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# THE ISRAELI INFLATIONARY EXPERIENCE

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The Israeli consumer price index (CPI) rose by more than 133% in 1980,[1] a rate which put Israel at the top of the list of the world's inflationary economies. While in the following year the CPI increased by a more moderate 101%, the January 1982 figure of 8.2%, the highest ever registered for that month, suggests that the fires of inflation are raging with new vigor. One month's data are insufficient to demonstrate a trend*, but the fact that they confirm the forecasts of many economists is hardly an encouraging omen.

First we must address the technical problem of what actually caused such inflation, and inquire into the nature of the mechanisms by which it is sustained. But it is the political cause of the inflation which is the focus of this essay. We shall ask how the Government of Israel allowed so egregious a situation to develop; what political considerations enabled that Government to be returned to power; and whether the very nature of Israeli society is somehow conducive to inflationary policy.

## The History of Inflation in Israel

Israel has been plagued by inflation since the formal proclamation of independence. The new state was burdened by extraordinary military expenditures and lacked an articulated tax system. Money printed by the Government was paid out by the ministries into the hands of the public in exchange for their goods and services; this enabled the State to finance the local component of its purchases. But the absorption of private spending power which could be done through taxation was far too small to balance the inflationary injection which this spending represented.

The supply of money in fact rose by 140% during 1950-52, while production increased by only 50%; the difference represents an "inflationary tax."[2] By this means the Government was able to transfer real economic resources from the public to itself. When in consequence the price level rose, the Government attempted to disguise this by means of price controls, replacing one hidden tax with an even worse variety; a subterranean "black market" followed as the flowers do the rain. When even the Government was forced to resort to it, the "white market" disappeared,

* For the curious, the compounded annual rate of inflation such figures imply would be in the region of 157%.



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to all intents and purposes.

It serves to emphasize that inflation was a monetary phenomenon; the psychological element held sway only in the short-run fluctuations of the CPI. Comparative studies indicate that injections of excess liquidity into the economy produce price rises after a lag of from one to two years[3]. When the Israeli government undertook to impose a continuing "inflationary tax," it started a game of leapfrog with the public. Consumers, interested in evading the hidden tax, tried to anticipate the lag between govennment actions and the resultant price rise, while the Treasury responded by printing currency at an even faster rate. Inflation fed on itself at a geometric rate and reached its natural limit when the money lost its principal *raison d'être* of being a stable store of value for the purpose of exchange, and the country was threatened by the emergence of a barter economy.

It was the absolute necessity of importing not only investment goods and weapons, but even day-to-day necessities such as wheat, which forced the Government to revamp the economy, establish a central bank, implement enforceable taxation, eliminate most rationing, and issue currency which the public would accept. In the process, economic growth had to be temporarily curtailed and even immigration was quietly and unofficially stopped for a year. This liberalization, termed the "New Economic Policy," (1953) was not voluntary, but enforced by circumstance.

## The Political Mechanism of Inflation

The political demon of unbridled government demand, which underlay the inflationary process, was never fully exorcised.* One manifestation of this was seen in the relative powerlessness of the Bank of Israel to control the supply of money. The Bank could manipulate bank credit granted to the public by setting the reserve ratios which banks were required to maintain. But the supply of credit was not the private reserve of the banks: great quantities were poured into the economy by the Jewish Agency and the various government authorities, particularly the Ministries of Defense, Development, Housing and Absorption. Even so, the Bank long lacked the basic tool of open market operations, by which the money supply is governed by means other than the manipulation of the banking system. Even after this tool was granted in the late 1960s, it was rarely used.

## Government Demand

Monetary laxity was coupled with a truly ravenous appetite for governmental expenditure. Since its establishment, Israel has devoted a greater portion of its domestic product to public consumption than any other non-Communist country. The proportion is even greater if total use of all resources, including transfers and credit from abroad, are taken into account:

The Ratio of Government Expenditure to Total Use of Resources

| | | | | | |
|---|---|---|---|---|---|
| 1958 | - 12.2% | 1964 | - 15.3% | 1970 | - 22.7% |
| 1959 | 12.7 | 1965 | 16.7 | 1971 | 21.4 |
| 1960 | 15.5 | 1966 | 21.0 | 1972 | 21.0 |
| 1961 | 14.6 | 1967 | 21.0 | 1973 | 25.5 |
| 1962 | 16.9 | 1968 | 20.8 | 1974 | 25.4 |
| 1963 | 17.3 | 1969 | 20.1 | 1975 | 27.0 |

Source: Bank of Israel

* Only during periods in which the Finance Ministry was under the stewardship of a leader with sufficient power to enforce the Government to adhere to its budget were the inflationary prossures contained.

There is no reason why a high level of public expenditure must lead to inflation; one need only balance fiscal expenditures by a corresponding absorption of spending power from the private sector, i.e., the taxpayer. But as the public spending component comes to take up a large portion of the GNP, the capacity to wring taxes out of the public dwindles to the vanishing point.

It has been pointed out that any state of a given political type and in a given political situation is very closely limited in its long-run capacity to collect taxes. The portion of the GNP which can be gathered in taxes is closely tied to the general level of development of the country. Israel's political leadership has circumvented this "law" by gathering unprecedented funds from foreign sources, in the form of private and public grants and loans, which have allowed Israel to maintain a continuous surplus of imports over exports. Not only has this enabled policy to undertake goals which otherwise could never have been managed, but the very independence of this source of revenue has allowed successive governments a measure of control over total resources which no democratic country could have attained on its own.

After the 1973 war the enormous increase in expenditures for defense was only partially balanced by the jump in U.S. governmental aid. The Labor Government of the day helped bridge the gap by printing money, but then took restrictive steps to rein in the rate of inflation to a barely-bridled 30-35%.

It is perhaps an amusing if bitter exercise to attempt to determine the date of the beginning of such massive new injections of liquidity into the monetary system by inspecting the following table, keeping in mind the approximately two-year lag between monetary actions and the corresponding price rise:

Percentage Increase in the CPI

| | | | | | |
|---|---|---|---|---|---|
| 1969 - | 2.5% | 1974 - | 39.3% | 1979 - | 77.8% |
| 1970 | 6.1 | 1975 | 39.3 | 1980 | 132.6 |
| 1971 | 12.0 | 1976 | 31.3 | 1981 | 101.3 |
| 1972 | 12.9 | 1977 | 34.6 | 1982 | - - |
| 1973 | 20.0 | 1978 | 50.3 | | |

Source: Central Bureau of Statistics

Of course, the principal injection was in October 1977, with the inauguration of the "economic revolution" of the Likud's first Finance Minister, Simcha Ehrlich.

The "economic revolution" entailed freeing the Israeli lira to float to its natural rate of exchange. This amounted to a massive *de facto* devaluation, and caused the value of all assets denominated in foreign currency which were in the hands of the Israeli public to increase in a very short time. This not only enriched those who held such assets, but greatly expanded the quantity of money. This was a truly unusual episode in the annals of Israeli inflation; the money supply was increased, but the government did not even "benefit" by garnering real resources from the public. One may conclude that this greatest of all inflations was triggered by sheer technical mismanagement, which did not even accomplish the goal of "liberalizing" the economy (which would require that everything be allowed to find its own market price, thereby diminishing the power which the government has over the economy). Thus in 1979 a massive burst of inflation was unleashed upon the Israeli economy.

## The Election Cycle

The existence of election-induced economic cycles has been well-documented in many democratic countries, including Israel. Politicians tinker with the economy because they think that voters tend to vote according to the trend in the economy in the period immediately before an election, rather than the general level of economic well-being over a substantial period of time. It is therefore politically expedient to engineer an unsustainable boom, though it will cost the economy dearly in the longer run. However, a boom cannot be orchestrated to good effect in the midst of runaway inflation, and monetary stimulation can exert a multiplier effect only when there is some slack in the economy. Thus, one paves the way for a boom by imposing a slump.

## The Political Reasons for Israel's Propensity to Inflate

Inflation today is an international phenomenon. It occurs autonomously for much the same reasons in most countries, and is imposed by external factors on all who participate in the general international commerce. But the sheer magnitude of the Israeli inflation is practically unparallelled.

Why is this so?

Inflation on such a scale has generally surfaced where governments are weak; while the present Israeli government is, like its immediate predecessor, weaker than the *Mapai*-dominated coalitions of the 1950s and 1960s, few would describe it as weak in comparison with those in other countries. Israeli defense policy continues to require the active support of the citizenry, which endures a crushing burden of personal military service; this cannot be said of the U.S. defense policy since 1973. Also, recent steps in Israeli foreign policy, such as the peace treaty with Egypt and the recent evacuation of Sinai settlers, testify to a capacity to act under pressure beyond what is found in Italy, for example.

One cannot pin all the blame on the external shock of the "oil tax" in the wake of the 1973 and 1977 oil price hikes, as other countries such as the Netherlands, Switzerland, and Japan, whose economies are even more dependent upon energy-intensive industries, were equally burdened by this. Other things being equal, the international component of the inflation rate can hardly constitute much more than 10% of the Israeli inflation. We must examine the particular political factors which distinguish Israel from the generality.

First, each country fashions economic policy in a framework which tends to reflect historical needs. If a country's political institutions represent the spirit of the country -- as they must if it is to command the loyalty of its inhabitants -- then they will contain biases in favor of policies directed against historical fears. Germany, for example, was traumatized by the 1924 hyperinflation, which pauperized the middle classes and thereby paved the way for Hitler. To this day, Germany has given pride of place to the preservation of the value of its currency and has been far more resistant to the temptation of solving unemployment by deficit spending than the U.S. The latter, on the contrary, was scarred by the Great Depression, the haunting memory of which is perhaps second only to the Civil War in the consciousness of the American psyche. Consequently, the U.S. has been relatively less reluctant to turn to inflation as an antidote to unemployment.

## The Importance of Full Employment

Israeli leaders have always put rapid economic development above all other economic goals, both to provide employment for what once was a very large flow of immigration, and to provide an economic base strong enough to support militarily strategic industries. These long-range goals were reinforced by the domestic political consideration of preventing unemployment. Israel's marked aversion to unemployment is not linked to a memory of a depression, but rather to the peculiar function which work has in the national consciousness.

The importance of labor was a cornerstone of the pioneering Zionist approach and assumed cult-like dimensions among the early *kibbutznikim* and pioneers. The ideology of labor derived in part from the Zionist reevaluation of the position of Jews in the world, which maintained that it was both ignoble and impossible for Jews to continue to specialize in "nonproductive" services in the larger Gentile society. Also important were the socialist and Tolstoyan theories which were fashionable among those who crystalized classical Labor Zionist ideology. As this set the tone of the nascent Jewish state, later waves of immigrants tended at least to pay lip service to these ideals.

The extreme sensitivity to unemployment dates to the Mandatory period, when the *Histadrut*, a comprehensive federation of labor unions, undertook to find -- or make -- work for members who might otherwise be unemployed. This could not be avoided so long as the Jewish *yishuv* remained a rather beseiged minority. The tolerance which most societies have for a certain measure of unemployment is conditioned by economic considerations, but the small society of settlers was disciplined by a sterner law.

## The Primacy of Politics

Economics consist of the management of scarce resources. Their scarcity consists in the "opportunity cost" which attends every possible choice, for every choice is also a renunciation. One must consider not merely the narrow material consequences of a given choice, but also the social considerations; if one rationalizes industry by replacing inefficient branches with more profitable ones, the human pains of "temporary" redundancy must be borne. But the *yishuv*, and the much larger post-independence state which was created in its image, was in the bizarre position of being in control of only a portion of its resources. Zionist ideology and the needs of an overwhelmingly outnumbered minority both demanded that the state import not merely capital -- in the form of Jewish and later foreign governmental aid -- but also labor. The society itself had to be imported, and this turned all economic assumptions on their head.

The society which was in process of massive growth could not judge each expenditure according to traditional economic criteria; there was no point in demanding that a given settlement or enterprise be "profitable," as the rules by which profits and losses are calculated were changing with each new boatload of immigrants and with each new influx of capital. The important thing was to develop everything as fast as possible, and to preserve the *élan* of the existing population. And as long as the dynamic situation continued, the arguments of cautious economists rightly fell on deaf ears. These professionals were, in the given situation, sometimes handicapped by what Akzin and Dror have called their "trained incapacity" to appreciate the fact that covering the deficit in the current account was actually a political, not an economic problem:

> The subjective forecast of future net capital import determines whether to adopt an optimistic or pessimistic view of the present economic situation of Israel... nearly all predictions of economists of the declines to be expected in net capital import have been wrong.[4]

But once the period of very rapid growth in population and in GNP came to an end, the management of resources which were actually on hand became imperative.

Such conventional economic management has been one of Israel's weakest suits precisely because of the seminal experience of the earlier "glory days." The country in general, and the governmental establishment in particular, had long, long before come to regard economic expertise with more than a touch of disdain, and were inclined to ignore the advice of its exponents.[5] For example, Finance Minister Ehrlich's liberalization of the exchange rate, which triggered the world's worst inflation rate, was opposed by all the economists who knew that no countervailing steps had been planned. At the time of the action, Mr. Ehrlich was quoted in Newsweek to the effect that Israel would thenceforth be numbered among the world's "well-run countries!"

An anti-economic bias has been institutionalized in Israel, a problem to which the earlier discussion of the Bank of Israel alluded. The essence of the bias consists in the fragmentation of economic authority among the ministries, each of which is akin more to the private fiefdom of its minister and his party, than a mere executor of a policy determined upon by strong Cabinet government. Those issues which are of prime importance to the State have been put under the stewardship of a unified team - one need only recall the defense/security establishment, or the settlement authorities. But the only minister whose sole responsibility is the economy as a whole is the Finance Minister, who lacks a natural political base. Each other ministry represents an interest group, such as the military professionals and defense-oriented industry, the teachers, the farmers, the *kibbutzim* (c.f., the old Ministry of Development), the religious institutions, and so forth; it is the Finance Minister who must stand against their natural proclivities to spend too much.

When *Mapai*, for long the largest party, dominated the key posts, the Finance Minister generally stood high enough in his own party to advance and defend a budget of sorts. Such Finance Ministers as Levi Eshkol, who succeeded Ben-Gurion as Premier, and Pinhas Sapir, who later refused that post when his party offered it, were powers in their own right. But the decline of *Mapai* had already led to relatively weaker political control over the economy even in the last days of the Labor Government, when the Likud came to power.

Mr. Ehrlich was the first Finance Minister not to come from the coalition-forming party. Indeed, his party, the Liberals, had technically joined Herut to form the Likud party -- but the latter was itself a rather loose coalition, in which the economic job was thrown to the weakest faction in part because Mr. Begin's Herut was almost devoid of interest in it. His successor, Mr. Yigal Hurvitz, was similarly hamstrung by his status as a member of the *La'Am* faction (though his economic sense was immeasurably superior to his predecessor). The current Minister, Yoram Aridor, though a member of Herut, lacks the party clout to control powerful bodies such as Defense and Education.

Minister Aridor was able to achieve his initial goals because they involved spending more rather than less than the economy could afford; this was in order to provoke a brief period of well-being before the June 1981 elections. Since that date, budget overruns have been supplanted by the virtual absence of a budget, which was only tabled in the Knesset at the end of February of this year.

## Conclusion: the Lessons of Youth

The most fascinating aspect of the monstrous Israeli inflation is the relative calm with which it is received by the citizenry. Indexation is not the reason for this, for it does not protect the full measure of value inherent in any wage contract. Perhaps a more subtle explanation can be found in the fact that so many conflicts in Israel have been drawn according to lines other than the traditional one of lenders *contra* creditors. Creditors are the single most important lobby against inflation, and the businessmen who depend upon credit serve as their squires; but Israel has yet to develop a true business class.

But the inflation is simply a symptom of over-extension in every field; the *per capita* external debt is another Israeli figure which has no other precedent, and it too is hardly mentioned in the Knesset. This writer is convinced that the real reason for Israel's singular acceptance of such an economy lies in the ingrained predilection to place high politics above mere economics, and to look to a *deus ex machina* rather than a balanced budget, as the solution for all its ills. One might blame the lessons of its impulsive youth for this, without denying that one would not have missed it for the world.

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## Notes

1 Unless otherwise stated, all figures are derived from the Central Bureau of Statistics.

2 See Milton Friedman, "Monetary Correction," in Essays in Inflation and Indexation (Washington: American Enterprise Institute, 1974), 29-30.

3 Ibid., 32.

4 See Benjamin Akzin and Yehezkel Dror, Israel: High-Pressure Planning, (New York: Syracuse University Press, 1966), 57.

5 Ibid., 7.

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