0792-7304.

The opinions expressed by the authors of Viewpoints do not necessarily reflect those of the Jerusalem Center for Public Affairs

"emerging" equity markets took off dramatically in the early 1990s and often provided investors with roller-coaster rides. With Germany now borrowing to finance reunification, and Japan in financial turmoil, America became the biggest single lender. Asia and Latin America became the biggest borrowers, led by China, Mexico, Argentina, Thailand, and Korea. On a per capita basis, the biggest borrowers in the early 1990s were Hungary and Malaysia. In the late 1990s, capital flows to Eastern Europe and Russia are increasing rapidly, as are flows to the Middle East, particularly to Israel.

The world's major importers of capital can be divided into three blocs. North America is a developed region, but nevertheless imports capital for a labor force that is growing rapidly due to immigration. Asia and Latin America are developing regions. They import capital for a labor force that is being absorbed from underemployment in agriculture and other traditional activity into employment in modern industrial and post-industrial sectors. Central and Eastern Europe and Russia are regions in transition from planned to market economies. They import financial capital to replace physical capital from the communist era that is now obsolete and misallocated.

Why Israel Imports Capital

Why does Israel import capital? Since its creation, the State of Israel's overwhelming need for foreign capital has been to finance defence, and the largest single source of foreign capital has been government loans and grants from the U.S.A. However, in the 1990s, much has changed. First, Israel is, we hope, on the verge of peaceful coexistence, and perhaps even economic cooperation, with its neighbors. Second, Israel has just experienced the largest wave of immigration in its history, five or six times the coincident rate of immigration into North America. Third, if the Oslo agreement sticks, Israel may, like Asia and Latin America, be able to absorb large numbers of (mostly Arab) workers from underemployment into a modern post-industrial economy. Fourth, like the former socialist states, Israel is about to privatize and deregulate most sectors of its economy.

Therefore, Israel's increased appetite for foreign private capital in the 1990s has elements in common with each of the world's three types of capital-importers. Like the developed economies of North America, Israel enjoys a high level of per capita income due to high labor productivity, but needs foreign capital because its labor force is growing due to immigration. Like the developing economies of Asia and Latin America, Israel has the potential to draw on underemployed labor and will need foreign capital to invest in that source of growth. Like the transition economies of Eastern and Central Europe and Russia, Israel is now attracting large volumes of capital in anticipation of privatization and deregulation. Witness Israel's stock market boom over the past year.

But Israel in the 1990s is experiencing another phenomenon that is unique: an exogenous inflow of human capital. Unlike the labor-importing countries of North America, Israel is committed, by the Law of Return, to accept as permanent residents all Jewish immigrants who apply. North America, by contrast, can turn the tap of immigration on and off, in principle at least, according to its economic need for labor. Moreover, North America can and does accept or reject applications for immigration according to its need for particular occupations and qualifications. In short, its inflow of immigrants is endogenous to its economic requirements, rather than exogenous to them. The supply of immigrants enters North America in response to the economy's demand for them. In Israel, by contrast, the supply of immigrants is exogenous, and demand must respond endogenously. Of course for non-Jewish labor, the causality is reversed and much closer to that in North America. Israel can accept or refuse non-Jewish foreign workers as desired; in fact, unlike Canada and to some extent the United States, Israel is not committed to according foreign workers permanent resident status.

What Role for Government?

Financial Capital

It might be imagined that massive inflows of financial capital in the 1990s have been an unmitigated boon to the recipient countries. A boon they have been to be sure, but they also pose problems. Capital inflows must be both sustainable and restrainable.

It was the sudden cessation of bank lending to dozens of developing countries that precipitated an international debt crisis during the 1980s after Mexico interrupted its interest payments in mid-1982. Fourteen years later, in late 1994, foreign financial capital again fled Mexico; this time it was bond buyers who backed out. Once a country becomes dependent on capital inflows for financing an excess of imports over exports, it runs the risk that these inflows will suddenly slow down. In short, to avoid a crisis, capital inflows must be *sustainable*.

Paradoxically, capital inflows should also be restrainable. Sudden surges in flows can be difficult for a country to absorb. Simply put, foreign currency flowing in from abroad, when converted into domestic currency, can cause inflation. In the early 1990s, faced with unprecedented inflows, several Latin American and Asian countries (fearing inflation) chose to "sterilize" the effect of the inflows on their domestic money supplies, which means that their central banks removed one peso or won from circulation for every won or peso that had been put into circulation in exchange for foreign currency. However, sterilization had the undesirable side-effect of propping up domestic interest rates and artificially sustaining the capital inflow. Eventually these countries gave up sterilization and ran the consequent inflationary risks.

The easy money that came with capital inflows also contributed to a boom and bust financial environment, culminating in a wave of bank failures. Among developing countries, the 1990s has seen banking traumas in Argentina, Brazil, Mexico, Jamaica, Paraguay, Venezuela, Egypt, India, Sri Lanka, Indonesia, and Taiwan; and among transition economies in Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, Rumania, Russia, and Slovenia.

Private capital has been pouring into Israel since late 1993. Until 1996 the bulk of it derived from Israeli residents bringing their money back home; now the inflows are mostly coming from non-residents. This inflow symbolizes a renewed faith in the future of Israel. If properly managed, it can only be beneficial to the economy. But the inflows will not be sustainable if foreign investors perceive that their money is at risk. This could happen if they suspect macroeconomic mismanagement — excessive monetary creation or expanding government deficits — or if they suspect microeconomic mismanagement — a bungling of the privatization and deregulation process, or a misallocation of borrowed money by the financial sector. Of course, the inflows will also reverse themselves if the peace process goes awry.

Since 1986, Israel's macro economy has been well managed, with both inflation and the deficit under control. How well liberalization and privatization will be handled in the late 1990s remains to be seen. The key to successful liberalization is to precede it by a sound macro economy, and a sound and well supervised banking system. Israel now has both. Aside from political risk, Israel is much less vulnerable to a reversal of capital inflows than was Latin America in the early 1980s, or many of the transition economies in the 1990s.

In short, Israel seems well poised to sustain its capital inflows. But can it absorb them without inflation, and restrain them when necessary? The key to this process is the exchange rate. The dilemmas recently faced by Latin America and Asia were brought about, in this writer's opinion, by their obdurate commitments to fixed or managed exchange rates. If the exchange rate (expressed as units of foreign currency per unit of domestic currency: for example, dollars per shekel) is allowed to rise in response to capital inflows, the inflows will naturally be discouraged as they become more expensive for foreigners. They will wax and wane in response to ups and downs in the exchange rate. Thus the need to sterilize against inflation will largely disappear, as will the need to restrain the volatility of flows by imposing capital controls or taxes.

As part of the inflation stabilization plan of 1985, Israel pegged the shekel to the U.S. dollar (and later to a basket of currencies). In January 1989, Israel adopted a target zone with a fixed central parity and a band of 3 percent, which was widened to 5 percent in March 1990 and to 7 percent last year. Over the last few months the shekel (valued in foreign currency) has been pushing against the upper range of the 7 percent intervention zone. Meanwhile, inflation has increased the real exchange rate and the Bank of Israel has seen fit to sterilize the impact of capital inflows on the money supply. This has had the unfortunate side-effect of widening the gap between Israeli and international interest rates, prolonging the incentive for capital inflows and setting up a vicious cycle. In an effort to restrain inflows, the authorities have mooted the idea of a 20 percent tax on the interest earnings of foreign investors. This would be ill-advised as it would impose dead-weight costs on the Israeli economy in the form of foregone investment opportunities.

Israel would do well at this point to abandon management of its exchange rate altogether. The present regime dates from the days when inflation was approaching 200 percent per year and an exchange rate anchor was essential. Rampant inflation has now been under control for a decade and this anchor is no longer necessary. The credibility of the Bank of Israel is sufficient. If Israel were to move to a fully flexible exchange rate, it would have no need to engage in the inevitably futile exercise of sterilizing capital inflows, or to institute a costly tax on foreign investors.

In short, Israeli government policy toward inflows of financial capital should be to intervene even less than

it already does. Financial capital will add to long run growth as long as it is invested in physical capital that yields more than the interest rate at which the financial capital was borrowed. Freely-fluctuating financial and foreign exchange markets are likely to ensure that this happens. The overall thrust of this argument is that capital inflows are likely to be self-regulating, both in volume and allocation, without government intervention beyond that which ensures macroeconomic stability as well as adequate banking supervision and financial market transparency.

Human Capital

For human capital inflows, the appropriate role for government may be larger. Financial and human capital are both potential engines of economic growth. In principle, inflows of human, like financial, capital can be self-regulating because wages should fall as the supply of labor increases, thereby discouraging further immigration. This process is analogous to a rise in the exchange rate and fall in the rate of interest as an inflow of foreign financial capital increases: both are market-based price adjustments that slow down the inflow.

However, human capital is different in several respects. First, wages, unlike exchange rates and interest rates, do not readily fall; rather, rapid immigration is likely to cause temporary underemployment or unemployment, particularly among the immigrants themselves. Second, under- and unemployed people present a moral and social challenge to public policy that misallocated or unemployed financial and physical capital does not. Third, under- and unemployment does not necessarily discourage continued immigration (the way that rising exchange rates and falling interest rates discourage financial capital inflows), since conditions in Russia continue to be far worse than in Israel, even if conditions in Israel deteriorate slightly. Fourth, Israel, unlike other countries, cannot control the volume or human capital characteristics of its immigrants.

Fifth, human capital, unlike financial capital, is not fungible. Financial capital is fungible: it can be used to purchase whatever kind of physical capital is likely to be most productive. By contrast, specific human capital cannot be transformed costlessly into whatever form of human capital is currently in demand. In other words, it is costly to retrain people.

Should the Israeli State Still Help Absorb Immigrants in the Late 1990s?

Israel is on the verge of a major round of deregulation, privatization, and further withdrawal of government from a wide range of activities. Much of this withdrawal is wise and will serve business, consumers, and even labor well. However, it is important that government's role in the economic absorption of immigrants not be abandoned thoughtlessly in the process.

Under the Law of Return, Israel is unique among nations. It has pledged itself to accept all Jewish immigrants from anywhere in the world, in whatever numbers they may arrive, and whatever their education, training, or job qualifications. This is a brave and admirable pledge. In modern history, no other country in the world has so completely relinquished control over the number and "human capital" characteristics of its immigrants: perhaps the closest parallel was America before World War I. This pledge has committed Israel to the admission of over 800,000 immigrants since 1989. It is as if the United States had admitted the entire population of the United Kingdom over an eight-year period, and with no control over their job qualifications.

Given the numbers, absorption of these immigrants into the Israeli labor force has been remarkably successful. Indeed, much of the economy's strong and steady growth during the 1990s can be attributed to this influx of highly qualified and productive people. Nevertheless, there have been problems, albeit problems with a silver lining. Many of the new immigrants have been over-educated for the kind of employment the Israeli economy could immediately offer. As a result, considerable human capital has been underutilized. This has been a waste for the Israeli economy, not to mention a source of discontent among the immigrants themselves.

Absorption of immigrants has been the responsibility of the Ministry of Absorption, with responsibilities also falling to the Ministries of Science, Industry and Trade, Health, Education, Finance, and even the Bank of Israel. Each ministry has achieved its own successes, but it is also clear that some housecleaning is now necessary. Some programs are obsolete and some never worked very well. What is also clear is that the costs and benefits of the various rather ad hoc absorption

programs beg to be compared systematically against one another. Next, it seems clear that while certain programs should be abandoned, others ought to be continued or strengthened and some new approaches should be introduced. Finally, far more coordination and perhaps centralization of programs and policies is needed. The obvious candidate for this coordination role is the Ministry of Absorption.

Job Creation Via Exports

Israel has long recognized that an active role for public policy toward immigration is legitimate. The absorption of so many people into such a small country calls for collective help. However, Israeli immigration policy in the 1990s has, in this writer's opinion, overemphasized the potential for job retraining to meet domestic demand and underemphasized the potential for job creation via exports.

Israel is a small country with a small economy; nevertheless, it has the potential to create export-oriented jobs for as many immigrants as might ever conceivably enter under the Law of Return. Indeed, despite the huge immigration wave of the 1990s, Israel has created more jobs than can be filled in some sectors: for example, in software programming. The key to sustained job creation does not lie in creating artificial jobs for immigrants in the public sector; nor does it lie in inflating domestic demand through monetary and fiscal policy. Rather, the key lies in export production and export marketing.

Israeli public policy has rightly sought to foster exports. For example, Israel's "Silicon Valley" is a notable success. But export promotion has (quite correctly) not been geared particularly toward job creation for immigrants. Although the Silicon Valleys of Haifa and Herzliya have created a surplus of programming jobs, immigrants have not proved particularly suitable for these jobs, despite their excellent education in science, engineering, and mathematics. What is wrong?

One answer seems to be that many immigrants, particularly those from Russia, have difficulty bridging the great gulf between basic research and its commercial application. This is certainly understandable given the nature of Russian scientific education, as well as the total lack, until very recently, of any commercial environment in Russia itself. Many Russian immigrants therefore face double jeopardy: they lack an applied education, and they have no experience with a commercial culture. In addition, they face the vast information gulf between domestic and export markets, a gulf that is equally faced by native-born Israelis.

What this suggests is that one appropriate role for the Israeli government toward absorption of immigrants might be to help bridge these three gaps: that between basic education and applied training, that between public and private employment, and that between domestic and export markets.

Since the early 1990s, several "bridge" programs for immigrants have been in place. One example is the plethora of "temporary" research positions provided for immigrants at universities. However, these positions often underemploy immigrants as laboratory technicians and the like; worse, they typically linger on for years, in the apparent absence of private sector alternatives — or perhaps because the immigrants themselves are not motivated or equipped to seek out such alternatives. A second example is the so-called "incubator" program that creates research environments intended to spawn proposals leading to commercial application. It has achieved notable successes but has also been sharply criticized because it served a relatively small number of immigrant scientists, and has proved very costly on a per person and per project basis.

A more promising "bridge" project is currently under consideration within the Department of Industry and Trade. The concept is to match scientists with inventive ideas to a "technical marketing manager" who would guide a proposal toward commercial application. A related idea is to link such proposals to information on export possibilities. An extensive data base already exists at the Israel Export Institute in Tel Aviv, but in its present form it is reportedly used mostly by well-established Israeli firms rather than fledgling immigrant entrepreneurs. A third role that the Israeli government has already experimented with is subsidizing venture capital. This is justifiable if and only if the social (e.g absorption) returns to successful entrepreneurship exceed the returns anticipated by private investors otherwise private venture capital firms should suffice

In some cases government intervention has proved unnecessary. For example, several Russian immigrant doctors have learned to export their services quite effectively to foreigners who come to Israeli clinics and hospitals for specialized treatment. But mining engineers, for example, will never find clients in Israel. They might nevertheless market their services internationally by forming a consulting firm. Better that than retrain as teachers of high school mathematics, as was the fate of many Russian immigrant engineers under absorption programs of the early 1990s. Israeli universities, which already enjoy a worldwide reputation for

excellence, might market their programs in Asia or even parts of the Middle East for full-cost tuition fees, as Australian universities have done so successfully. Surely that would provide more suitable employment for immigrant academics than driving taxis. Or Israel might even form a brand new symphony orchestra from Russians busking on the sidewalks, send it on global tours, and sell recordings worldwide.

These examples may be far-fetched, but they are presented to pose a tough question: should public policy toward absorption of human capital invest more resources in international marketing, and less in retraining to meet existing domestic demand? In other words, should not a country that is faced with an inflow of human capital whose total volume and human capital characteristics it cannot control take full advantage of the unprecedented global marketing opportunities of the 1990s? Do private markets really work well enough to ensure that new immigrants can take advantage of these opportunities, or is there, perhaps, a role for government?

This writer believes, as do many professional economists, that the free market for human capital works less than efficiently, and that government should play an active role in assisting immigrants to find their most productive positions in the labor force. Part of this role should be to help immigrants seek out foreign markets for the goods and services they have been trained and educated to produce, rather than underutilizing their human capital, or attempting to retrain them to fit into the existing structure of the Israeli domestic economy. In the late 1990s, with Israel well on the way to export-led growth and with the government rightly withdrawing from its role as an "employer of last resort," public policy toward immigration should reorient itself toward the private sector and toward global markets.

* * *

References

James W. Dean, "Recent Capital Flows to Asia Pacific Countries: Trade-Offs and Dilemmas," *Journal of the Asia Pacific Economy* 1(3) (1996):287-317.

James W. Dean and Iris Geva-May, "Immigration Policies and Economic Myopia," *Journal of Policy Analysis and Management* (forthcoming 1997).

* * *

James W. Dean is Professor of Economics at Simon Fraser University in Vancouver, British Columbia, and Kaiser Distinguished Professor of International Business at Western Washington University in Bellingham, Washington, U.S.A. Among his many appointments, Professor Dean is a consultant to the World Bank and Government of Canada. This *Jerusalem Letter/Viewpoints* is based on his presentation at the Jerusalem Center Fellows Forum in March 1997.