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## 1984 INFLATION: ISRAEL'S STABILISATION PLAN

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### ABSTRACT :

*Inflation is one of the most misunderstood phenomena, and many economists have attached different degree of significance to inflation. Many economists differ in ways to cope with the problems of inflation, however every economist agree that hyperinflation is not good for the economy. In this article I would discuss about the 1984 inflation of Israel. The paper would primarily focus on the stabilisation plan adopted by Israel, but it would also discuss the reason behind inflation, and what are the problems faced by Israeli leadership while addressing the problem of inflation.*

**KEYWORDS :** *Inflation, Israel, Monetary Policy, Labour Union.*

### INTRODUCTION

According to Kaushik Basu inflation is, one of the most dreaded and one of the most misunderstood of economic phenomena.<sup>1</sup>Radford (1945) states that Inflation has been with humankind ever since we moved away from barter to the use of mediums of exchange, like paper money, precious metals or even cigarettes, as happened in a prisoners of war camp during the Second World War. Yet the exact cause or the factors which are responsible for inflation are not known with the certainty. There are many theories from Philip Curve to monetarist theory each having their own explanation behind the cause of inflation, yet the exact cause is not ascertained According to Jonathan Nitzan and Shimshon Bichler in their article: 'Inflation and Accumulation: The Case of Israel' maintains that, inflation is neither the consequence of market imperfections, nor the result of misguided policies, but rather part of an on-going restructuring of capitalist society. The central facet of this



restructuring, they argue, is the process of differential accumulation, that is, the progressive redistribution of ownership claims in favor of dominant capital group.<sup>2</sup> In their article they (Nitzan and Bichler) have taken very clear stance and are against all the standard economic model explanation. According to them inflation is not the result of any market imperfection as mentioned earlier, rather inflation is the result of collusion between capitalist class and State, to the benefit of former. Capital as we understand is not something tangible and confined to machines, land and capital goods, it is more than that. Capital has to do more with profit than productivity. Polanyi (1944) maintains that in real sense what makes profit possible is not productivity but the strategic

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<sup>1</sup> From the excerpts of paper based on the First Gautam Mathur Lecture that I delivered in New Delhi on 18 May 2011 delivered by Kaushik Basu.

<sup>2</sup> Nitzan and Bichler, Inflation and Accumulation: The Case of Israel, Science & Society, Vol. 64, No. 3 (Fall, 2000), pp. 274-309.

control of productivity of business ends. Markets usually operate with some principal actors who can affect production and prices. More importantly, markets never exist in a political vacuum. In the real world, market outcomes as well as their very existence, are political phenomena. In this paper I will discuss the reason for the 1984 hyperinflation in Israel. Here while going to reasons or factors responsible for the inflation I will focus more on political aspect of it. Though I will be dealing with the economic definition and will take clue and references from the articles of the economists but my attempt here is to keep it as simple as possible and will refrain myself from using economic jargons and won't be dealing with all the Greek symbols and equations, through which economists put their model forward. Here main focus of this paper is to determine the factors which were responsible for the historic inflation in Israel and how later the stabilization program was successful only in 1985. Inflation in Israel is not overnight phenomena it was there from the 1977 from the formation of the Likud government and steps were being taken to stabilize the economy but it was successful only in 1985 during National Unity Government. So in this paper I will try to link this two broad political event along with various events which took during that place and briefly I will focus on external factors also and their role in fuelling as well as combating inflation.

### HISTORICAL BACKGROUND

Here we will discuss the socio-political cause of hyperinflation in Israel. But before going to that we need to understand the link between the political structure and the economics. In this case the political structure is democratic, since we are dealing with Israel and on the other hand economic phenomena which we are going to analyse is inflation. So before going in detail about the socio-political cause we need to understand the link between inflation and democracy and why it is difficult to implement stabilization program in democracy than other form of government. . Nordhaus( 1978) argues that in democratic regimes politicians are able to exploit the economic tradeoff between inflation and output (Phillips Curve) and do so periodically before elections. . Hibbs (1977) claims that the inclination of democratic policy makers toward painful economic policies is not related to the timing of elections but rather to the interests of the political groups they need to accommodate. Stallings (1989), and Haggard and Kaufman (1992) hypothesize that in a democratic regime, social divisions among parties may increase macroeconomic instability and undermine stabilization programs. Keren (1995) emphasizes the distinction between populism aimed at low income groups which was used by the Israeli government in the early 1980s (headed by the Likud party), and the form of democracy employed by the government formed in late 1984 (headed during its first two years by the Labor party). He finds this to be the key factor in the success of the Israeli program. Whereas Bruno (1993) links the success of stabilization program with credibility of the government, according to him only stable government which has credibility in the public opinion can bring about the stabilization. Many scholars have pointed out that during the turbulent year that is in late 1970s Israel lacked the political leader with courage to implement the economy stabilization plan.<sup>3</sup> in early 1980s Israeli government in order garner public support focused on raising the standard of living of people and to accomplish this task government spending was needed which in turn became the reason for the inflation.<sup>4</sup> Maital and Benjamini (1980) claims that factors related to inflation are political structures of that time. Since 1977-1984 there was a Likud government but not with strong political majority, rather it can be said that it was not the victory of Likud but the loss of Labor party. Likud which needed to take everyone on board succumbed to the pressure of many small parties to be form the government. In early 1970s inflation rate of Israel was less than 25 percent and economy was also growing at healthy pace but in late 1970s it grew from acceptable 31 percent to more than 350 percent by 1984. The only explanation of this phenomenon was the lack of strong majority of Likud government, which made finance minister vulnerable to the pressure of coalition parties, which increased the deficits. Much of these financial pressures came from religious parties, as there is no government in Israel till now formed without the support of religious parties, they have much greater power in respect to their share of votes. These

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<sup>3</sup> Reuveny Rafael, Democracy, Credibility, and Sound Economics: The Israeli Hyperinflation, Policy Sciences, Vol. 30, No. 2 (1997), pp. 91-111

<sup>4</sup> Special issue of Globes, Israeli Business Magazine, June 1995.

religious parties demanded the financial package in return of their support to the government.<sup>5</sup> Keren (1995) claims that Likud support base was basically Jews from Asian region (Sephardic). Jews from non European countries had very less resources and Likud gained their support by allocating them resources which was not with them, this in turn increase government spending and liquidity in the market, which triggered the inflation. One of the major reasons behind the inflation according to Fischer (who also helped in restructuring the loan from IMF and stabilizing the Israeli economy) was the labor union of Israel. Israel has the past of very strong labor union known as 'Histadrut', since 1952 this organization is one of the most powerful organizations in Israel. This organization reflects the socialist nature of Israel. Fischer (1986) the labor union 'Histadrut' demanded the rise in wages anticipating the rise in inflation and moreover there was a resentment in the labor union that there nominal wages is increasing according to inflation but there real wages were at previous level only, so continual increase in the wages of labor kept inflation going. Another reason for the ongoing inflation at that time could be attributed to indexation. In 1980 government of Israel indexed the saving and wages to CPI (consumer price index). Many empirical studies in economics points to the fact that people are sensitive to indexed economy and the decision to index the wage and saving to CPI came at very wrong time. It was due to indexation labor union came to know about the difference between real wages and nominal wages and demanded the continual increase in their wages. In the middle of all trouble government tried to implement some stabilization but at that time whichever measure government tried, it backfired. In 1981 and 1982 government tried to slow down the devaluation rate and at the same was appreciating exchange rate in hope that it will make import cheaper and reduce price and will contribute in customs revenues, things worked well for a period then a bigger problem surfaced, that was current account<sup>6</sup> deficit. This move of government was exhausting foreign reserve, which in turn would again lead to the vicious cycle of inflation. Likud party which came into power tried to curb the government expenditure to control the inflation, but end up spending more than the Labor government. In case of Israel big part of government expenditure is linked with military and social service and Likud government could not alter any of those sectors, fearing national security and alienation or resentment of people in hard times. As already mentioned since Likud didn't enjoy the strong majority it was more vulnerable to pressure from smaller parties, hence Likud end up spending more than Labor government. This was the time Israel spent huge sum on importing weapons, and this also coincides with the Israeli invasion of Lebanon. Yearly around \$ 1.25 billion was spent during Lebanon occupation, and this mounted huge pressure on the Israel, so this can also be attributed to the causes of inflation.<sup>7</sup>

### STABILISATION POLITICS

Instead of saying it 'stabilisation plan' I prefer to say is 'stabilisation politics', because government was trying to implement the stabilisation plan from early 1980s but could not succeed in that, it was only after the formation of National Unity Government in 1985, stabilisation plan was successfully implemented and ironically everything fell into line at that point of time. The economic feature of the stabilisation programs was: (1) reducing the liquidity in the market that is the growth of money supply; (2) curbing government expenditure; (3) implementing credit ceiling so that cheap credit doesn't hurt economy anymore; (4) devaluating the currency and freezing exchange rate in order to promote export to correct current account deficit; (5) freezing labour wages for three months; (6) tighten the number of subsidized goods and the subsidy. On top of that a committee was formed to determine the prices of various goods and price charged by the private player came under the surveillance of the government. It is still the puzzling question that why these initiatives were not taken before 1984, when the inflation rate touched three digit was approaching towards the four digit, and answer is simple that measures were taken at time but there was not strong government to implement that plans, and moreover so many measures were never taken simultaneously at the same time. We can say that there is role of political factor in explaining the success story of Israel. Political factor can be summarized in three points: (1) politicians were able to protect themselves from the pressures

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<sup>5</sup> Weissbrod, D. and L. Weisbrod( 1986). 'Inflation in Israel: The economic cost of political legitimation,' Journal of Social, Political, and Economic Studies 11: 201-226.

<sup>6</sup> Current account: net earnings from export minus payment to imports.

<sup>7</sup> Rivlin, P. (1992), The Israeli Economy. Boulder CO: Westview Press

from the smaller parties by forming the coalition between two biggest parties<sup>8</sup>; (2) the new government was able to convince labour union i.e. 'Histadrut' and business community to support the national stabilization program and to sacrifice their personal gains for the benefit of country at large; (3) public cooperation was gained as public believed the credibility of government and its New Economic Program.

Skidmore (1977), Haggard and Kaufman (1992) argued that civil liberties were curtailed in many places while combating the hyperinflation, many places civil liberty was compromised, but in case of Israel due its high democratic nature government could not simply take these steps, so in order government need to convince people and make them believe that this all are short term measures and in long term it will be good for people at large. During late 1970s Israel was divided into Labor and Likud Party and there difference was mostly centred around Arab Israeli conflict and on top of that Labor party controlled 'Histadrut' led to the partisan politics coming into the sphere of politics, yet they agreed on the basic agenda to solve the immediate problem that nation was facing, generally National Unity Government are formed in times of crisis and that too in times of war, but here the National unity Government was formed to solve the economic crisis that country was facing. In 1984 election neither Labor nor Likud got enough support to form the stable government, after a long stalemate President of Israel ask the biggest two parties to form the National Unity Government, to tackle the economic crisis that country was facing. There are many scholars who believe that National Unity government formed at that point of time because of Lebanon problem as causalities in Lebanon war were growing and it was being difficult to maintain army there, but the biggest problem was not Lebanon war but the cost attached to it, annually around \$1.25 billion was going in Lebanon war and that at time of economic distress and current account deficit. Both leader Prime Minister Simon Peres of Labor Party and Itzhak Moda'i Likud Party declared that the economic reform or New Economic Program was at top of their priority list and they put their prestige behind it.<sup>9</sup> Cooperation was achieved at three levels to deal with on-going political crisis. First the broad cooperation was the National Unity Government by the cooperation among Labor and Likud party. Economic cooperation was achieved by the tripartite agreement between employers, government and labour union 'Histadrut' to support the plan and wage scheme of the government and lastly at micro level public was convinced that the measures taken by government to deal with crisis are credible. Many scholars have linked the credibility to implementation of program, without the credibility government cannot launch the program to fight the crisis. Kydland and Prescott (1977), and Barro and Gordon (1983) analyse the effect of monetary policy and demonstrate that policy credibility and government's reputation play an important role in the decision making process of both the government and welfare maximizing individuals. These authors assume that individuals make economic decisions based upon rational expectations of their future results. If individuals assume that declared economic policies are not credible, their actions may force democratic governments to change those policies. Suppose that public does not believe in the policy of government and believes that government will finance its deficit by printing money, then individuals will expect an increased inflation rate, so credibility is must under any program to be implemented successfully. In case of Israel we can ascertain the credibility of public from the survey. Week after the implementation of program Israel Institute of Applied Social Science found that 61 percent of the public believed that the government would carry out the programme and 50 percent believed that the programme was needed.<sup>10</sup> The source of credibility flows from the following: (1) credible signals sent by actors important in decision making and government; (2) withdrawal from Lebanon; (3) formation of National Unity Government.

First thing that Israeli government did to emit a positive signal was to form the committee to design the stabilization program; the team consisted of academician and critics of government who had less to do with electoral politics. So the first step got legitimacy from public because government was successful in keeping politics away from the economic stabilization program.

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<sup>8</sup> Possible only in parliamentary system, where parties of opposite ideology come together to fight bigger cause.

<sup>9</sup> Jerusalem Post. June 28, 1985

<sup>10</sup> Persson, T. (1988). 'Credibility of macroeconomic policy: An introduction and a broad survey,' European Economic Review, pp. 519-532.

Second government did not leave any moment to signal that it intended to carry out reforms, as already mentioned leaders of both party came together and announced in public that they are putting their prestige behind the program.

Finally as United States decided to provide Israel with financial problems and current account deficit, this was done by the loan of IMF which in turn was mediated by United States only, these all measures signalled the credibility of the new government.

Secondly, Keren (1995) The Israeli army entered Lebanon in 1982 in what was originally declared to be a short and decisive anti-terrorist operation. Things got complicated when the army became involved in domestic Lebanese affairs while trying to mediate between different ethnic groups. As the number of Israeli casualties rose, the stay in Lebanon became extremely unpopular and the government adopted a guns and butter policy that fed inflation in 1982-1984. As already mentioned keeping army in Lebanon was huge burden for the government and it was costing in terms of life, economy and image of Israel in international community. In June 1985, the Israeli army left Lebanon as was promised at the time of the formation of the National Unity Government in September 1984. The withdrawal strengthened the government's position in implementing the stabilization program since it permitted a substantial cut in defence commitments, which in turn enabled the government to reduce its budget deficit and rein in inflation. Leaving Lebanon as promised may have been perceived by the public as a sign of overall government's credibility, commitment to declared fiscal goals, and an ability to follow them through. Lebanon was very much linked with economic instability in eyes of public in Israel, for example in the pre-election interview Gad Yaacobi,<sup>11</sup> mentioned the withdrawal from Lebanon in the same statement in which he discussed the Labor party's intentions to stabilize the economy.<sup>12</sup> The link between the withdrawal from Lebanon and the economic plan was also evident in a petition sent to the government by a group of social scientists on June 1984. The petition recommended two goals (1) leave Lebanon; (2) stabilize the economy.<sup>13</sup>

Lastly, there are many scholars who argue that it was the formation of National Unity Government that helped in the successful implementation of programme and enhanced the credibility of the program in public eyes. D. Weissbrod and L. Weissbrod (1986) it was clear to public also that small parties in the Likud coalition are using their electoral power to gain the benefits financially which in turn create more burden for government resulting increasing deficit. But in this arrangement of government where two opposite parties came together to form the government, the leverage or bargaining power of smaller parties was neutralized. This may have contributed to the credibility and successful implementation of program as program was not dependent on the political support of the smaller parties. But as argued by Keren (1995) too much emphasis should not be put on the National Unity Government, as it the success of the plan was not due to National Unity Government but due to the arrangement in which Simon Peres emerged as the Prime Minister. According to Keren indeed National Unity Government was big achievement but in the time of crisis one expects such move, but the success of this National Unity government lies with the fact that Simon Peres held the Premiership. Because according to Keren, Labor controls the 'Histadrut' and it came to terms and condition of the new government because a man from Labor party was leading the coalition. Without taking 'Histadrut' into confidence no program of any government can be implemented successfully.

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<sup>11</sup> Head of Labor party economic team

<sup>12</sup> Jerusalem Post, June 24, 1984

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