THE SABAN CENTER FOR MIDDLE EAST POLICY

AT THE BROOKINGS INSTITUTION

Dollars for peace: the monetary foundations of the two-state solution

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P R O C E E D I N G S

MODERATOR [KENNETH M. POLLACK]: Good afternoon, ladies and gentlemen. Welcome to the Saban Center for Middle East Policy.

I'm very excited to be able to do this. Sever Plocker has been for us a model of what we were hoping when we set up our Visiting Fellows Program. He is, in his own right, an important thinker on important issues related to the Middle East, having served as a journalist for many years, won many awards. Sever also acted as a consultant to the Israeli government, to Israeli businesses, to a whole variety of different people. And as a result, he brought to the Saban Center a wide range of expertise and interests. And of course, he's currently the Chief of Economists editor at Yedioth Ahronoth, which is the largest Israeli daily newspaper.

And so he came to us with a great deal of experience, with a great deal of energy and enthusiasm. He was here for a number of months and wrote what we thought was a terrific paper.

And of course none of us at the Saban Center are real economists. And so one of the things we did was we sent the paper to a number of economists around town. And for me, the best response--in fact, all of the responses were along similar lines at least in their broad guidelines. What was so gratifying about them was that pretty much uniformly, the responses were, this is both very provocative and very solid.

And that just warmed the cockles of my heart, because that of course is absolutely what we at the Saban Center are looking to do, to present new ideas, to make people think, but to present very serious provocative ideas backed up by serious scholarship that forces people to look at them twice and not simply dismiss them.

And Sever has written a terrific paper for us. And we're delighted to have him back to be able to at least sketch out for you the outlines of his thinking and give you some insight into how he's tackling this critical issue of dollarization of Israel's economy.

We'll have Sever present, and afterwards, we'll take questions and answers. All of Sever's remarks are on the record. So if anyone would like to, you certainly can use the information on your own. And I recommend to you Sever's paper. We have copies of it outside for those of you who have not picked it up.

And with that, I will turn things over to Sever for some opening remarks.

Please.

MR. PLOCKER: Thank you, Ken. Thank you for the great introduction.

I enjoyed every moment studying here at the Saban Center. It was one of the most exciting moments, most exciting periods of my career.

I would like to say a few things at the beginning. The first one is that I do hope that I'm a better writer than a lecturer and that my paper is better than my lectures.

So, you know, journalists are used to write and not to talk. So please excuse me.

The second is that the topic is a very complicated one. One of my teachers in the School of Economics at Hebrew University used to say there are two things of which people die at a young age: one is passion and the second is study of monetary problems.

[Laughter.]

So this is the second.

And as I said before Ken, it's a provocative paper. And I know people can be for and against. So let me start with the introduction.

As I said, my paper is a proposal for a radical kind of arrangement by which the U.S. dollar will become the only legal tender in Israel and Palestine, completely replacing Israel's shekel, which is already used as the currency in the Palestinian Authority.

The popular name for such an arrangement is full dollarization, defined by the IMF, the International Monetary Fund, as used defined by the IMF as the use by a country of the currency of another country, which circulates as the sole legal tender.

In the dollarization scheme, my dollarization scheme, the United States would become the anchor in either of the client countries.

Three perspectives of the dollarization I hope to present here. One is the Israeli, one is the Palestinian and one is the American.

I'll start with Israeli perspective. After a few years of economic recession, followed by modest recovery in 2004, the new Israeli shekel is still a marginalized currency. And its future is still very uncertain.

The neighbor currency, Europeans, the euro is steadily gaining new users. Israel - which actually enjoys only a limited economic association are growing with the European Union in the framework of what's called the Europe and Neighborhood Policy - isn't even at the back of the line of countries wishing to join the enlarged European Union of the Euro bloc.

Another rising and strong economic bloc, the monetary union of Gulf Cooperation Countries--Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates--is close to Israel, in principle, of course.

Just in not so distant future, Israel will find itself geographically squeezed between two powerful monetary unions, both offering investors new super-national currencies. This, what I call currency alienation, could have a negative effect on exports from Israel and for investments of Israel in the growth of Israeli economy.

Short-term capital flows in and out of Israel, motivated by currency risks only, removes exchange rate of the shekel up and down in dangerous cycles as they did in the past.

The continuing use of the shekel in Israel will present an even higher barrier to the flow of trade, money and international business in Israel. This could and should be changed by replacing the shekel with the dollar, and liberating Israel once and for all from the burden of managing an independent currency.

And the shekel, our shekel, is never a source of national pride, not a symbol of Jewish sovereignty. Replacing it with the U.S. dollar would not rouse any real opposition in Israel on so-called patriotic grounds.

On the contrary, the vast majority of the citizens of Israel will see such a move as a blessing to the economy, and as a way to strengthen and cement Israel's special relationship with the United States.

Now, the reason the economic story of Israel could be seen as a never ending search for the right exchange rate regime is the frequent shifting of exchange rate regimes in Israel - with a significant drag on growth. And until 2003, the performance of the Israeli economy has been deeply disappointing. The economy stagnated despite very rapid growth of GDP per capita in countries similar to Israel

Even the 2.4 per capita growth achieved in 2004, doesn't change the picture.

Let me just give you a few numbers. The real per capita national income today in Israel is only 5 percent higher than it was 10 years ago.

In the two countries, which have more or less similar economic structure to Israel and adopted the euro, which is similar to adopting the dollar by Israel, the national income per capita is in Ireland, higher by 74 percent in 10 year's period and in Finland by 32 percent in 10 year's period.

According to very good estimates made by a leading private economic company, the actual GDP of Israel is still 20 percent lower than its potential gross domestic product. Only 5 percent of this huge gap can be attributed to the terror wave. And the rest to monetary policy of higher interest rates, a policy basically motivated by fear of exchange rate crisis.

So maintaining and managing domestic currency would eventually have a burden on the limited government's resources of the captains of the Israeli economy. If the same amount of soul searching, public energy were to be invested in promoting growth, implementing structure reforms and fighting poverty, no doubt the economic and social situation of Israel today would be much better.

The policy zig-zags of the Bank of Israel were particularly damaging to the economy in the past few years when it was suffering from a deep economic recession. Far from being a shock absorber, the so-called sovereignty to devaluate is—in the case of Israel—a shock amplifier, seen by economic actors and the public at large as an ineffective tool of economic policy.

Used to the frequent devaluation, inflation and recession cycles, Israel is free from monetary illusion. People in Israel think only in the real inflation adjusted, dollar adjusted terms.

New studies by young economists from the Bank of Israel even reject the popular notion that the more free exchange rate movement in Israel in the last years did not translate into inflation, inflation cycles. They do even more strongly.

Now what are the additional benefits of dollarization for Israel? First, the total elimination of the prospect of a currency crisis, which in the case of Israel, could mean and meant in 1998 and 2002, a sharp devaluation of the shekel and a massive buying of dollars. By dollarization, Israel will avoid any possibility of further crises of such a kind and create a stable environment supportive of goals.

Now, second, Israel will adopt not only the American dollar, but also the monetary policy and the creditability of the Federal Reserve in Washington.

But would the policy of Mr. Greenspan be good for Israel, a small client country? The answer depends on the core movements of our goods and prices in Israel and the United States. The more correlated the movement, the more symmetric the so-called shocks and the more alike the business cycles between the two economies, the better initial conditions for adopting the dollar.

Now, a group of very distinguished American economists looked for an economic answer to the question and reached the conclusions that, I quote, "Israel may be a good candidate for the euro, although it could also be very well served by the U.S. dollar."

The monetary policy of the U.S. Federal Reserve would just well serve the Israeli economy even on the basis of economic developments up to the year 1990, extending the relevant period to the year 2004, makes the case for dollarization even stronger as the Israeli economy became much more integrated with the U.S. economy through bilateral trade, the high-tech industrial sector, and capital markets and flows

From the early spring of 2005, Israel is even the one and only country in the world having an American citizen serving as the governor of the Central Bank.

I mean, the one and only except for the United States, of course.

The geographic structure of Israel's foreign trade has also changed considerably in favor of ties with U.S. markets and goods and services.

The rise in the share of trade with the United States is the result of the rapid growth of two U.S.-oriented sectors of the Israeli economy--diamonds and technology, paving the way for extensive U.S.-Israeli financial integration.

Now, the high tech sector of Israel already has a double identity--as Mr. A. Fischer, our governor, has double citizenship, it's American and Israeli. Capital raising, venture funds, industry estimates, and public offerings with our equity all depends on U.S. financial markets.

Just a few numbers, from 1995 to 2004: Israeli companies made 150 public offerings on U.S. stock exchanges and raised almost $15 billion.

The total original value of deals in which Israeli high tech companies were acquired by or merged with U.S.-based companies in the same period of time is $25 billion.

Dollarization will produce an additional push to expand trade between Israel and the United States and may even double its volume.

Another influential study by Andrew Rose and Jeffrey Frankel from Harvard University and the University of California estimated the effects of dollarization on the Israeli economy based on the structure of exports and imports in 1995. Dollarization would bring an additional 121, 121 gross--percent, gross in trade, primarily with the United States. And an additional 17 percent gross in GDP.

Now, it's a well-known fact that high interest rates depress investments. Dollarization means lowering the cost of capital in Israel. It also means stimulating investments in the Israeli economy.

From 1998 to now, foreign direct investment in the Israeli economy totaled something like $24 billion. Eighty percent of it concentrated in the high-tech sector.

This sum may look like a big one, but actually represents on average only 2.5 percent of Israel's GDP, gross domestic product.

During this same period, countries with similar technology like Israel, enjoyed foreign direct investment of almost 7 percent of their GDP.

So let me say, even before the intafada started, the Israeli economy lost potential foreign direct investment by an additional $20 billion with all its beneficial impact on growth, exports and welfare.

One central factor explaining the disappointing level of foreign investment in Israel was and is the exchange rate regime--unstable, changing and moving towards the free-float of the shekel.

This is in sharp contrast to the hard pegging of fixed exchange rate regimes in most of the small and technologically advanced countries.

I said before, this is Ireland, which is part of Europe and the monetary union. Finland, which is part of the European monetary union, and

Spain, which is part of the European monetary union. Cyprus, which is on its way to becoming part of the European monetary union, but only to fix its export trade and so on.

I know only one country, New Zealand, with the New Zealand dollar being free to float in the foreign currency markets.

Full dollarization, in my view, would provide a great stimulus to American investments in Israel, including investments in the financial sector, giving considerable advantage to the Israeli economy. It will counter balance the negative influences of geographic distance and political resistance.

It will reduce the cost of doing business in Israel by eliminating the conversion fees and the necessity to hedge against fluctuations in the shekel-dollar rate. It will make Israel a business environment much more homelike and accessible to the average American corporation.

This is my view - that by sticking with the shekel, Israel will probably suffer another loss of potential gross domestic product by the magnitude of 20 percent or more.

Now, the high level of official dollars in Israel makes dollarization a relatively simple act.

After announcing the exchange rate for the shekel versus the U.S. dollar, the Bank of Israel can buy all the shekels from the public by using a very small fraction of its dollar reserves and keeping the rest to assure orderly supply of liquidity to the growing economy.

The only remaining procedure of dollarization is a bookkeeping operation, efficiently implemented in Europe with euro and in a few Central American countries with the U.S. dollar.

Dollarization works. It can work even under a special and favorable conditions, like for example, in Ecuador.

It can provide an incentive, an impulse, and example for a variety of previously unthinkable forms.

But, it should be understood from the outset, dollarization is not the miracle drug to cure the Israeli economy of all of its diseases. It supports structural reforms. It helps to establish fiscal responsibility, but it cannot compensate for bad policy. It never can replace bad policy, not in Israel, never in Germany.

Neither can dollarization by itself solve some social problems, ease class tensions or ensure peace and security.

But it can, by creating an atmosphere of change and new beginning, be very helpful on those issues, provided of course the social and political forces are ready to make all of those changes.

Now let me say something about the Palestinian perspective. The Palestinian people never had a currency of their own as they did not have a state of their own.

After 1967, as a consequence of the Arab-Israeli Six Days War, Israel occupied the West Bank and the Gaza Strip and introduced its own currency, - the lira, Israeli lira, and later the Israeli shekel - as the principle legal tender there.

In 1994, in context of the peace process, the Palestinian Monetary Authority was created with the aim of supervising and regulating the domestic Palestinian banking system. The Palestinian Monetary Authority was and still is prohibited from issuing national currency, a limitation the Palestinian, political and economic leadership accepted and even enjoyed up to now.

Freedom from a national currency served the Palestinians very well and served their interests in peace and in war. Even after the violence of the second intafada escalated, the Palestinian commercial banking system continued functioning in an uninterrupted manner, providing normal services to the local population thanks to the non-existence of a Palestinian national currency.

But this efficient monetary arrangement is going to change in the near future. As Israel withdraws completely from the Gaza Strip in the context of the unilateral disengagement plan, it will leave behind a monetary vacuum and the question of an independent Palestinian currency will appear.

The government of Israel seems to neglect the problem, just stating that economic agreements that are currently in effect between Israel and Palestinians will remain valid after the disengagement, including monetary regime.

But this is typical wishful thinking statement. In ending the inhumane occupation and then substantially restricting the access to its markets, Israel will also end the official shekel regime in the Gaza Strip.

There even is a decision by Israeli Parliament to completely phase out the movement of the Palestinian labor to Israel.

So, which kind of money would they then keep in their pockets, the 1.5 million Palestinians living and working in the Gaza Strip? And who will supply them the currency that they need?

Here is the answer I propose. The Israeli shekel in Gaza and in the whole of Palestine should be replaced not by a new currency, something like Arafat dinar, but by the U.S. dollar. The sooner the better.

A substantial part of the Palestinian finances are already dollarized. Although the majority of cash transactions is conducted still in Israeli shekels, and daily consumer products are priced in shekels. The dollar became the pricing authority, the growing currency of choice of the store values, says the IMF in its latest report on the Palestinian economy.

The creeping dollarization reflects the increasing importance of dollars for a wide range of transactions.

First, international aid, including Arab aid, flows in billions, billions of U.S. dollars. Just as aid to the Palestinian Authority in the last five to six years was around $6 billion in U.S. dollars.

Rents in the Palestinian Authority are quoted in dollars. European goods are priced in dollars. The greenback is dominant in banking activities. Sixty percent of all deposits in Palestinian banks are dollar dominated. And 68 percent of all commercial loans are now conducted in dollars.

Now, Palestinians, I note from my personal connections, Palestinians enthusiastically welcome either the idea of replacing the shekel with the dollar. Dollarization means removal from Palestine of one additional symbol of Israeli occupation, the Israeli currency.

Of course, deciding to dollarize, the Israel authority should therefore, actively cooperate with the Palestinian Authority in all the considerations and preparations, treating them as equal.

This is needed for the smooth implementation of the passage from the shekel-based to a dollar-based economy in Israel and in Palestine.

Now, I think, I hope that the debate on dollarization, as a concrete act, will bring together Israelis and Palestinians around an entirely new and common civilian agenda, even if economics is very small factor in the push for peace.

It may be a strong motive for preventing war. For the people in the streets of Gaza, the so-called peace dividend is the statistical obstruct concept.

Foreign aid is suspicious, it's '80s (ph) and it's corrupting. But dollarization will be a tangible feature of everyday life.

Properly conducted and subjected to strict fiscal, fierce fiscal conditions, dollarization in Israel and Palestine will benefit all, the Israelis, the Palestinians and the United States.

It could even serve as a test case for a possible and future dollar Middle East monetary union just as the free trade agreement between the United States and Israel 20 years ago--almost 20 years ago--served as a starting point of the free trade agreement the United States concluded since with a lot of Middle East countries.

Now let me say something about the American perspective. From the American perspective, dollarization is Israel will be a net economic gain to the United States. By adopting the dollar as legal tender, Israel will give up one of the most important prerogatives of a government, the money printing machine, and transfer the profits from its use, the so-called “seigniorage,” to U.S. federal government.

In fact, extending to the United States, a perpetual interest free and growing loan. Using one way of calculation and assuming some realistic assumptions about the long-term interest rates in the United States and inflation and growth in a dollarized Israel, the net present value of the total gain to the United States from the dollarization in Israel approaches $20 billion.

Looking at those and similar estimates, politicians and economists in America concluded five, six years ago already, that they represent a huge obstacle to the country interested in dollarization and an unfair profit to the United States and proposed ways to rebate to the dollarizing country for the loss, including a special bill introduced in 1999 to the U.S. Congress by Senator Mack, then Chairman of the Joint Economic Committee, the so-called International Monetary Stability Act.

Now this bill is still in the Congress. The most important benefits to the United States from foreign dollarization, the greater capacity for capital and trade flows in both directions and greater economic stability and growth were given attention in the testimony of Lawrence Summers, the Secretary of Treasury during the Clinton Administration, before the Banking, Housing, and Urban Affairs Committee during the 1999 hearings on official dollarization in emerging market countries.

Dollarization, concluded Lawrence Summers, would clearly be in the economic and national interest of the United States.

Economic models predict that, as a consequence of dollarization, exports from the United States to Israel will rise by a magnitude perhaps as much as by $3 billion annually, not only replacing European products on Israeli markets, but also by creating new trade capacity.

American companies operating in Israel, invested in Israel, will save a lot of money now paid to banks and currency dealers.

The profitability will be much higher. Conversion and hedging costs will disappear. Furthermore, as there is dollarization in Israel, the pace of reduction in civilian American aid to Israel could be greatly accelerated and the assistance, still about $500 million U.S. dollars real, could be completely phased out.

The basic problem of the Government of Israel, the so-called original sin, in international capital markets is its inability to borrow in shekels, the domestic real currency.

This is seen by economists as a huge obstacle to financial stability and potential source of crisis. Unable to sell its shekel bonds, the government of Israel asked the U.S. government to guarantee its dollar loans. It happened in year 2002. One should remember that the Israeli government has never defaulted on foreign debts. It has paid all foreign debts like a Swiss watch- on the minute. Still, Israel has had no ability to raise money on foreign financial markets.

Had Israel instead of looking for U.S. guarantees, opted for dollarization in the summer of 2002, there would have been no need for U.S. guarantees. After dollarizing, the Government of Israel could raise the money it needed to finance its budget, by issuing bonds denominated in the new currency, the U.S. dollar of course, and selling them in the world financial markets.

Both currencies would gain something. Israel, more financial stability, the United States, more peace of mind.

Now to conclude, let me say a few words as an economist.

Summing up economic research, regarding dollarization and euroization: the utilization of the euro and the formation of so-called currency unions- economists were unable to formulate a clear position regarding the benefits and costs of such a move.

Economists tend now to blame the political decision-makers of nationalism and symbolism. But the truth is that nations generally do not take pride in national currency and are ready to abandon it without tears. So voted the vast majority of people in the ten nations that have joined the European Union in May 2004 just one year ago. No doubt in my mind, the European Monetary Union and euro would never have been born if the decision had been in the hands of university economists or central bankers.

The European Union and the European currency were products of motivated politicians. So should be the dollarization in Israel and Palestine by replacing the narrative of bloody conflict with the narrative of uniting new money. The dollarization process has the potential to start the positive phase in the Israeli-Palestinian relationship.

At least this is something I believe in.

Thank you very much.

[Applause.]

MODERATOR: Thank you, Sever.

And why don't we open things up to questions. And if people could identify themselves for Sever and other guests when they ask their questions.

Sever, do you want to call on people or do want me to?

QUESTION: Gipper Contz (ph) on Foreign Relations. To your knowledge, are there discussions going on between the Israelis and the Palestinians about the monetary situation in Gaza? There's of course been the comments that trade and everything will continue, but the lack of coordination seems to be more prominent than the coordination. And this, I think, for both sides is a very, very key issue, the currency.

MR. PLOCKER: As far as I know, nobody writes the question. And you know, there's total chaos now in Israel and the Palestinian Authority.

Nobody knows what will happen the next day, not the next day, the next months, next year.

The question of the monetary vacuum in Palestine, in Gaza Strip, after disengagement is not on the table. Nobody speaks about it.

Yes, yes please?

QUESTION: What are the arguments against it?

MR. PLOCKER: Excuse me?

QUESTION: What are the arguments against dollarization?

MR. PLOCKER: A lot of arguments against it. It starts with losing sovereignty. It starts with losing a proper response to external shocks of the economy. It start with a very stiff resistance of the Central Bank. There would probably be no place for a central bank and a strong central banker in Israel and in Palestinian Authority.

There are a lot of arguments against it. There was even a small episode in Israeli history. In 1983, dollarization was formally proposed by the Likud government. A treasury finance minister of the Likud government, Mr. Aridor proposed it, and the reaction of the people from the Likud Party of the government was very negative for many, many reasons. But the main reason was that it was not patriotic, and it's not proper for a Jewish state.

QUESTION: Could you give examples of a few scenarios in which a dollarized economy in Israel or in Palestine would be stressful, that the loss of control would be problematic and why you think those risks are controllable or tolerable?

MR. PLOCKER: The main risk is so-called a lender of last resort, with the argument as follows. When people are running banks, for some reasons, the Central Bank should hold the authority and the possibility of printing enough money.

Now if the economy is dollarized, then the Central Bank of Israel is prohibited from printing money.

So a run on banks can be a very destabilizing factor in the Israeli economy or in the Palestinian economy.

Now, what is the answer? For instance, stands to reason there is a very slight probability of a run on banks even when people get dollars and make their daily transactions with dollars. The second is that in a run on dollars or a run on banks, saving the banks from crisis is problem of government, not of the Central Bank.

If a bank falls, this is the problem--and if a government is ready to keep it going in some way and to pay the people who had money in this bank, it should be paid with government money and without printing new money.

This is accepted today in almost all economies I know all over the world.

So the problem with the lender of last resort is not the real one.

But still, one can think about the very extreme scenarios in which the destabilizing factors in the Middle East will be so strong that even dollarization would not help, and there will be a monetary and economic chaos in the Middle East and especially within Israel and Palestine.

But it will always be worse with a separate Palestine currency and separate Israeli currency. Except with the dollar, this may be of course.

Yes, please?

QUESTION: Have you discussed this issue with U.S. officials? And do you have any sense of their reaction? And number two, you came up with the net gain for us, $20 billion you said?

MR. PLOCKER: Yes.

QUESTION: How did you come up with this figure?

MR. PLOCKER: This is the net present value of the gain of this. This is quite complicated but let's say this is the net present value of the loan. By using the U.S. dollar, Israel is giving the U.S. Treasury and U.S. Federal Reserve a kind of loan. And you can--there is a way to figure out and to calculate that present value of this loan. It's approaching $20 billion, but it's of course for a very long period, like 75 to 40 years.

And no, I did not--I'm a journalist and I've not discussed with officials, especially not with U.S. officials.

Yes, please?

QUESTION: I've a couple of different comments for you in different areas of your discussion.

One is that there are in recent history a number of examples of countries or entities in post-conflict situations for which dollarization or a currency board, something you didn't mention, have been viewed as good regimes. And if you look, for instance, at the former Yugoslavia, Bosnia, Herzegovina has a currency board to the euro. And in that case, it was thought that they should have a distinct sovereign currency, that this was very important in terms of establishing the political and cultural approach to a nation state, rather than to euroize, for instance, which would have been another option for them.

A different case was chosen for Montenegro, which has adopted the euro and has euroized. And in both of those cases, it was taken into account not so much what the appropriate monetary regime was from the standpoint purely of economics, but really more the political situation.

And I would say that that's the more relevant determination for Gaza or for a Palestinian state. I think when you get to Israel, though, it's a very different situation. You've got a much more advanced economy. You've got an economy that trades. Fifty percent of its imports are with Europe.

And if we look at a predecessor situation like in Argentina where there was an operant currency board for more than 10 years. And in fact, these--or about 10 years--and this discussion of dollarization in the Mack legislation that you mentioned were really introduced at a time when Argentina was considering dollarization.

So Argentina was seriously considering dollarization. They've had--their currency--they had ridden up the appreciation of the U.S. dollar, and this led them to great troubles because they had a lot of the percentage of their trade with European economies and not just all with the United States.

And this is one of the major problems if you link directly to one economy, but you have a more diversified trade position, as Israel does.

So I mean, that's only one objection I would say to dollarization for Israel. I think there are many other objections that, at least in your discussion, you really don't deal with.

MR. PLOCKER: On the first point, I just want to comment, would like to comment that there is one case of full dollarization in a post-war region. It's East Timor. East Timor was fully dollarized by an accommodation of the IMF and the U.S.

And the people of East Timor, as far as I know, are very happy with it. And from my personal talks with leaders of Palestinian Authority, they view dollarization as the best option for right now.

But nobody is really doing something about it because a euroization is not really an option for the Palestinian Authority.

Now they can have a currency board. But I'm not very much in favor of currency boards. And the currency boards still should be, they should have some currency to be based upon it.

I think for the time being, dollarization is the best thing, is the best way to deal with the currency vacuum, the monetary vacuum in the Palestinian Authority.

There are, of course, many--the second point--there are of course many, many arguments against the dollarization of Israel. I know them all very well. But remember this. The foreign trade is, as you said, rightly, is like 45 percent with Europe. But even the trade with Europe is really conducted in U.S. dollars. I mean, like 75 percent of all billing, actual billing done in Israel exports is in U.S. dollars. Because Israeli exporters still prefer, any exporters, prefer thinking in U.S. dollars.

Therefore, people do not pay attention in Israel to fluctuations in the euro. They pay attention to fluctuation in the dollar.

Fluctuations in the euro have no impact on the domestic prices. Fluctuations in dollars do have impacts in trade.

The second point is that all of the real estate market in Israel is fully dollarized already. And, as I said before, the high-tech sector is totally dollarized in Israel. [inaudible] But this is a fact of life in Israel. And one should take into account facts of life.

This is my view.

Yes, please?

QUESTION: I certainly am not knowledgeable about Israel and Gaza and the West Bank.

I came expecting to have you emphasize a lot of the political arguments for your proposal. And I'm puzzled that in fact you emphasized those much less and you mainly rehearsed the economic arguments. And to me, it's puzzling that you invoke countries as different as East Timor and Ireland and Finland and Spain as though that justifies your proposal.

It seems to me implausible as those conditions are all so different.

But if I try to think about Israel and a possible Palestinian state, I was guessing you would do lots of things emphasizing how this could buttress cooperation and peacemaking.

But if I think about that unit--let's just for a moment think about those two nations as bound together with a single currency, the U.S. dollar- my mind floods with all of the difficulties that could come from dollarization.

The situation is very different from Ireland or Finland. Let's just take two cases.

I found your argument about the lender of last resort very unconvincing. A financial crisis would be managed very differently if Israel really did dollarize. And let's just imagine--I wish it were a hypothetical imagining--but let's suppose the dollar weakens strongly against the euro and the yen in exchange markets over the next two or three years as the markets try to adjust to global imbalance.

And imagine that Israel had adopted this policy, would you feel you wanted a very sharp depreciation with the dollar against the euro and other currencies? And if there were a financial crisis associated with that so the stock markets fell sharply, I mean, Israel would be much less protected against that than they would be if they had their own currency.

It's of course true that currency fluctuations produce instabilities of all sorts when you have your own currency. But I don't think you should suggest to people that you're impervious to those fluctuations if you somehow dollarize.

And the reminder about Argentina, I should think would sober you that part of Argentina's problems were that it had to stick with the U.S. dollar and appreciate against Brazil and Europe. And then there was a big financial crisis. And in fact, they've had to abandon the currency board arrangement, which for many economic purposes is quite close to what you imagine with dollarization, though the politics are very different.

So again, to come back to my theme, I think you should probably emphasize the political pros and cons as a basis for convincing others about your arguments, not so much the economic, because those are more contentious than you presentation suggested.

MR. PLOCKER: And now I said before I do have some political arguments in my paper. And I suppose it is better than what my presentation was here.

Just two quick comments. One is about the fluctuations of the valuation of the dollar. I think the devaluation of the dollar would be, if Israel dollarized, it would be a blessing for the Israeli economy, not a problem for the Israeli economy. Because of course, it would help Israeli exports and so on.

But what happens in Israel actually is the following. When dollar becomes--if there is a crisis in dollar, let's say when there is a devaluation of dollar, there is a devaluation of the shekel on top of what's going on with the dollar because people feel somehow that there is a wind, there is a growing uncertainty in the world financial market.[inaudible]

We know from our experience the Israeli still think and act and are connected deeper to the U.S. dollar, and there is no way to change it, I think, especially after the huge immigration from the former Soviet Union.

People in Israel feel very strongly about the U.S. dollar. And as I said before- all our real estate market is conducted in U.S. dollars.

All of our financial transactions in the foreign world, almost all are in U.S. dollars. All of our living sector of the economy, the so-called high-tech sector is all thinking in dollars, making arguments in dollars, making profit and loss statements in U.S. dollars. We are already a highly dollarized economy.

I would not recommend any form of fixed exchange rate. I think fixed exchange rates are disastrous for the economy, but I would strongly recommend replacing the Israeli shekel with the U.S.

dollar, not like in Argentina. To fix an exchange rate, I think, is very bad for the economy.

Yes, please?

QUESTION: This may be a little beyond the scope of your presentation. And it's way beyond the scope of anything I know about, but besides East Timor, are there any other successful examples of full dollarization?

MR. PLOCKER: There are a lot of successful examples of full dollarization-- Now there is at least one country which I know very well. This is San Salvador, which made dollarization and it's working very well for them.

And I wish we could--I put it another way-- I wish we could adopt the euro as a currency in Israel. This is impossible. It's not in the cards. It's not the political possibility. It's not a national possibility.

The Israeli people will be against it. The Europeans will be against it. This is not a possibility.

So, the second best, from my point of view, is dollarization. Keeping the Israeli shekel as an independent currency for a long period of time has strong negatives, I think, or strong negative impacts on the Israeli economy, and causes preoccupation with the question of exchange rate, instead of another much more important question.

Yes?

QUESTION: I was very struck by some of the things in the paper. Not so much on the northern economies in the EU that you mentioned, but the fact that Israel is being caught up with by Club Med economies. And that really, for me, was very interesting to see that, you know, countries like Greece and Spain are catching up with Israel. And it's very strong...

MR. PLOCKER: Cyprus.

QUESTION: Cyprus as well, yes.

But the thing is though that these countries have benefited from a positive asymmetric shock and they've also had large structural EU transfers.

I know; I'm from a country that contributes to those transfers.

But of course, there are negative asymmetric shocks on the way, and I think that's what's been mentioned earlier. And I think that should be a concern as well. Because the EU has been able to deliver negative asymmetric shocks. I mean, the ERM (Exchange Rate Mechanism) crisis in 1992 is a good example.

However, and what strikes me though about what you said about not being a panacea was very important. I want to ask you this.

Now Argentina, as we know, one of the problems there, the inability to sustain the currency board was that they got this wonderful short-term boost to investment. Inflation came down. Growth went up. They didn't do the structural agenda. They really just didn't do it properly.

What is in Israel the structural agenda? And what will make Israeli politicians actually implement the structure agenda? Because I'm always struck by a politician saying, we're going to do the structural agenda, we're going to do the structural agenda.

Well, you know, if you haven't done it in the last 20 years, mate, you're not going to do it now.

What is the structural agenda in Israel, and can they do it?

MR. PLOCKER: My friend, Israel has done a lot of structural changes in the last 10, 15 years.

The Israeli economy is one of the most open economies in the western world.

The Israeli market is very competitive. There is no way to put it together with Argentina. The Israeli labor market is very competitive, very open. The trade unions are very weak.

The Israeli foreign exchange, we are fully--there is free flow of foreign dollars into Israel and out of Israel.

I think that we are in the very last stage of structural reforms, very, very last stage. So those are the luxury structural reforms, not the basic structural reforms. We did the basic structural reforms 10 years ago, 12 years ago.

We are ready, I would say from my point of view, as economist traveling all over the world, I think we are much more advanced in structural reforms than most of the rest of the European nations, much more advanced.

And in some structural reforms even more advanced than the U.S. So I do not think that this is somehow a problem for dollarization or whatever. This is not really connected with dollarization.

There is a political will in Israel to do structural reforms. Treasury and finance ministers are doing it, not only Mr. Netanyahu, but the finance minister before him as well, before him and the one before him. There is a domestic consensus for structural reforms. And we are really very advanced on this.

So I do not see this as a particular problem for Israel.

Yes?

QUESTION: I'm just wondering if you can comment on, what affect if any, this might have on U.S. relations to the Islamic world, Israel dollarizing and linking to the U.S. like this?

MR. PLOCKER: I think that for this - dollarization in Israel and in Palestine - can be made with both countries together. There can be no dollarization in Israel without Palestine and no dollarization in Palestine without Israel.

I think I see no problem with the Islamic world. On the contrary, as far as I know, the so-called monetary union of Gulf countries is considering adopting the dollar as its currency, or at least fixing the exchange range of its new currency and the U.S. dollar. And most of the incomes of the Arab and Islamic countries from oil are dominated in U.S. dollars.

So I think it should have no negative impact. Maybe some positive political impact, I think so.

QUESTION: Could you just explain to a non-economist, people have spoken disparagingly of a fixed exchange rate. Why would it not be an intermediate step to fix the shekel to the dollar and for that matter, some Palestinian currency to the dollar and to vary it only under the extreme cases that you identified earlier where you have that unexpected or particularly difficult scenario?

Why is that not a solution?

MR. PLOCKER: I think the exchange rate is very difficult to conduct and very difficult to defend. As economies open to free flow of foreign currency into and out of it, keeping a fixed exchange rate requires a lot of intervention in the foreign currency markets by the government and by the Central Bank.

This is almost impossible. I personally, as an economist, I know no one country was really successful in having both open markets and open financial markets, and a fixed currency.

The only one, which I know, is Hong Kong. Now Hong Kong, it is not exactly a country and not exactly a free country. So it's completely--take China. China has a fixed interest, a fixed exchange rate. But China has really been very strict at foreign exchange market.

So I think that this is not a good substitution or a good solution for Israel.

I think that--we tried, by the way, from time to time, this fixed exchange rate. It was very costly. And it was not--it was a real drag on our growth.

So I'm returning to my--still sticking to my proposition of dollarization.

QUESTION: Going back to the political issues for a minute in Gaza.

Why wouldn't it make more sense for Gaza to go in--I'm not quite sure about the status of the monetary union in the Gulf. I know that they've picked the dollar as an interim measure, and so on and so forth. But why wouldn't it make more sense for Gaza to go with the Gulf countries, given they share the same cultural--and it would be a different set of countries than following your suggestion, which is to implement the same policy as Israel. It would seem to me that that would be a more natural political alternative.

MR. PLOCKER: I can give you just one answer. Jordan had this world economic forum just one month ago with a lot of economists and politicians and businessmen from Gulf countries. And I asked a lot of them and they say, God forbid, not with the Palestinians.

So this is the only answer I can give you. I see really no way in which the Gulf countries adopt Palestine as a member of the monetary union, really no way.

They should first of all increase some substantial measure of assistance to the Palestinians. It's so low it's really, it's kind of--I don't know how to say it, but I think the Palestinians feel that they are not welcome in the community of those wealthy Islamic and Arab states.

So there is, in my way, no way in which--there might be no way in which the Gulf monetary union will even consider the next 20 to 30 years taking Palestine as a full or even a partial membership.

QUESTION: Sir, I'd like to ask you a question which is also a political one, and in some ways, it's the flip side of a last question.

I hear your points, and I think that you make some very strong points about the creeping dollarization of Israel, that this is in effect happening regardless of whether or not any one wants to do it.

But that said, there is a big step, big political step, even if you get 90 percent of the way through creeping dollarization, it is still a huge political step to take that last one and say, we are going to simply do away with the shekel.

And the question I have in my mind, as I said, is the flip side of the last question, and the moment it was asked, I knew the answer to that, which the Gulfies would never let the Palestinians in on their party, which has always been the case.

By the same token though, you know, I think you moved lightly past the issue of Israeli sovereignty and the thing that looms large in my mind is that in even 20 years from now if Israel is even more dollarized than it is today--and I agree as a frequent visitor in Israel, you see it all of the time there--I still find it very hard to believe that you could get this through the Knesset, that you would not have some MK stand up and say, this is abdicating our monetary policy. And as the only Jewish state, how can we abdicate our monetary policy?

MR. PLOCKER: OK, I have no personal answer to your suggestion.

QUESTION: Could I just do a quick follow-on question?

MR. PLOCKER: I'm not sure--I mean I'd like you to answer whether or not it would require a vote of the Knesset. It might be the case that the Central Bank could simply declare dollarization as its monetary objective.

I mean, there are different situations in different countries. Well, I know one of Stan Fischer's first jobs is to write further legislation for the Central Bank and to set up a monetary policy committee and so on.

And so I would think that legislation has to go through the Knesset. But it may be that the current legislation permits him to implement dollarization if he wanted to.

QUESTION: I guess, whether it's the law or not, there would have to be a vote on it.

MR. PLOCKER: Yes, sure, sure.

What I can say, I mean, we have conducted a few public opinion polls and we find that the majority, vast majority of Israelis are in favor of dollarization, full dollarization.

And we know that the idea of dollarization was first proposed by a minister of funds from the Likud Party, by people connected with the late Prime Minister Menachem Begin.

I think that I really cannot see it being a national problem or a national prestige problem. This is my feeling, of course. But you are right, there will be a strong opposition. There always is strong opposition. And in Israel to everything, there is strong opposition. When we make a public opinion, asking public opinion about the weather, 50 percent on one side and 50 percent on the other side, because is on every issue. And we require a strong political leadership. But from time to time we have strong political leadership. It's not frequent, but from time to time we have it. We have one right now who is trying to make disengagement.

You know, we met from time to time with some of the experts one year ago and if you told them, Mr. Sharon will be the fighter for disengagement, a man who will run Israeli settlements from Gaza, they would have said, it's impossible.

So everything is possible in the Middle East.

MODERATOR: That strikes me as good a place as any to end things.

Sever, thank you very much. And please join me in thanking Sever for a wonderful presentation.

[Applause.]

MR. PLOCKER: Thank you very much, really.

[Applause.]