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RECOLLECTIONS OF THE UNITED STATES ROLE IN THE ISRAELI STABILIZATION PROGRAM1/

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The Israeli stabilization program had many very interesting economic aspects, some of them--the heterodox elements--novel at the time, though less so now. Its lessons will continue to be drawn and redrawn as long as stabilizations are studied.3/ The key economic aspects have already been discussed by the previous speakers, and especially by Michael Bruno, whose role in the formulation and execution of the program was critical.4/

Rather than focus on the economics, I will talk mainly about the American role in the stabilization. My memory has been reinforced by detailed notes that I kept at the time. I will also talk about one or two underemphasized economic elements in the program, and will conclude by reflecting on the current economic situation in Israel.

1/ This is an edited and extended version of a lecture given at the Israel Economic Association's Conference on the 10th Anniversary of the Israeli Stabilization Program. Although the lecture has been rewritten, I have tried to retain its informal tone. The conference took place in Jerusalem in June 1995 and this paper will appear in the Economic Quarterly. I am grateful beyond words to the late Don Patinkin, who had taken a keen interest in the stabilization program, and who managed despite his terminal illness to attend the lecture. I am grateful also to George Shultz and Herbert Stein, both for permission to quote from conversations, and for their extraordinary cooperation during the period we worked together on Israeli stabilization.

2/ International Monetary Fund. The views expressed are those of the author, and not necessarily of the IMF.

3/ For instance in the volumes edited by Bruno et al, 1988, and 1991.

4/ Bruno (1993) presents the most complete account of the stabilization program.

I. George Shultz

The key American figure in the Israeli stabilization was then Secretary of State George Shultz. My own formal involvement began at the end of 1983 when Shultz put together a group of American economists to advise him on the Israeli economy. The original group of four academic advisers consisted of Paul McCracken, former Chairman of the Council of Economic Advisers (CEA) and then at the University of Michigan, Abraham (Abe) Siegel, then Dean of the Sloan School at MIT and a longtime friend of Shultz's,5/ Herbert Stein, also a former Chairman of the CEA and longtime friend and colleague of Shultz's, then at the American Enterprise Institute, and myself, a Professor at MIT.

I must have been included for my knowledge of the Israeli economy. I had studied the economy of Israel for some time, originally informally during sabbaticals at the Hebrew University from the University of Chicago in 1972 and from MIT in 1976-77, then more systematically starting in January 1980 which I spent as a visiting scholar in the Research Department of the Bank of Israel.6/ That visit to the Bank of Israel resulted in a paper with Jacob Frenkel on stabilizing the economy, which was discussed at a seminar in the Bank and later published (1982). In the United States, it was probably a paper on the Israeli economy written for a 1983 Carnegie-Rochester conference that received most notice around the time I was asked to join the State Department team.7/

5/ Shultz started his academic career as an Assistant Professor at MIT.

6/ I was invited by Mordecai (Meme) Fraenkel, then Director of the Research Department, who had spent the academic year 1978-79 as a Visiting Scholar at MIT.

7/ The paper was published in 1984.

I was initially reluctant to join the State Department group, partly because I thought I knew too much about the stabilization plans that were then being entertained by Israeli policymakers, and partly because the State Department had an anti-Israel reputation at the time. After a conversation with Abe Siegel which concluded with his telling me "Fischer, when the Secretary of State asks you to do something, you do it!", I joined up -- for what turned out to be one of the most interesting and meaningful experiences of my life, and one which helped shape my future career.

It did not strike me in 1983 that there were several odd things about Shultz's advisory group. For one thing, it is not normal that the Secretary of State deals with the economies of other countries. Normally it is the Treasury.8/ And even if it had been the State Department, the Secretary surely would not normally have spent so much time on a problem of this type. For another, now that I have worked inside bureaucracies, I realize how unusual it is for outside advisers to be given as active a role in the formulation of policy as we eventually had, and also how impressive the State Department's cooperation with the group was. Under-Secretary for Economic Affairs, Allan Wallis, who headed the U.S. side of our talks with the Israelis, was especially generous in this respect.

8/ Representatives of other interested U.S. Government agencies, including Treasury and OMB, attended meetings of the advisory group and meetings with representatives of the Israeli government throughout. Shultz took over formal control of the United States role in the Israeli stabilization program at a meeting in March 1985 attended by Secretary of Treasury Baker, White House Chief of Staff McFarlane, OMB Director Stockman, Richard Murphy and Tim Hauser from the State Department, and Herb Stein and myself.

Shultz opened the first meeting of the advisory group with the Israelis, which took place in Washington early in 1984. Emanuel Sharon, then Director-General of the Treasury, headed the Israeli delegation, which also included the late Eytan Berglas, Nissan Liviatan, and Eytan Sheshinski. Speaking quietly, Shultz said it was not good for the U.S. to have the economy of its most dependable ally in the Middle East be weak, and that its problems could not be solved by throwing more money at them. He said he intended to try to help the Israeli government strengthen its economy, by giving it advice in whatever ways might be possible.

The advisory group met either with other members of the United States government, or with visiting Israelis, in a series of meetings through the middle of 1984. But because of the Israeli elections, nothing came of those meetings. I did however see how effectively Paul McCracken used his ignorance of the Israeli economy: whenever a particularly complicated explanation of some Israeli problem came forth--and they were typically very complicated, often built on a firm belief that the Israeli economy was immune to the laws of economics and sometimes logic, Paul would say, pulling the hayseeds out of his hair, that he didn't really understand the Israeli economy, and perhaps someone could explain why something which worked one way in the United States worked the opposite way in Israel.

II. Prime Minister Peres

The group came back to life in October 1984, when Shimon Peres visited Washington as the new Prime Minister. He arrived with the newspapers saying that he was not coming to ask for aid. I was teaching and couldn't make it to the meeting, but Herb Stein, together with whom I had the pleasure of working throughout this period, and from whom I learned a great deal, was there.9/ Herb called later to report on the meeting and said "You know, for a guy who didn't come to ask for aid, he did pretty well."

Mr. Peres asked for an additional four billion dollars of aid over the next two years, as a safety net to support stabilization; he also asked for a ten billion dollar investment fund to help support entrepreneurs, and a few other things. But I guess what you learn watching Shimon Peres is that if you don't ask, you don't get--and that some of the impossible things you ask for and dream about, actually happen.

As a result of the Peres visit in October 1984, the Joint Economic Development Group (JEDG) was set up. The idea was the same as that underlying the Joint Military Working Group between Israel and the United States, that people from each government meet with their opposite numbers to review current problems. But there was an important variation, namely that there would be private economists, both American and Israeli, together with government officials, in the working group. The idea, almost certainly George Shultz's, was that there were people in Israel, professional economists, who knew what needed to be done, but who were not succeeding in influencing their government's policy. The JEDG would help provide a forum for them, and in turn help the Israeli government think its way through the issues.

The JEDG, the Joint Economic Development Group, played an important role in the stabilization process from the time of its setting up till the

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9/ The original group of four private economists gradually became two, Herb and I. Herb Stein (1990) has published his own brief account of the stabilization.

day the program was decided on, June the 3rd 1985. The JEDG worked primarily because of the importance that George Shultz assigned to it, and to a considerable extent because of Emanuel Sharon, Director-General of the Israeli Treasury, who headed the Israeli team for the negotiations. His counterpart was Allan Wallis, Under-Secretary of State for Economic Affairs.

Sharon, who was determined to deal with Israel's economic problems, played a central and vital role in the stabilization. He understood how to use the JEDG, both the advice that came from it, and the fact that it was the channel to the United States. Many outside economists believed there was no-one in government who had the technical and political skills to bring about stabilization. I don't know how many such people there were, but there was at least one, Emanuel, who acted as the conductor of the stabilization orchestra, calling forth the right notes and even occasional harmony, from the many actors involved in the program, politicians and bureaucrats on the Israeli side, the administration and the legislature on the United States side.

After an abortive two visits by Israeli economists to Washington in November 1984 and January 1985, to explore United States support for a program that would start with a pegging of the exchange rate and controls on some prices, with fiscal action being deferred till later, there was not much work until March. In March, George Shultz sent Herb and me to Israel, to try to figure out what needed doing.10/ We met with the relevant policymakers in the Treasury and the Bank of Israel, with academics, and

10/ Of course, there had been much thinking by Israeli and other economists about Israeli stabilization; several of the plans are described in Bruno (1993).

with the Secretary-General of the Histadrut. At the end of this visit Herb pulled out of his pocket a list of ten points, ten actions the Israelis needed to take in order to stabilize the economy. The ten points were a bit heavier on the monetary aggregates than I might be today, and some Israeli friends told me there was too little on the fiscal side, but they were the essential components of a stabilization program.

III. Supplemental aid

There were intensive contacts between the Israelis and the U.S. side in the first half of 1985. By that stage Israel's request for a safety net for stabilization had taken shape as a proposal for a $1.5 billion grant that the United States would provide to Israel when it stabilized.

From the time of Herb's and my visit to Israel in March, until the end of July, 1985, much of the attention of the United States side was focussed on, first, encouraging the Israeli government to stabilize, and second, making sure that the supplementary aid was not disbursed to the Israelis before they had taken action to stabilize the economy. The problem was that the Congress was so favorably disposed towards Israel at that time, that it was difficult for the administration to keep them from giving money to the Israelis no matter what their economic policy.

With the permission of both Herb Stein and George Shultz, I want to tell two stories, which illustrate both the Congressional pressure to give the money to the Israelis, and the subtlety of the Israel-U.S. relationship.

First, a story about Herb. In April 1985, after our visit to Israel, the two of us were called to testify to a subcommittee of the House Appropriations Committee, chaired by Congressman David Obey. This was supposedly a secret meeting, but Danny Halperin, the Economic Attache at the Israel Embassy in Washington, was there.

We explained what we hoped would happen, and how the US aid would be used. Congressman Jack Kemp, who came in late, looked at us and said, "You are worse than the IMF, all you're going to do is to create a recession. What Israel needs to do is to cut taxes, not to go in for austerity." Then he turned to Herb Stein and he said: "Professor how much aid would it take Israel to stabilize the economy?" And Herb replied without missing a beat: "Congressman, it will take exactly as much money as you are willing to give them. It's called supply side economics"

The second story took place at the end of May 1985, just before the U.S. team came to Israel for what we were sure was going to be the critical meeting with the Israeli government. At that time, there were many signs that the Israeli government was trying to get the money without agreeing to a program.

Further, George Shultz did not like the idea of conditionality. All along his idea had been that the Israeli government would set out a program with their own "markers", actions that they would set as their own conditions so that both sides could monitor the program. Neither Herb nor I thought that this generous approach would work, and so Herb visited George Shultz to ask him if we could impose conditions on the aid. Shultz said no. Herb called me in Boston and said well, why don't you try.

I was as usual staying up late to try to finish a paper for a conference,11/ but managed to fit in a six hour trip to Washington on the day I was supposed to depart from Boston for our Israeli visit. I arrived at the State Department with a speech all ready to deliver to Secretary Shultz. As I was winding up to deliver my speech, he said "You want me to tell the Israelis that they are not going to get the money unless they do a program, is that right?" and I said yes. He said: "Well, I won't say that". I asked why not, and he said: "Because they will get the money even if they don't carry out the program, and I don't make threats that I can't carry out."

So I said "Well, this is awkward. We are going to Israel to say you have to carry out this program, or else. What is the or else?" Mr. Shultz thought about it for a while and he said: "You can tell them I will be very disappointed if they get the aid without carrying out the program."

Before coming to this tenth anniversary conference, I wrote to George Shultz to ask if he would mind my telling this story. He wrote back and said it would be fine to tell the story, but that you should understand that the word "disappointed" carried a lot of weight under those circumstances. He must have meant that the U.S.-Israeli relationship is multi-dimensional, and that his goodwill was needed across the board. Besides, there was an extraordinary degree of trust between the Israelis and George Shultz.

11/ This paper, "Exchange Rate versus Money Targets in Disinflation", later published in my book, Indexing, Inflation, and Economic Policy, (MIT Press 1986) was written to analyze the basic choice between a fixed exchange rate and money targets that would have to be faced in the Israeli stabilization.

IV. Jerusalem, June 1985

The U.S. delegation for the JEDG meeting in Jerusalem in June 1985 was headed by Allan Wallis. The key meeting took place on June 3 between the U.S. side and the Israeli economic team headed by Prime Minister Peres, and including of course Finance Minister, Modai. I am sure Mr. Modai will confirm that the U.S. side did not go beyond its brief on conditionality.

Under-Secretary Wallis opened for the U.S., and he was followed by Herb Stein. They made very strong presentations, emphasizing among other things that the monthly inflation rate in April had been 19.4 percent. When my turn came, I started with two general comments: first, that working with the State Department, I had been astonished by the depth of support for Israel, and that the proposals that were being made came from friends of Israel. And second, that there were many excellent economists in Israel who had been thinking about how to do a stabilization, on whom he could draw. Further, that although views on what had to be done might seem to differ among these economists, there was virtually total agreement on the essentials, including the need for a large budget cut and for a devaluation.12/

Among other things I said that no economic program has succeeded without a small team that runs the intellectual part of it, and that is responsible for the coherence of the program and for following its execution.13/ At that point Mr. Peres turned to Emanuel Sharon and said in Hebrew "Who will we put on the team?" -- and that was the moment that I

12/ I was covering many of the same points as Herb Stein.
13/ Emanuel Sharon and I had discussed this and other details of the possible stabilization program the day before.

knew that this time the Israeli government would actually undertake a serious stabilization program.

After that the team of Emanuel Sharon, Mordecai Fraenkel14/ (Research Director of the Bank of Israel), Amnon Neubach (Economic Adviser to the Prime Minister), as the insiders, and Michael Bruno and the late Eytan Berglas as the outside academics, was appointed, and the hard work began. They worked intensively, together and with the Prime Minister, and on July 1, after an all-night cabinet meeting, the historical stabilization program was adopted. The American role was much less significant after that.

V. Economic aspects of the program

It is important to recall that this was a heterodox program, orthodox in the massive (about 8 percent of GDP) cut in the budget deficit, brought about mainly through a cut in subsidies, the fixing of the exchange rate15/ and the tightening of monetary policy, but decidedly not orthodox in freezing prices and originally wages. The heterodox elements played an important part in bringing inflation down almost immediately, after the initial price shock associated with the devaluation, and were certainly critical to the political acceptability of a very tough program.

I am sure that George Shultz did not like the heterodox parts of the program, and nor did Herb Stein; they had both been in the Nixon administration when it imposed wage-price controls, and they thought that

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14/ Meme and I worked closely together during the stabilization. His good judgment could be relied on for an accurate reading of what was happening and what would happen.

15/ Successful stabilizations from high inflation have generally operated with a fixed exchange rate. Only in recent years, in some of the transition economies, have there been successful money-based stabilizations.

had been a mistake. But as long as the fundamentals, particularly the budget deficit, were taken care of, they were willing to go along--the very tough budget correction made everything else in the program possible. I don't underestimate the importance of the heterodox elements. Nor should one underestimate the role of the pegged exchange rate: I believed then, and believe now, that pegging to the exchange rate in a situation when you have very little idea what will happen to money demand, is the right strategy.

I would like also to reflect on a few aspects of the program that have been underemphasized. One, which I largely missed at the time, and that George Shultz emphasized from the beginning, was the Bank of Israel Law. From 1984, at every meeting with the Israelis, Shultz kept asking when that law was going to be passed.16/ Believing in those days that if you are going to do the right thing you will do it with or without a law, I couldn't understand his insistence. However, the law was extremely important: it freed up the Bank of Israel to do what had to be done to assure the success of the stabilization program.

The second element that I would like to mention is that every program is tested at some point. Exchange-rate based stabilizations are easy in the beginning. Countless exchange rate based stabilization have reduced inflation early. It is the next two or three years that the program succeeds or fails.

That is what happened in Israel. It took a big battle between the Bank of Israel with its newly appointed governor, Michael Bruno, and populist

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16/ The law removed the obligation for the Bank of Israel to finance the government deficit.

pressures to cut interest rates and devalue, to ensure the success of the stabilization program. The battle was concentrated in 1986 and 1987, but guerilla warfare continued afterwards.

There are two types of economies. In some economies people are always pushing for an appreciation; those economies are in real trouble, because there are no exporters. In other economies people are always pushing for a depreciation; they are in better shape because the export interests dominate, but they are bound to have a serious problem with inflation. The predominance of the devaluation school in Israel is exaggerated to a remarkable degree. The unremitting pressure in this country for devaluation no matter what, for lower interest rates no matter what, was dealt with by a newly independent central bank, and by a tough governor with the courage to use the legal independence he had been given.

Those were difficult times for the Bank of Israel. It took a recession in 1988-89 to bring about the stabilization after all. Miguel Kiguel and Nissan Liviatan (1990) have argued that you always get a recession in a stabilization program, it is just that with an exchange rate based stabilization, the recession comes later. However, I don't think it was inevitable that there be a stabilization-related recession in the Israeli case. Rather I believe that the recession can be traced to a very specific mistake that was made early in the program.

The stabilization program assumed a cut in real wages that was supposed to accompany the reduction of absorption in the domestic economy produced by the budget cutting exercise. After a one-time nominal wage increase, there was a wage freeze at the beginning, and a cut in real wages as a result of the larger price level change associated with the devaluation. The wage freeze generated protests and strikes. Just when the government was winning that battle, it signed a very generous wage deal with the Histadrut, which I believe led eventually to the recession. The deal raised real wages by a cumulative 12 percent in the first three months of 1986, totally undoing the real wage decline at the beginning of the program. Consumer demand rose and the economy grew rapidly. The Bank of Israel had to put on the interest rate brakes to prevent a recurrence of inflation. That led to a recession--but not one that was inevitable from the beginning.

I made at least one other mistake at the time, in underestimating the importance of structural reforms. My colleagues on the U.S. team, particularly Martin Bailey, economic advisor in the State Department, were pushing hard for structural reform from the beginning. As a good macroeconomist I said rightly that this doesn't have much to do with stabilization. That's true. But given the need for structural reforms in Israel, including privatization, and the resistance of the political system to making them, the pressure for structural reform should have been much greater from the American side then at its time of maximum leverage, it should be greater now, and it should be much greater from Israeli economists.

If there is a real failure in the stabilization program, this was it, that the second stage, the structural reforms either didn't happen or have taken place very slowly. There have been some reforms in the capital markets, and trade liberalization is continuing. But the privatization debate is much the same now as it was ten years ago. Relatively little has been privatized, and the same reasons are given for not privatizing, the stock market is either too high or too low, it is necessary to put a regulatory framework in place, the investors are unwilling, and so forth. The first time you hear why privatization is going slowly you are very impressed. You are less impressed hearing the same stories ten years later. Similarly, progress in reducing the role of government in the economy, and in removing a variety of price and non-price barriers to competition, has been extremely slow.

Growth after the stabilization was disappointing, and it should have been possible to make progress with structural reform more rapidly. Of course, with growth now at 6 percent, the perceived need for reform has been reduced, but those reforms--including the need to cut the size of government--would still raise the growth rate.

VI. Concluding comments

It is surprising to come to Israel every few months and hear the same arguments that were made more than ten years ago and that led to the high inflation: we need a devaluation, we need lower interest rates, and a little more inflation doesn't hurt. Today the Israeli economy is overheating, growth is rapid, unemployment is below the natural rate -- and there is pressure for lower interest rates. To be sure, the argument is that the interest rate should be cut to produce a devaluation, which is needed because the current account deficit is large. But in these conditions, cutting interest rates through monetary expansion will lead very rapidly to inflation. The right cure is a tightening of fiscal policy, which will reduce aggregate demand and make it possible to reduce interest rates and depreciate without increasing inflation.

It was relatively easy to get inflation down to the 20 percent range in the stabilization program. It was much more difficult to get down to the single digit range. Inflation is finally within that range now. It is tempting to say that a small incease in inflation wouldn't make a difference, so interest rates should be cut whether or not there is a fiscal contraction. But without a fiscal contraction, inflation will show up very quickly, and then there will be the same argument, that another few percent on the inflation rate doesn't matter. In fact, a percent or two more inflation never does matter much. It's just that these things add up. That is how you get to higher and higher inflation--and we should not need to be reminded that inflation is very costly to the economy and the society.

Let me sum up with a true story. In December 1984, since George Shultz had appointed us to work on stabilizing the Israeli economy, and I had never before been involved in such an exercise except in the text books, I went to see a very senior IMF official, to ask him how to stabilize an economy. He had been studying the Israeli economy and he said: "Forget it. They are not going to stabilize now. They don't have enough of a crisis. It's true the inflation rate is 500 percent, and there has been pressure on the reserves, but the economy is still growing a bit. They have a guarantee of U.S. assistance if there is a run on the reserves. You will not persuade them to undertake a stabilization until the crisis gets much worse".

Well we all very grateful that he was wrong. You did stabilize earlier than other economies would have, the stabilization was skilfully carried out, and it has been extremely successful . George Shultz helped make that happen. But United States assistance also made it a relatively costless stabilization. Unlike stabilizations from hyperinflation, like the German hyperinflation, or the Argentinian hyperinflation of 1990, this inflationary episode did not leave enough antibodies to inflation in the system. In that respect, this was a stabilization that came too easily.

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