

Right of reply: Why Prof. Yaron Zelekha is harming the public economic debate

A response to economist Prof. Yaron Zelekha's assertions regarding growth, unemployment and the cost of housing in Israel.

By Prof. Omer Moav Jul. 18, 2013 | 10:34 AM

In Ayelett Shani's interview with Prof. Yaron Zelekha ("The Number Cruncher," July 5), Zelekha is scathing about Israeli government policy. There is certainly room for serious criticism of the government and prime minister, especially in regard to tough talk that is not backed by positive government action, but Zelekha's criticism is based on flawed arguments. As a result, rather than contributing to the public discussion, he sabotages it. Here I refute a large portion of his claims, but given the sheer number of flawed arguments, I will address them in summary form rather than examining each one closely.

I begin with Zelekha's claim that, since the 1970s, Israel has not been closing the gap in per-capita GDP relative to developed countries, and that the failure to close this gap contradicts the theory that poor countries grow faster than rich countries – if the poor countries are following a reasonable economic policy. This is an empty argument, for it could be argued that any country that does not close the gap is simply employing an unreasonable economic policy.

Reducing the GDP per-capita gap is commonly referred to as "convergence," and the theory that Zelekha relies upon is based on the growth model described by Nobel Laureate in Economics Robert Solow. Zelekha makes a common error in his interpretation of the model, which does not predict "global convergence" of the type that Zelekha claims, but rather convergence of similar countries. So, contrary to what he says, there is no accepted economic theory that says poor countries grow faster.

The empirical test for convergence is simple: Do poor countries grow, on average, at a faster rate than rich countries? Examining per-capita GDP in 1960 and the economic growth in per-capita GDP from 1960-2010 shows that, contrary to Zelekha's claims, there is no evidence of convergence. Countries that were poor in 1960 did not grow faster than the rich ones. The statistics from 1980-2010 give the same result. For both periods – again, contrary to Zelekha's claims – Israel is not an exception. Israel is not poor, and its growth is consistent with the expected growth rate (and actually even a little higher), given the level of GDP in 1960 or 1980.

Zelekha applies the convergence argument exclusively to democratic countries. There have been many studies of democracy's influence on economic growth. The general conclusion is that there is a correlation between growth and democracy, but the direction of causality is not clear. There are no findings supporting the claim that democracy is the cause of growth, rather than its consequence. I will say that if Zelekha intended to limit his arguments to the OECD countries, then in this group there was in fact convergence, at least during part of the period (but there, too, contrary to his claims, Israel is not a negative exception). However, if that was his intention, then it's not clear why he excluded Sub-Saharan Africa. In any case, Zelekha is correct in saying that Israel should have a policy that promotes growth.

But how do you promote growth? Zelekha has an interesting theory – which is not accepted by most economists, including the Keynesian ones – that says the key to economic growth is consumer spending. Israel's slowdown, he says, derives from a policy that does not encourage consumer spending. In particular, he claims that Israel has a low rate of consumer spending to GDP: just 55 percent, when the Western average is 65 percent.

The Keynesian approach says that during a recession, an increase in demand does contribute to GDP. This theory considers three main types of demand: consumer spending; public spending; and investment in buildings and equipment (there is also the surplus of export over import, but this is relatively small). It's not clear why a consumption rate of 65 percent of GDP, in tandem with public spending and investment making up the other 35 percent, is preferable to a consumption rate of 55 percent, and public spending and investment of 45 percent. Zelekha has not published a single study that shows that this is the case, and therefore in my view, this claim simply reflects a fundamental lack of understanding.

But Zelekha purports to be discussing long-term economic growth. Increasing consumption would at most increase economic activity to the point where existing production capacity is fully utilized. However, long-run growth is achieved by increasing production capacity itself – for example, by investing in technology and manufacturing capital. Diverting resources to private consumption at the expense of investment actually has a negative impact on production capacity. Most success stories of rapid growth in the latter half of the 20th century, such as that of the "Asian tigers," are based on increased investment by means of promoting personal savings (i.e., reduced consumer spending). The impressive growth of the former Communist Bloc countries in the 1950s and '60s was also a result of forced savings and low consumer spending.

Zelekha's faith in a policy that promotes consumer spending as a means to achieving economic growth is not based on logic or facts. And what about the numbers that Zelekha cites? According to OECD data, in Israel in 2011 the ratio of consumer spending to GDP was 62.4 percent, and the average for OECD countries was 58.2 percent. Israel was thus above the average and ranked fifth after Greece, the United States, Portugal and Britain. In 2006, apparently the last time that Zelekha checked the figures, the rate of consumer spending in Israel was indeed 55.4 percent, but that was just slightly below the European average of 57.6 percent, and still high with respect to Canada, Austria, Holland and all the Nordic countries. In short, Zelekha's theory, and the data he cites, is not solid.

He declares his expertise to be macroeconomics, but the economic arguments he presents make this seem an exaggerated claim. His statement that he may make mistakes in microeconomics but not in macroeconomics also shows that he is actually not so well-versed in modern macroeconomic theory, which is based on microeconomic analysis.

Zelekha implies that the government, via the Central Bureau of Statistics, is spreading tendentious lies about housing costs, the unemployment rate and the number of part-time positions. Anyone who knows Prof. Shlomo Yitzhaki, who headed the CBS until a few months ago, and followed the process by which the prime minister released him from the position, knows there is no way that Yitzhaki collaborated with the government in misleading the public. As to the claims themselves: The OECD publishes comparative data on the scope of part-time and long-term unemployment (unemployment which lasts for more than a year). In clear contradiction of Zelekha's claims, in both measures Israel is not outside the norm at all.

Zelekha says that the rate of long-term unemployment in Israel is the highest in the West. But OECD statistics show that the rate of long-term unemployment in Israel is much lower than the average in OECD countries. Zelekha further claims that the rate of part-term employment in Israel is the highest in the West. Here, again, the claim is baseless: OECD statistics show that the extent of part-time employment in Israel is

below average. (It should be mentioned that Zelekha claims the CBS submitted inaccurate data to the OECD regarding the number of part-time positions.)

And what about his criticism of the Bank of Israel's low-interest policy, which caused the sharp rise in housing prices? Few would argue that the low interest rate has played a significant role in the rise of housing prices. But Zelekha argues that the interest is actually too low. He also hints that the bank's governor, Stanley Fischer, gave preference to wealthy exporters at the expense of apartment buyers, and says this occurred without any public discussion.

As far as that goes, readers – some of whom apparently consider Zelekha a hero fighting on their behalf against the government and tycoons – ought to be reminded that Stanley Fischer is not connected to the tycoons and financial organizations in Israel. Zelekha, however, was hired by Partner Communications in 2010 to support its battle against a sharp reduction in interconnection fees. Zelekha's move to join Partner's consultants raised eyebrows, since seven months beforehand he had written an economic study for Mirs Communications in which he argued that interconnection fees should be lowered. Eventually, interconnection fees were reduced far beyond the price that Zelekha recommended as part of his work for Partner, and his predictions that this would hurt the Israeli public, especially the weaker sectors, were proved wrong.

Let's return to the matter of interest rates. First of all, the interest rate is set by the governor of the Bank of Israel together with a monetary committee comprised of people of unquestioned integrity. Second, the low interest rate has many significant advantages in terms of growth and the reduction of unemployment. These advantages obviously outweigh the disadvantages in terms of increased housing costs. In addition, one should remember that while the low interest rate does contribute to higher housing prices, it is simultaneously lowering mortgage costs.

The interview gives the impression that Zelekha just doesn't understand the function of the Bank of Israel. Worse, his criticism may be related to Fischer having backed the ending of Zelekha's tenure as accountant general in 2007.

One of the most astounding claims made by Zelekha is that the housing index issued by the CBS is biased and that prices actually rose more than was publicly reported, since in the past six years the size of an average apartment has decreased from 100 square meters to less than 80 square meters. But the opposite is true: The size of an apartment in Israel has been steadily growing over the years. In particular, according to CBS statistics, from 2001-2010 the overall area (including common built areas) of an average new apartment has risen by 30 percent, from 133 square meters to 172 square meters. This increase does not derive from the wealthy building much larger houses, while the middle class is seeing a decrease in apartment size. Out of all new apartments in that period, the proportion that are five rooms or larger rose from 40 percent to over 50 percent, while the proportion of apartments that are three or less rooms declined, from about one-fifth to less than a tenth.

But, again contrary to what Zelekha says, the housing price index is adjusted for changes in apartment size, and thus there is no deviation of the type that he claims exists. Zelekha is correct, of course, in saying that the cost of housing is a problem. But everyone knows this. His arguments in this regard do nothing to aid in understanding what policy could bring down housing prices without raising unemployment and hurting the public.

The reader may think that my criticism of Zelekha's theories derives from ideological differences. Perhaps "socialist" economists think that Zelekha is right? On his blog *Minority View*, Ori Katz interviews Prof. Yossi Zeira, a renowned macroeconomist who was a member of the [Trachtenberg] committee of experts during the summer 2011 social protests, and who supports an increase in public spending and taxation in the spirit of Labor's economic plan. But Zeira says the Bank of Israel was right to lower the interest rate, and does not think that encouraging consumer spending will help economic growth.

I will say that it is possible that some of Zelekha's arguments relied on some knowledge, but it's hard not to conclude that he has a tendency to toss out numbers indiscriminately, and his grasp of macroeconomics appears to be quite limited. Consequently, in my estimation, he is harming the public debate and making it harder to create a united front that will pressure the government to implement a wise economic policy for the benefit of the broader public in Israel. On the issue of housing costs, his criticism is aimed at the Bank of Israel instead of at the Israeli government, whose job it is to increase the housing supply. And on the issue of economic growth, he proposes a policy to encourage consumer spending – even though this hurts long-run growth and, of course, personal savings.

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