Israel's economy

The Israeli Economy, 1985–1998: From Government Intervention to Market Economics. Edited by Avi Ben-Bassat. Cambridge, MA, Massachusetts Institute of Technology, 2002, 514 pp., $40/cloth.

As editor, Avi Ben-Bassat presents a series of 14 essays based on a 1996 research project by various Israeli academic and financial institutions as well as the International Monetary Fund, plus his own contribution in the form of an introductory essay discussing the obstacles Israel faced in its transformative efforts. These essays detail efforts to reform Israel from a poorly performing centralized command economy to a dynamic market economy. *The Israeli Economy, 1985–1998* explores the obstacles faced and transformations experienced during this transition period. These essays describe the fiscal and monetary changes, changes in the markets, and external developments that allowed Israel to move from a situation where it faced 400 percent inflation to relative stability and growth.

After the intensified conflicts of the 1967 Six Day War and the 1973 Yom Kippur War, Israel reacted by centralizing decisionmaking and controlling resources. These conflicts resulted in the growth of the public sector and the public deficit. Lax fiscal discipline and the growth of government, due to increased defense expenditures and subsidies to businesses, resulted in severe economic decline. After a relaxation in the intensity of the Israeli-Arab conflict during the latter part of the 1970s and early 1980s, Israel was in a better position to address the economic difficulties it faced in the forms of high inflation and almost nonexistent growth of gross domestic product (GDP).

To address these economic difficulties, Israeli policies needed some serious reform. How Israel addressed its reform program is described in six major headings: fiscal policy; monetary policy; financial market reforms; reforms in the goods and services markets; immigration and the labor market; and changes in growth, branch structure, and income distribution.

Changes in fiscal policy are explained in the first essay showing efforts at implementing tight fiscal discipline and a reduction in the size of government. Because of fiscal reform, three areas saw the greatest change in an effort to reduce expenditures: defense spending; subsidies to the business sector and interest payments; and welfare transfers to households. Another part of these efforts was the drive to reduce public expenditures through the elimination of interest payments on external debts that approached 80 percent of GDP.

Reform of monetary policy, as part of these stabilization program efforts, is addressed in three essays: reform of the financial system; disinflation from 1985 to 1998; and the international view of Israeli inflation. Israel's greatest accomplishment was to achieve disinflation. Liberalization is shown to be a key to enhancing competition in the financial markets in this accomplishment, as well as the Bank of Israel's (BoI) increased independence and use of interest rates as an instrument of monetary policy. These measures were fairly successful when combined with a reduction in the government budget deficit through fiscal discipline. The program did not work as well as it could have due to political pressures; changes in employment due to increased immigration from the former Soviet Union; and Israel's inability to reach a consensus about the process as a whole, shown by a conflict between the BoI and the Treasury.

Achieving disinflation proved a difficult process when compared to nine other countries—all of which went from high inflation to lowered inflation levels with varying results. Despite set-back periods of double-digit inflation rates, Israel, by 1998, was experiencing mid single-digit rates. Liberalization of financial markets also saw mixed results, but in general the outcome has been positive.

Liberalization of financial markets has allowed many projects to proceed when previously they would not have done so under government-provided funding, while others of less likely profit have been dropped. Because of more reliance for funding from the Tel Aviv Stock Exchange and less from bank debt or government-provided credits, credit crunches and reduced output volatility have been reduced over the business cycle, and results of this program are fairly solid.

Pension reform, however, is a work in progress. Balancing social needs of pensioners against relieving the younger generation from the burden of a large share of income support is difficult. The solution is to accumulate more pension savings while workers are young, thus sharing the burden of risk between the generations.

Fortunately for these workers, the unemployment rate dropped from 12 percent to 6 percent during the 1990s. This effect was produced by changes in immigration and liberalization of the goods and services market. These two issues are addressed separately, but are closely intertwined. While immigration increased during the 1990s due to the fall of the Soviet Union and an increase in migrants from Eastern Europe, the labor market grew as well. With the diminishment of economic centralization came growth in the labor market as industries increased efficiency efforts. In the first half of the 1990s, growth was greatest in exposed industries that were open to competition from imported items and required lower skills. In the second half, growth was seen most in more sophisticated industries that required skilled workers.

Changes in capital accumulation and increased productivity resulted in changes to the labor market. It also resulted in challenging questions of income distribution. While Israel was growing in a dynamic market economy with immigration increases, income inequalities were also growing. The approach to these questions, and how Israel is going to answer them, is addressed in the book's final chapters.

A constant theme emerges as the authors describe the complex, and often contradictory, events and efforts to reform. Sectors and industries that are opened to competition thrive and become more efficient, providing benefits to both labor and consumers. Efficiency aids efforts to globalize Israel's economy, though it also is more exposed to external crises. Another recurring issue of many essays is that success is not seen in every effort to liberalize, as is the case in some public utilities.

Because this book is a collection of studies analyzing one country going through one process, there are some redundancies. This is unavoidable because this one process is complex and has many levels that are affected by the same events. The essays provide a nonpartisan view of an economic system in transformation, and a good argument for market solutions versus dirigiste philosophies toward providing a healthy economic environment.

—Scott Berridge

Office of Publications
and Special Studies,
Bureau of Labor Statistics