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Israel Has Made Aid Work

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Israel is the largest single recipient of economic aid from the U.S. This is partly because the economic stability of Israel is uncertain and is important to U.S. national interests. Therefore a report on the progress of the Israeli economy is relevant to policy decisions to be made here.

A common view, supported by some experience, is that the availability of foreign aid prevents the recipient country from taking the steps required for its own economic health. The story of Israel suggests that there may be exceptions to this dismal lesson.

On July 1, 1985, Israel introduced a radical stabilization program designed to bring the inflation rate down from 1000% to 20% a year or less. Success was swift. Within two months inflation was down to less than 4% a month; in November and December 1985 it averaged only 1% a month. But there is still a long way to go before success is assured.

The Israeli inflation rate rose by stages from 2% per annum in 1967-70 to the 1000%-per-annum area at the end of 1984. The pattern was for an inflationary shock to kick the inflation rate up to a new plateau, at which it stabilized before the next shock.

Underlying the Israeli inflation were massive budget deficits averaging 15% of gross national product for more than a decade, fueling, and fueled by, a fast-growing national debt and rapid monetary growth. At the heart of the government's budget problem is defense spending of 25% of GNP. Despite large-scale U.S. aid, the government found it increasingly difficult to borrow at home or abroad in 1984 and 1985, and was forced instead to print money. More than anything else, it was the difficulty of borrowing that forced the government to undertake the stabilization program.

Three Policy Positions Argued

Widespread indexation of assets and of wages made living with inflation tolerable. As inflation persisted from 1979 to 1983 in the 100%-130% range, Israelis explained to foreigners that they had found a way of living with high but non-exploding inflation.

Three policy positions were argued during this period. A first group was willing to live with inflation. Another group wanted steady disinflation through gradual reductions in the budget deficit and money growth. A third, shock-treatment group argued that only a comprehensive program designed to move the economy immediately to a sustainable low inflation equilibrium could succeed.

The living-with-inflation group evaporated as inflation hit the 20%-a-month range in 1984.

Tough anti-inflationary policy was widely expected from whichever party won the July 1984 election. But it failed to materialize. The election led to a coalition government that took nearly three months to form.

The first stabilization program of the new government was a package deal with the Histadrut (national trade union organization) and employers whereby wages and prices would be frozen for three months. However, devaluation continued. The planned 1985/86 budget had sharply cut the deficit, but with the government spending increasing amounts to maintain the prices of subsidized goods, the deficit did not fall. Nor were other planned cuts in government spending implemented.

By April and May of 1985 the package deal had fallen apart and inflation was back to the 400%-per-annum area. The balance-of-payments deficit had been reduced from its 1983 level, but foreign-exchange reserves were falling rapidly as Israelis switched into dollars. The government budget deficit was at an unsustainable level and the need for action was clear.

By this stage the comprehensive approach was the only choice. The aim would be to move the government budget, monetary and exchange-rate policy, and wages and prices all at once to a new, sustainable level.

Israeli Inflation 1985
% per month

Jan.-May	11.3*	Sept.	3.0
June	14.9	Oct.	4.7
July	27.8	Nov.	0.5
Aug.	4.0	Dec.	1.5

*Average

The essential requirement for the stabilization was a sharp reduction in the budget deficit. Without that, no amount of wage and price controls, sophisticated exchange-rate management or clever monetary policy could do more than temporarily slow the inflation.

The program had three main ingredients:

- A cut in the budget deficit from 17% to 8% of GNP. The cut came mainly through subsidy reductions.
- A large devaluation to be followed by a stable (though not formally fixed) exchange rate against the dollar.
- Introduction of wage and price controls and suspension of wage indexation and other elements of existing labor contracts by emergency decree.

In support of the program, monetary policy would control the growth of credit.

The devaluation and lifting of subsidies caused a 28% jump in the price level in July. Wage earners were not compensated for most of the July inflation, with the result that the real wage fell about 20%.

The government's main fear about the program had been that it would create massive unemployment. Economists argued that a reduction in the real wage and devaluation would prevent unemployment and allow a switch of production into exports. The knowledge that a requested supplementary U.S. aid package of $1.5 billion over the next two years was likely to be granted within a few months encouraged the government to act decisively, in the belief that it would have a safety net of reserves and resources to use to increase employment if things went badly wrong.

Immediate results of the plan have been positive. The data show the inflation rate coming down fast. In January 1986 the consumer price index declined 1.5%. The budget is doing even better than expected as the reduced inflation increases real tax revenue (tax receipts previously lost much of their value by the time they were collected). The trade balance has maintained the improvement that began with the maxi-devaluation at the end of 1983. The black-market exchange rate, which had been at a premium of 25%, has fallen to 5%. Price controls have not yet produced serious shortages.

Although labor objected bitterly to the use of emergency decrees to suspend contract terms, a new voluntary wage agreement was reached after remarkably little strife. The agreement allowed the real wage reduction of July to go through, but maintained partial indexation and provided for nominal wage increases of 4% a month from December 1985 to February 1986.

Monetary policy during the first months of the stabilization was strongly contractionary. The nominal interest even in October was still 13% a month, implying an annual real interest rate of more than 100%. Several large firms are in financial difficulties. The nominal interest rate was brought down rapidly in November and is now 5% a month.

Contrary to fears, unemployment rose only briefly in July and August, and has started back down again.

So far, then, the plan is a total success. Public approval for the economic policy, despite the immediate hardships it has caused, is widespread.

Prospect of Inflation-Rate Rise

Nonetheless, serious difficulties remain. The first is that the government budget deficit is still too high. At 8% of GNP, it cannot be financed without increasing debt or printing money too rapidly. Yet the government finds it increasingly difficult to cut spending. Because government revenue in Israel is near 50% of GNP, the tax burden is too high and taxes should be cut. But without further spending cuts, taxes cannot be cut. Further spending cuts are thus a high priority.

The wage agreement will raise nominal wages at least 17% over the next three months. Unless the government finds a way of neutralizing that increase, the price level will rise as business costs increase. Price controls cannot contain such pressure, and in any event cannot be successfully maintained over long periods.

The prospect is that the inflation rate will rise back to the 3%-4%-a-month rate by the end of April, unless the government finds a way of dealing with the effects of the planned wage increases. There is no way of doing so without further budget-deficit reductions. From 3%-4% a month inflation, the trip to 10% a month is easy, especially for an economy that has been that way before.

Budget decisions of the next few weeks will show whether the coalition government can bring itself to the measures now needed to protect the gains achieved by its decisive action of last July.

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