Boom,Bust, and Reboot

The Israeli Currency Crisis

Overview

- First there was the Israeli pound, then the old shekel.
- After frequent devaluations against the US dollar and other foreign currencies during the 1960s and 1970s the result was hyperinflation in the the 1980s.
- Inflation was contained as result of the 1985 Economic Stabilization Plan, the new shekel was introduced replacing the old shekel on 1 January 1986 at a rate of IS 1,000 to NIS 1.
- Crisis of Israeli government.
- Involved U.S. deeper into Israeli affairs.

Actors

- Simon Peres
- George Schultz
- Minister of Treasury, Aridor
- Governor of the Bank of Israel, Mendelbaum
- Joint-Economic Group

Decision-type

- Bureaucratic
  - Government of Israel
    - Treasury
    - Knesset
  - Bank of Israel
- Rational choice
  - Israeli Prime Minister
  - George Schultz (Joint-Economic Group)

Economic Priorities

- After statehood (1949 onwards), government priority was given to establishing industries in areas slated for development, among them Latish, Ashkelon, the Negev and Galilee.

- The expansion of Israel's textile industry was a consequence of the development of cotton growing as a profitable agricultural branch.

- By the late 1960s, textiles were one of the largest industries in Israel, second only to the foodstuff industry.
  - Textiles constituted about 12% of industrial exports,

- In its first two decades of existence, Israel's strong commitment to development led to economic growth rates that exceeded 10% annually.
- However, after 1973, growth stalled, inflation soared and government expenditures rose significantly.
- There was the 1983 Bank stock crisis.
- By 1984, the economic situation became almost catastrophic with inflation reaching an annual rate close to 450% and projected to reach over 1000% by the end of the following year.

The cause?

- The year 1973, marked an unprecedented event and juncture for the economy, which plunged into a long recession. Since that year also saw the world economy sink into a drawn out crisis.

- With the recession, the question was asked:

  - To what extent Israel's economic woes to external factors, or whether they resulted from can be attributed to properly respond to the international crisis and policy which failed adjust the structure of the economy to the new economic environment.

- The fact that during the rapid growth years (1960-1973), the economy developed faster than its inflation groups in terms of GDP and GNP.

- Investments were made in unprofitable activities.

- At least part of the investments were made in un-utilized capital stock, financed at a high negative real interest rate.

- Large scale subsidization of investment did not lead to viable economic growth as seen in excessive priced market credit, and waste of resources.

- Manifestations of the failure to adapt.
- Two major events to the changing environment.
- 1. failure by the government, but also business and households to balance incomes and outlays which lead to attempts to live beyond ones means.
  - post-War of Attrition, welfare issues dominated domestic politics
    - National Insurance Transfer (child allowances)
- 2. related to the first, payment of excessive real wages relative to labor productivity resulting in progressive drop in rate of return on capital in the business sector.
  - Excess of labor
- Most important to the failure though is the evolution of the public sectors income and expenditure system

The cause?

- The government failed to change.
- External (raw material, price shocks)
- Internal (heavy increase in defense expenditure) and cut to direct government investment in national infrastructure.
  - “crowding” out of the private sector from the capital discouraged private finance of investment and growth
  - limited degrees of freedom of monetary policy
- Result was large deficit.
- External and internal debt.
  - prevention of labor force movement into the private sector.
- Problems then within balance of payments. Requirement of price level adjustments, devaluations and subsidy cuts that forced sustained shifts in the inflation rates.

- It is interesting to note the substantial rise in the size of the overall public sector deficit even while the economy was still growing.
- From rear balance during the first half of the 1960s, the economy went into a 12.6 percent (GNP) deficit during the so-named “Golden Age” between 1967-1972.
- There was a rise in civilian consumption, investment and subsidies and predictably defense expenditures.
- The economy did not increase tax rates since the rapid growth made easy borrowing possible both domestically and abroad.
- The Israeli Treasury borrowed substantial amounts from the Bank of Israel, print money, during this period of boom characterized by relative stability and growing demand.
- Increased government spending in all sectors of Israeli life. “Wave the flag” (defense, development, social welfare) that fit the expansionary period and psychological mood ‘we can do anything’.

- From 1973 to 1985 was known as the “Lost Decade” of Israel’s economic history.
  - The period was characterized by significant growth in the government deficit, which was in large part due to the increase in defense expenditure.
- The decade can be summarized as follows:
  - Economic growth fell off sharply as a result of the oil crisis, which began simultaneously with the Yom Kippur War,
  - Inflation accelerated rapidly until it reached levels bordering on hyper-inflation just prior to the Stabilization Plan of 1985.
  - The level of debt, both internal and external, reached proportions that could not be financed in the long term and which brought the economy to the brink of collapse in the financial and foreign currency markets
    - see Ben Porath, *The Israeli Economy – Growth Pains*.

Bank crisis

- The Bank stock crisis in 1983, was when the stocks of the four largest banks in Israel collapsed.
  - As a consequence, these banks were nationalized by the state.
- In the beginning of 1983, a crisis occurred in the free stock market (all the non-bank stocks), and large supplies in all market sectors forced the banks to invest very large sums of money maintaining their stocks' stability.
- From January through March some regulators, among them the Minister of Treasury, Aridor, and the Governor of the Bank of Israel, Mendelbaum, approached the banks several times, trying to get them to gradually reduce their adjustments.
- Although some bank managers realized they could not continue this for long, they did not stop.
  - Fearing a market collapse, Ministry of Treasury officials kept knowledge of this from the public.

- Failing to stop the banks, Ministry of Treasury heads wished to execute a large devaluation of the Shekel, serving as an excuse to stop the adjustments.
- However, the August 1983 8% devaluation was far too small for that end.
- Additionally, the supplies in the stock market grew steadily, and reached new heights in September. The public unremittingly sold bank stocks, and purchased US dollars.
- The crisis erupted fully on October 2. That day, the first day of trade after the Sukkot holiday, the public sold more bank stocks than in the entire month of September.
- On October 4, the Minister of Treasury appeared on television saying to say the large supplies would not bring about a devaluation or change of policy.

- On October 5, the stock exchange again opened with large numbers of sell offers, and on October 6, 1983, nicknamed "Black Thursday", brought an onslaught of sales.
- A collapse was imminent, since the banks declared that day they would be unable to absorb additional supplies without government assistance.
- That night, in a meeting in Aridor's home, it was decided that the government would purchase the banks' stocks from the public, to prevent the loss of their investments.
- On Sunday, October 9, the stock exchange remained closed, and stayed closed till October 24.
- In the meantime a devaluation of 23% was executed.
- The stocks sold by the public were bought by the Bank of Israel at an average loss of 17%. 35% of the stocks' value was lost.

Losses

- An immediate consequence were the loss of a third of the public's investments in them.

- The acquisition of the banks by the government, at a total cost of $6.9 billion (for reference, Israel's entire GDP in 1983 was about $27 billion), and

- The nationalization of the major banks (Leumi, Hapoalim, HaMizrachi, Discount, and Clali).

  - Blass, A. and Grossman, R. (2001), ASSESSING DAMAGES: THE 1983 ISRAELI BANK SHARES CRISIS. Contemporary Economic Policy, 19: 49–58.

Limping forward

- Bank crisis 1983
- Austerity program July 1984
- Stabilization Plan 1985
- Armored cars arriving at the Bank of Israel, to pick up their daily allotment of shekels for distribution to banks across the nation, were filled with $20 billion worth of the new shekel in 1986.
- That was the second new currency to be introduced in Israel’s inflation-riddled economy in five years.
- Officials expected the change from old to new shekel to have no impact on the economic austerity program.

Stabilization Plan

- The Economic Stabilization Plan was implemented in Israel in 1985 in response to the dire domestic economic situation of the early 1980s.
- After Israel suffered “the Bank stock crisis” and in1984 inflation was reaching an annual rate close to 450% and projected to reach over 1000% by the end of the following year.
- The Knesset implemented an economic stabilization plan aimed at generating “sharp disinflation” after smaller, so-called "package deals" were negotiated with selected entities in the Israeli economy proved ineffective in stemming the rise of inflation.
    - The plan was devised by Yitzhak Moda and Michael Bruno.
        - Joint Economic Group
            - MOUs

- This wider-scale stabilization plan brought together all the main players in the Israeli economy: government, labor unions, and the central bank and the stabilization plan helped make inflation successfully brought to under 20% in less than two years. Some of its main points included:
  - A significant cut in government expenditures and deficit.
  - Reaching an agreement with the then-powerful Histadrut labor union to enact wage controls, thus decoupling rampant wage from price inflation.
  - Emergency measures imposing temporary price controls over a broad range of basic products and services.
  - A sharp devaluation of the Shekel, followed by a policy of a long-term fixed foreign exchange rate.
  - Bank of Israel strictly controlled in its ability to print money to cover government deficit.
- Such steps, with the subsequent introduction of market-oriented structural reforms successfully reinvigorated the economy, paving the way for its rapid growth in the 1990s and 2000s.

Outcomes

- Avoided the 2008 crash
  - Strict regulations.
  - The Bank of Israel and the government of Israel have maintained much more careful and conservative fiscal and monetary policies
- Two developments have helped to transform Israel's economy since the beginning of the 1990s.
- The first is waves of Jewish immigration (1million), predominantly from the countries of the former Soviet Union. These new immigrants, many of them highly educated, now constitute some 16% of Israel's 7.5 million population.
- The second development benefiting the Israeli economy is the peace process begun at Madrid in October 1991.
  - Oslo Accords
  - Peace treaty between Israel and Jordan (1994).

Outcomes

- The second development helped in the signing of free trade agreements which helped the Israeli economy become more competitive.
- While heavy investment in its industrial and scientific base allowed the country to take advantage of opportunities associated with the rise of the global knowledge economy.
- Increasing exports and opening new markets for its products and services since 2000 has occurred.
- As a result of these factors, inflation has been relatively low and the country now maintains a positive balance of payments and in 2010 a current account surplus equivalent to about 3% of its GDP.
- As a consequence, the currency has risen approximately 20% in value relative to the US dollar in the 2000s decade.
    - A complete reversal on the trend of historical weakness for the Israeli currency shown in previous decades.

Recommend readings

- *Turmoil and Triumph: My Years As Secretary of State*. George Schultz
- *The Israeli Economy – Growth Pains.* Ben Porath
- *Israel's Crisis and Economic Reform: Historical Perspective.* Michael Bruno