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AFTER TWO YEARS OF ECONOMIC STABILIZATION

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Israel's plague of superinflation, that spanned a period of almost 15 years, and at times reached annual rates in excess of 1,000 percent, came to an abrupt halt in the wake of a new economic stabilization program in July, 1985. Now that stabilization has held for two years, it seems fitting to review both the inflationary rage and the succeeding calm, and to try to draw lessons from both.

Two Competing Theories of Inflation

Any evaluation must begin by reviewing the argument that raged no less than inflation itself. It centered on the question of what it was that produced inflation, and why it intensified so greatly. The conventional school argued that a government deficit financed by the printing of money was to blame. This view was firmly in line with accepted economic theory and hence needed no specific proof. The minority view was that the inflationary process in as open an economy as Israel's cannot be explained in the same terms as those of economies whose foreign trade is negligible relative to their national product. Whereas in such economies excess demand by the government exerts considerable pressure on domestic resources, which are unable to respond adequately and hence must result in inflation, very open economies could react differently. That is to say, excess demand can be offset by excess imports, i.e., current account deficits. In that case, a growing foreign debt would replace inflation. Not that there

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is no cause for alarm, but if this is so, then the causes of inflation in an open economy must be sought elsewhere.

The minority's view was that Israel's inflation is caused by developments in nominal, not real magnitudes. In particular, the inflationary process was seen as fueled by a race between nominal wages, especially in the business sector, and the rate of exchange. In order to understand the origin of this view, one could consider the following very simple argument. In essence, out of the three inputs going into industrial output -- labor, capital and raw materials -- Israel provides domestically only the first. Virtually all capital goods, and certainly all raw materials, including in particular energy, are imported. Consequently, the weight of the wage component in the cost of production, relative to labor productivity, is crucial to the determination of the international competitiveness of Israel's industry. The key fact in this regard is that ever since the first oil price shock, industrial wages grew at rates not always justified by productivity gains.

Without intervention on the part of the state, this process would have led to bankruptcies and unemployment. This, in turn, would have put a damper on wages, though, as experience in other countries such as Britain shows, this is liable to be a long and painful process. Competitiveness would thus be restored. In any event, the state did intervene, since unemployment was clearly, and probably justifiably, the dread of Israel's politicians. The method of intervention was to repeatedly devalue Israel's currency. In effect, these devaluations denied the incremental purchasing power of wages gained through nominal wage increases. In other words, devaluations caused all exports and imports to become dearer in the domestic market. Thus, the real value of wages did not grow in proportion to the increases in their nominal value, and sometimes even declined. In this manner the danger of unemployment was avoided. However, like all battles, this one escalated as well. It took ever bigger devaluations to achieve the same goal, which made the cost of maintaining full employment ever steeper; inflation reached ever higher rates and caused complete disorientation of the economic system. Thus, for instance, financial manipulation became the most rewarding activity in terms of returns to the individual, though completely worthless as far as the national economy was concerned.

The diagnosis of the inflationary process as being caused by nominal phenomena and not by a real imbalance (though the latter clearly exists and requires redress -- more on this later), is no longer a minority position. The prestigious daily, Ha'aretz, which had persistently and vehemently defended the excess demand view, editorialized on June 2, 1987, under the headline "The Governor's Nominal World" (the allusion being to the governor of the Bank of Israel) as follows:

> "The economic policy followed since the initiation of the anti-inflationary drive in July 1985 is based on two assumptions: one, that the mechanism which caused inflation was powered by production costs; two, that by stabilizing the ratio between the main nominal cost component, the wage rate, and the rate of exchange, one could stabilize the entire nominal system. These assumptions were since borne out by actual developments...."

The words of the editorial reflect accurately the rationale behind the attempts to fight inflation during Yoram Aridor's term as Finance Minister after the elections of 1981. Those attempts failed because of a lack of the sort of political backing that the National Unity Government was able to bring to bear. In 1984 and during the first half of 1985, there was a return to the conventional, and wrong, wisdom. It took the Peres government almost a year before it decided to try the Aridor approach, which proved to be the right one.

The Dramatic Effects of Stabilization

Although the stabilization program had many components, its essential features were a substantial reduction in real wages

and the fixing of the exchange rate of the Israeli shekel vis-a-vis the U.S. dollar. The effect was nothing less than dramatic: within one quarter, inflation declined from an annual rate of 367 percent to a rate of only 41 percent. Consequently, while the average rate of inflation in 1984 was 375 percent and in 1985 was 305 percent, the 1986 rate of inflation was 48 percent and still declining. From April, 1986 to April, 1987, Israel experienced a rate of inflation of only 21 percent -- almost total stability by Israeli standards.

How secure is this new-found stability? The answer must lie with the degree to which the ratio between wages and the exchange rate is maintained. In this respect, it is important to emphasize the fact that the exchange rate had been fixed relative to the dollar and not relative to the basket of currencies reflecting Israel's main trading partners. Only in August, 1986, was the shekel pegged to a basket of currencies consisting of the dollar, the German mark, the British pound sterling, the French franc and the Japanese yen. The reason this is important is that between July, 1985, when the program commenced, and the end of 1986, the shekel depreciated along with the dollar, especially against the yen, the mark and the franc. Measured against these currencies, the shekel's depreciation totalled 10.5 percent.

What happened to wages in the meantime? They increased very considerably: private sector wages at the end of 1986 were 77 percent higher than they had been in July, 1985. Clearly, then, the balance between wages and the exchange rate was not maintained, and one would expect a tremendous pressure on profitability as a result. Indeed, matters would have been quite difficult if relief had not come from another important cost component; namely, the cost of energy, which declined during the same period because of the momentous decline in oil prices. Even that, however, was not enough, and a formal devaluation of 10 percent was instituted in January, 1987. At this point the balance between wages and the exchange rate is probably quite precarious and must be watched diligently if inflation is to be kept in check.

What happened to the economy in addition to the reduction of inflation to an annual rate of about 20 percent? Clearly, the decline in inflation restored calm to the economy. The most obvious symptom was the disappearance of lines from banks and the subsiding of the fever that characterized activity in the stock market. In other words, people no longer devoted substantial portions of their time to financial wheeling and dealing. But the most significant result of stabilization was that, despite the fact that the government budget came into balance, the overall economy did not.

An Increase in Tax Collections

How was that possible? The explanation lies with the fact that the balancing of the budget was partly an effect of reduced inflation, rather than a cause. Specifically, the elimination of the public deficit resulted only partly from reduced expenditures. The rest came from increased taxes. This is not because tax rates were increased or new taxes imposed. Rather, the very decline of inflation brought about a real increase in the value of tax receipts. This is a well-known effect; since corporations and the self-employed pay delayed taxes, usually a few months after the accrual of the income which prompts these taxes, and since there is no workable mechanism for the indexation of taxes, inflation erodes their real value and, hence, causes a decline in government revenue. This erosion effect disappears when inflation stops, and so revenues increase.

In fact, real tax revenues were 9 percent higher in 1986 than they had been in 1985. This, coupled with the facts that government subsidies declined by some $1.5 billion and domestic public consumption decreased by 4.6 percent in 1986 (virtually all of it in defense spending), brought about a balancing of the public budget. (The distinction of domestic public consumption is a consequence of the fact that Israel's government spends a sizeable amount on imported armaments, financed

by U.S. aid, so that this component of public expenditures exerts no pressure on domestic resources.) Yet despite the elimination of excess public demand, the overall imbalance remained unaffected.

Spending Private Savings on Consumption

Although domestic public consumption declined by 4.6 percent, the rise in private consumption more than offset this decline. The relevant data are as follows: private consumption increased in 1986 by 14 percent. Consequently, combined private and domestic public consumption increased by 7.8 percent in 1986 compared to 1985. That domestic resources did not keep pace with this increase is evident from the fact that the excess of total domestic uses over gross domestic product (GDP) increased in 1986 by a towering 15 percent. Hence, every angle of examination leads to the conclusion that the real domestic imbalance of the Israeli economy increased very substantially, even as inflation was being reduced enormously.

The evidence shows up very significantly in Israel's foreign accounts. A cursory review of the data reveals that in real terms, total imports exceeded by 17.5 percent the figure of the "catastrophic" year of 1983. Again, in real terms the trade deficit in 1986 was 35 percent higher than in 1985. In dollar terms, imports of consumer goods in 1986 exceeded by 7 percent those of 1983, the year referred to sarcastically in Israel as the "Happy Aridor Days." The increase over 1985 was a whopping 65 percent.

How could this happen? Where did Israelis find the wherewithal to finance such an increase in private consumption? One possible answer is through increases in their incomes. However, the data indicate very clearly that incomes did not grow very much. The actual answer is to be found in a considerable decline in savings. Israelis are much richer, in terms of the ratio between accumulated net financial assets and current income, than are the citizens of any other developed country. Consequently, even if current incomes are reduced significantly, total disposable resources are not. Moreover, Israelis can allow themselves to spend from savings for a while without seriously jeopardizing their future consumption ability.

This net wealth was accumulated because, while financial assets were indexed, financial liabilities were not. Consequently, inflation eroded liabilities while assets remained intact. Since these assets were created in large measure by government obligations, and not by real investment, net financial wealth is not balanced by real wealth. Rather, it is balanced by Israel's foreign debt. However since people apparently do not consider the foreign debt in personal terms, they act as if they were rich.

Interest Rates Skyrocket

Another very significant development which accompanied stabilization concerned the credit situation. Events here were the consequence of the attempt on the part of the Bank of Israel to follow a very tight monetary policy. Thus, the marginal interest rate for someone who took a loan on July 1, 1985 and held it for 6 months, was 163 (yes, one hundred and sixty-three) percent in real terms on an annual basis. Yet over the same period, a saver putting his money in certificates of deposit (CD's), would have lost 5 percent in real terms. The comparable figures for all of 1986 were 43 percent for the borrower and minus 2 percent for the saver. The textbook conclusion from these numbers would be that it is not worthwhile to save and even less so to borrow. Indeed, such interest rates would be a classic recipe for a severe depression. No business pays a real rate of return which is even close to the interest rates which prevailed in Israel over the past two years, which means that wide-spread bankruptcies and unemployment should have developed.

As it turns out, the textbook result did apply in regard to savings, but not to borrowing. Despite the steep interest rates, non-directed credit increased in 1986 by 65 percent in nominal, and by 38 percent in real terms. (Part of the credit provided by commercial banks is directed by the Bank of Israel for export purposes,

is rationed and carries a lower interest rate; at the end of 1986 it constituted 25 percent of all commercial credit.) Thus, if the Bank of Israel really did intend to pursue a tight monetary policy, it failed dismally.

Where Does Israel Go From Here?

This question should be juxtaposed to the interest rate story, because the skyrocketing interest rates which failed to arrest borrowing are a harbinger of troubles to come. It is abundantly clear that businesses which borrowed at the prevailing interest rates will not be able to repay those loans, and will either face bankruptcy or will have to be rescued by the state. In fact, the first of these cases are already on the agenda in the form of requests for relief by two of the larger agricultural organizations -- the Moshav Movement and the United Kibbutz Movement. Given the political unacceptability of unemployment in Israel, it may be expected that the government will dole out the money needed to provide relief from the effects of these incredible interest rates.

The most pressing problem by far is the imbalance between what Israel produces and what it spends. A policy to redress this imbalance can rely either on reducing spending or facilitating higher growth rates so that output is more capable of supporting the existing rate of expenditures. Unfortunately, the alternative of reduced expenditures is virtually unavailable at this stage. On the public side, there is public consumption and debt service. Considering consumption first, one finds that domestic defense spending constitutes almost 50 percent of total domestic public consumption. Even at that, public consumption makes up only 27 percent of GDP, not an excessively high figure by Western standards. Furthermore, by the same standards, civil public consumption which stands at 15 percent of GDP, is on the low side. It follows that any substantial contribution toward balancing the economy from the standpoint of public consumption will have to involve a considerable reduction in defense spending.

Defense spending could be cut if relations between Israel and its neighbors in the Middle East were to become more cordial. However, no serious economic planning can assume that this will happen any time soon. Hence, if defense spending is to be reduced substantially, it must be based on a different security concept. In addition, the economy will have to absorb elsewhere the manpower that will no longer be employed in defense-related activities. That, in turn, will require massive investment in the economy at large.

Based on what is known publicly, no serious discussion is taking place on any of the topics whose resolution is a condition for defense cuts. True, there are those, both within and without the defense establishment, who write and speak from time to time about the need to change Israel's security concept. It is also clear in which direction that change will proceed, namely to base Israel's defense on a smaller force with fewer heavy capital goods (tanks, personnel carriers, heavy artillery, etc.) but with much more sophisticated weaponry and munitions. Still, no serious debate is taking place about these issues where it really counts, in the upper echelons of the political structure. Hence, it is hard to visualize reductions in defense spending in the foreseeable future.

Increased Growth: The Only Answer

There remains only one practical way out of this dilemma - much faster growth. However, this requires decisions which are politically far more difficult than the decision to stop inflation. Basically what is needed is a dynamic, independent private sector, something Israel has never had. Three conditions must be fulfilled if Israel's business sector is to justify that name: first and foremost, the government has to get out of the capital market. For years it has completely dominated the market, not on the strength of offering higher interest rates, but rather administratively. Banks, insurance corporations and pension funds are obliged by law to invest the lion's share of their funds in non-negotiable government

securities. On the other hand, firms have to obtain permission from the Finance Ministry (in addition to the Securities Authority) to issue common stock. Corporate bonds have been virtually eliminated altogether. Thus, virtually every new business venture had to be dependent on the government from the very beginning, because it needed the government if it wanted to obtain capital.

The second basic condition for revitalizing the private sector is that the government must stop rescuing faltering businesses, because the expectation by corporations that the government will save them when they run into trouble creates an enormous moral hazard. Corporations will be less resistant to unjustified wage demands and will generally be less scrupulous, thereby increasing the probability of financial difficulties. The most spectacular example of how the dependence of business on the government prevents a business from making sound financial decisions and the government from making sound policy decisions is provided by the Lavi fighter. Israel has already invested in excess of $1.25 billion in the project and the development phase is expected to cost a total of twice that amount. At this point, support for the project on both defense and economic grounds has declined sharply. What keeps it going, despite the fact that it may cause a lot of damage, is the fear of what is going to happen to Israel Aircraft Industries, which has thus become the tail wagging the dog.

The third basic condition, one which is not directly related to the business dependence question, concerns investment in infrastructure. In this respect Israel's situation is nothing less than sorry with regard to both roads and the telephone network. Israel now has one of the highest densities of automobiles per mile of roads in the world. Some of its major centers are not yet connected by even a single expressway and sections of the road between Jerusalem and Beersheba, for example, are not up to standard even for country roads. The telephone network is grossly inadequate. There are times during the day when whole sections of cities, and occasionally even entire area code zones are inaccessible. It often takes three attempts for every successful connection. It is unimaginable that in today's fast-paced world, an economy can grow vigorously if its telephone system is in such a state.

Israel should have used a healthy proportion of the special $1.5 billion emergency fund granted by the U.S. to finance essential projects that would have created favorable conditions for private business investment. But in its zeal to show a balanced budget, the government failed to make the distinction between consumption and investment. Israel thus finds itself in the ridiculous situation of having crumbling roads and a congested telephone system, as well as excess foreign currency reserves which have accumulated to $4.5 billion. The accumulation of these reserves not only deprives the economy of urgently needed investment, but creates an atmosphere of complacency, as though things are just fine and there is no reason not to enjoy the good life. Even the possibility of early debt retirement by Israel is now being seriously considered by the government. A country which should go out of its way to invite investment is thus thinking of paying off its creditors instead.

Under these circumstances, it is hard to be optimistic about Israel's ability to start rebuilding its economy, now that the threat of it being ruined by inflation has been removed.

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