The Israeli Economy

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Preface

Twelve years ago when I taught a graduate course on the economic development of the Middle East at London University, I was surprised that there was no up-to-date book in English on the Israeli economy. The most recently published general book, suitable for students, was Nadav Halevi and Ruth Klinov-Malul's *The Economic Development of Israel*, published in 1968. Since then Yoram Ben Porat has edited a collection of papers on the economy in a volume entitled *The Israeli Economy: Maturing Through Crises*, published in 1985. This work deals with many of the major problems facing the economy in the period leading up to the economic stabilization program of 1985.

I therefore decided to write a nontechnical, general guide to the economy covering the period since 1985. As I studied the issues in greater detail, particularly the political economy of Israel, I became more critical of the performance of the economy and the way in which it has been managed. I have as a result included a discussion of economic reform and the context in which it might occur. Although this book is aimed at a non-Israeli readership, it does not attempt to hide the problems that have arisen in the economy because of domestic constraints as well as difficult external conditions.

In writing this book I have benefitted from many discussions with friends and colleagues. I would like, in this connection, to thank Yair Aharoni, Daniel Gottlieb, Nahum Gross, Jonathan Katz, Yaacov Kop, Azriel Levi, Amnon Neubach, Yoram Peri, Francis Wood, and Ben Ami Zuckerman for their suggestions and comments. Adam Klug read and commented on several chapters of the draft and provided me with many insights about the economy. Tami Bercovitz, Barbara Davison, Michael Josephs, and Zena Rivlin proofread parts of the draft; Rutti Dagan and Diana Rubanenko assisted in word processing. Thanks to Jacques Gansler for his insights into the functioning of defense markets. I am also grateful to Barbara Ellington of Westview Press for her encouragement.

Finally, my thanks to Rosemary for her help, encouragement, and patience. Without her this book could not have been written.

I am, of course, solely responsible for any errors and omissions.

Paul Rivlin

Notes on the Text

Extensive use has been made of the publications of the Central Bureau of Statistics of the government of Israel and of the Bank of Israel. Major references have been indicated in the text.

The Israeli lira, or pound, was replaced by the shekel in 1980 at a rate of 10 lirot to 1 shekel. The shekel was replaced by the new shekel in 1986 at a rate of 1,000 shekels to 1 new shekel.

Abbreviations used in the text include the following:

bn.	billions (thousands of millions)
m.	millions
fob	free on board
cif	cost, insurance, and freight

Due to rounding, some columns in the tables do not sum to the totals given.

Unless otherwise stated, figures are in current prices and those in U.S. dollars are converted at current exchange rates. The annual average exchange rates of the new shekel against the U.S. dollar were as follows:

1985	1.1789
1986	1.4878
1987	1.5947
1988	1.5989
1989	1.9164
1990	2.0162

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1

The Economic Development of Israel: 1948–1985

The purpose of this book is to analyze the performance and institutions of the Israeli economy. This analysis will be done using macroeconomic, sectoral, and historical methods.

As Israel experiences the largest wave of immigration in forty years, the central problem facing the economy is lack of growth. Since 1973 the economy has stagnated; the causes and effects of this stagnation are at the center of this study. Without economic growth new immigrants and many of the unemployed among the veteran population will face a continuing lack of work opportunities.

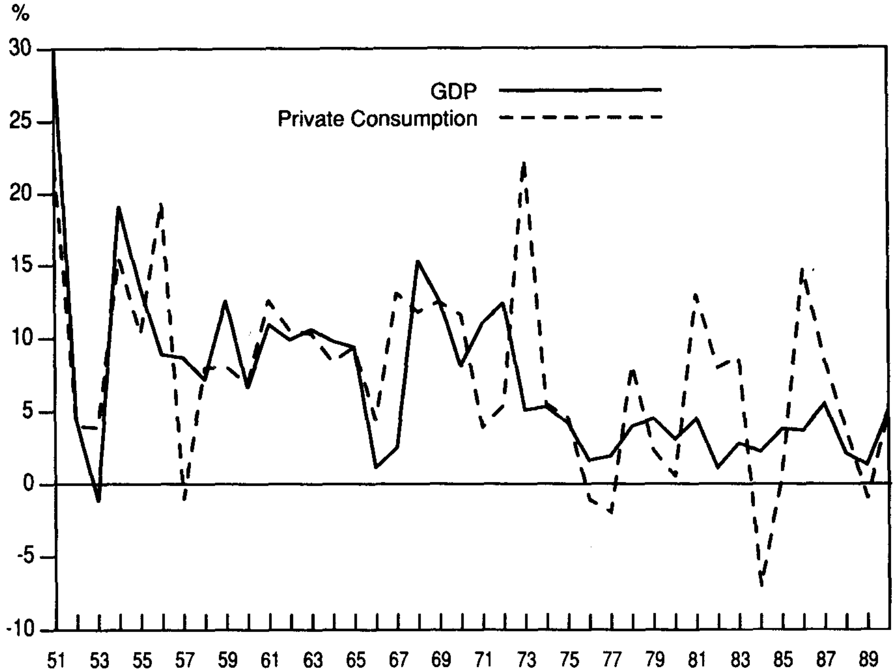
Between 1950 and 1973 Israel's gross national product (GNP) grew at an average annual rate of about 9 percent, one of the highest rates in the world (see Figure 1.1).[1] Since 1973, however, it has experienced slow growth that has at times barely exceeded that of the rate of population increase (see Table 1.1). It has been plagued by balance-of-payments problems, and between 1979 and 1985 prices rose by over 100 percent a year. Despite large government expenditure and budget deficits, the provision of public goods such as education has declined to unsatisfactory levels. At the same time tax levels are among the highest in the world, with severe negative effects on incentives to work and invest. These problems, which are sectoral and political, are due in part to the confrontation between Israel and much of the Arab world.

There were a number of distinct phases in the development of the economy, marked by changes in growth rates and economic policy. It is necessary to go back as far as the immediate prestate period in order to trace the origins of economic policy.

1939–1945: The Effects of the Second World War

The 1939–1945 period was one of relative prosperity, mainly because the economy of the Yishuv (the Jewish community in Palestine) had

Figure 1.1 Annual Rates of Growth of GDP and Private Consumption, 1951-1990 (constant prices)



Source: Statistical Abstract of Israel 1990, Central Bureau of Statistics

important markets in the British military establishment in the Middle East. These markets contracted when the Second World War ended. Citrus was the economy's leading sector and provided most of the economy's exports. The disruption of the international citrus trade during the war also helped to turn many in the Yishuv against reliance on external trade. These pre-1948 experiences invoked a national ideology of self-sufficiency. After the declaration of independence in 1948, the country's socialist leadership favored minimal reliance on foreign sources of capital and revenues from trade in order to build an independent economy.

1948–1952: Austerity

In 1948 after the declaration of independence, Israel's economic prospects were bleak. The country was at war with all of its neighbors. After cease-fire agreements were signed Israel was subject to terrorist attacks from across its borders. In addition the first Arab-Israeli war of 1948–1949 provoked an exodus of Jews from Arab countries. As a result, 100,000

TABLE 1.1
Main Indicators of the Development of the Economy, 1981-1990
(annual percent change)

	1981-85	1986-87	1988	1989	1990
Sources	3.2	8.1	0.9	-1.4	6.3
GDP	2.9	4.8	2.7	1.6	5.1
Civilian imports (cif)	4.6	13.6	0.0	-1.1	7.0
Uses	3.2	8.1	0.9	-1.4	6.3
Private consumption	4.4	11.9	4.2	0.3	5.0
Public consumption (excluding direct defense imports)	1.5	0.3	3.6	0.6	1.9
Gross domestic investment	-0.1	5.9	-0.3	-5.3	25.2
Exports (fob)	5.2	8.4	-1.6	3.9	2.2
GDP of the business sector [a]	3.4	6.7	2.5	2.0	6.2
Rate of growth of population	1.7	1.6	1.6	1.9	5.5

[a] GDP of the business sector is equal to output of the whole economy less output from government, housing and non-profit making organizations.

Sources: 1981-1987: Annual Report 1989, Jerusalem: Bank of Israel, 1990; 1988-1990: Annual Report 1990, Jerusalem: Bank of Israel, 1991.

immigrants arrived in the country in the year of independence alone; over 200,000 arrived in 1949. The flow of immigrants was so large that only a bare minimum of support could be provided for them from public funds. Thousands were initially housed in tent encampments throughout the country before being moved into government-supplied huts.

The government's economic priority immediately after the war was to create work, but it lacked the necessary financial resources to achieve this objective. Loans were, therefore, taken from commercial banks through the sale of foreign exchange and government bonds. In addition money was printed, which resulted in inflationary pressures. These measures enabled the government to finance its basic activities and thus prevent a rise in unemployment. The latter came to only 6.7 percent of the labor force in 1950, a remarkably low figure given the large and sudden increase in the labor force.

Influenced by the success of wartime Britain's planned and tightly controlled economy, the government instituted a policy of austerity. Basic goods and services were rationed and controls were placed on the production of nonessential items. Such policies were in keeping with the egalitarian ideology that characterized the new state and its Labor-led government. They also seemed to be the only way to manage the pressures caused by war and mass immigration. Despite these measures, during the first few years after independence, there were widespread shortages in official markets and rapidly rising prices on increasingly important black markets, with deleterious effects on morale. But there were also achievements: A network of roads and thousands of housing units were built, and the government began to develop basic services such as postal delivery, telecommunications, railways, airlines, and radio broadcasting.

During the period before 1952 government policy attempted to achieve greater economic self-sufficiency. The emphasis of investment and settlement policy was agricultural; funds were channelled to new rural, agriculturally based communities. This policy, it was felt, would provide employment, food, and raw materials; agricultural settlement was also seen as a means of dispersing the population throughout the country. Furthermore, by the building of settlements in outlying and border areas, security was strengthened and the claim of the Jewish people to the land was enhanced. Because the private sector would be unlikely to invest in remote areas of the country, the logic of government action was reinforced.

In the area of foreign trade, government intervention was, by its very nature, better suited to preventing imports than encouraging exports. Imports could be easily controlled by administrative measures, whereas marketing exports abroad required the creation of companies with the necessary products and expertise, something that was beyond the government's capability. Hence, emphasis was placed on import substitution rather than exports as the driving force for growth in the economy. This emphasis applied to both industry and, where possible, agriculture.

1952–1972: From Stagnation to Rapid Economic Growth

1952: The First Moves Toward Liberalization

By 1952 the very tightly controlled economy was suffering serious shortages of foreign exchange and rising unemployment. In order to ease the foreign exchange constraint and provide funds for investment and thus employment, the first steps were taken toward economic liberalization. The government devalued the Israeli pound and took other measures to reduce inflation, cut the budget deficit, and improve the balance of payments. Price controls were also relaxed.

Financial pressures and a desire to increase the resources available for development were major factors leading to the decision to sign the Reparations Agreement with the Federal Republic of Germany in 1952. Designed to partially compensate Jews for the Holocaust, this arrangement provided for US$800 million to be paid to the Israeli government and Jewish institutions over the following twelve years. Another source of foreign currency was the sale of State of Israel bonds in the United States, which began at that time and was very successful.

The decision to raise capital abroad had important ideological and practical implications. Orthodox economic theory might suggest that at least part of Israel's underemployed labor force of the time would have best been employed in export industries set up by foreign investors. The latter would provide the technology, management, and marketing skills lacking in the economy. A deliberately undervalued exchange rate for the pound would encourage this development. However, policies of this kind ran counter to the political views of the government and the Histadrut (General Federation of Labor), which together dominated the country's economic and political life. They wanted to create well-paid jobs that provided a high standard of living so as to attract new immigrants in accordance with Zionist objectives. They did not favor reliance on the vagaries of foreign investors and international markets. By importing capital itself, the government was able to control a large part of the investment process and choose the sectors for development. It dominated the domestic capital market, borrowing from private savers to fund its deficit. This practice was not only a matter of financial necessity; there was an ideological preference for centralized direction in the allocation of resources. It is also doubtful that foreigners would have invested directly in the Israeli economy given the general risks involved at that time. The government, therefore, effectively became the guarantor of investments made by the private sector.

The improvement in the capital account of the balance of payments, as a result of the reparations agreements and the sale of bonds, was the major factor behind an acceleration of the economic growth rate. GNP rose by an annual average of nearly 17 percent in the period 1954–1955 compared to 1.8 percent in the period 1952–1953.[2]

The Economy in the 1960s and Early 1970s

During the late 1950s and early 1960s, with full employment and rapid economic growth, domestic costs rose. Exports of goods and services grew more slowly in volume terms than they had in the early and mid-1950s;

domestic demand squeezed them out. Imports rose more quickly and in February 1962 the minister of finance announced an economic stabilization program that included devaluation and a reduction in protective measures. The current account of the balance of payments had deteriorated because of a large growth of imports. In 1964 the excess of imports over exports was $464 million, a 43 percent increase over the previous year and a much higher level than had ever been experienced.[3] In 1965 the government once again decided on a policy of reducing demand in the economy in order to increase exports and reduce imports. Reparations payments from Germany had declined, as had foreign investment and other capital transfers. The economy relied increasingly on short-term borrowing. Anxiety about the foreign trade account also increased as France adopted a hostile policy toward Israel in negotiations on associate membership in the European Community (EC) (see Chapter 5). This hostility, it was felt, would threaten the development of trade links with the community.

These events led to a change in government policy that caused the economy to go into recession. The slowdown was deeper than originally contemplated: Growth of gross domestic product (GDP) slowed to about 2 percent a year in 1966 and 1967 compared with 10 percent in the previous five years. Growth of consumption and investment also decelerated and unemployment tripled between 1965 and 1967.

The Six-Day War of June 1967, however, changed the picture dramatically: As public sector demand (mainly from the defense sector) rose sharply, economic activity took an upward turn. The dramatic military victory produced a wave of optimism throughout the country that lasted until 1973. The victory of 1967 encouraged foreign investment and capital inflows. The GDP growth rate jumped to 15.3 percent in 1968; during the period 1969–1972 it averaged nearly 11 percent a year. This growth was made possible not only by an increased inflow of capital but also by a new supply of labor from the territories that had been captured in the war. In 1970 over 20,000 Arabs from these areas were working in Israel; by 1973 the number exceeded 60,000. There was also a significant increase in immigration from the West: 123,000 arrived between 1969 and 1972.[4] These immigrants brought both skills and capital and were rapidly integrated into the economy.

Factors Behind Rapid Growth

The rapid growth of the economy between 1948 and 1972 was largely the result of inflows of labor and capital. Between 1948 and 1973 the population of Israel increased from 870,000 to 3.3 million. Between 1974 and 1982 the population rose by 20 percent. Between 1983 and 1989 it increased by about 11 percent.

The civilian labor force more than doubled, from 450,000 in 1950 to 927,000 in 1967. In 1973 it reached 1.1 million. The skill and educational level of the labor force rose, despite large-scale immigration from developing countries, as a result of government training and educational programs. The growth of the other main factor of production, capital, was much greater. Between 1950 and 1967 the gross capital stock, measured in constant prices, increased eightfold. Output rose by 9.3 percent a year, while inputs increased by 5.9 percent a year.[5] All of these factors contributed to the large increase in productivity.

Almost all of the capital invested between 1948 and 1972 came from abroad; there was virtually no net domestic saving.[6] Although individuals and companies saved, the government borrowed from them in order to finance its deficit. The state's contribution was its organization of the inflow of capital from abroad. Inflows of labor and capital accounted for about 75 percent of the increase in GNP, the rest coming from increased efficiency in production.[7] This situation was a function of the stage of development: Management and technological change became more important than increases in the supply of labor and capital as development proceeded and the economy matured.

The fast rate of growth and high levels of defense spending resulted in balance-of-payments problems, even though capital imports usually exceeded the growing current account deficit. These capital imports were mainly preferential forms of finance; the scale of expensive, short-term borrowing on international markets was limited before 1973.

The structure of the economy, in terms of the share of different sectors, changed little between 1950 and 1967, despite rapid growth. There were, however, some changes within the period. The share of agriculture in national income rose from 11 percent in 1950 to 15 percent in 1958 but fell back to below 10 percent in 1966. Industry grew more slowly than other sectors in the early 1950s, but following a change in government policy and increased investment, growth of industrial output accelerated from 4.2 percent in the period 1950–1954 to 12.2 percent in the period 1955–1964. As industrial prices rose more rapidly than those of other sectors, industry's share in national income, on a current price basis, did not alter. Transport and communications increased their share with large-scale investment in the road network in the late 1950s. Increased construction followed the pattern of population growth, itself mainly a function of immigration. The level of construction activity was also related to the rise of living standards. The service sector accounted for over half of GDP throughout the period, reflecting the dominance of the state in the provision of social welfare and economic inputs.

Although the balance between sectors did not change very much, there were important developments within each sector. These developments led