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DEFENSE EXPENDITURES, DEBT, AND DEVALUATION —

THE DILEMMAS OF ISRAEL'S ECONOMY

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The Origin of the Problem: Defense

No intelligent treatment of Israel's economic predicament can commence without comprehending the dimensions of Israel's defense outlay. Israel spends annually at least $6 billion, or about 27 percent of its gross national product (GNP), for defense purposes. This is in addition to $1 billion in interest payments servicing the debt of past defense-related borrowing. Thus the total defense-related outlay is at least $7 billion, or 31 percent of GNP. In reality, the GNP figure does not represent the full defense burden. For example, the cost of conscripts to the economy is recorded according to their actual pay, which barely amounts to pocket money. A conservative assessment of their true cost to the economy adds on at least another $300 million.

Against this huge defense liability, the United States currently grants Israel $3 billion annually. Although not all of the U.S. aid granted to Israel is billed for defense, it is reasonable to assume that the entire U.S. aid package is motivated by the American concern for Israel's survival. Therefore, even that which is considered economic aid can reasonably be ascribed to the fundamental problem of Israel's existence. Bearing this in mind, the net defense burden amounts to at least $4 billion annually, or close to 18 percent of GNP.

By comparison, the countries of

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Western Europe spend between 2.5 and 5 percent of their respective GNP on defense; Britain heads the list at 5 percent. In terms of the share of domestically produced resources devoted to defense, Israel spends more than three times that of Western Europe's biggest spender. Even in comparison to the U.S., which spends 7-8 percent of its GNP on defense, Israel's burden is horrendous. Can there be any doubt about the effect that this abnormal situation has on Israel's economy?

The comparison between Israel and the Western European countries does not do complete justice to the subject. The Western European countries cannot manage alone with their existing levels of defense outlays; the U.S. spends billions of dollars directly in Western Europe on their defense. This is in contrast to U.S. defense aid to Israel, which is in the form of grants and loans. Consequently, the people of Western Europe enjoy a very high standard of living without anyone questioning if they are living beyond their means. Israelis, by contrast, face this question daily.*

The Making of the Problem: Wrong Response

Israel's leaders try to bring spending into line with what economic resources are available while not subjecting future generations to excessive debts. Israelis are not thoroughly convinced that U.S. aid reflects purely American interests, but rather that such aid can be viewed as charity. This erroneous view produced a harmful response of not wanting to appear to be accepting charity and, in turn, led to serious policy mistakes. The attempt to internalize the defense burden is such a reaction.

One way of substantially reducing dependence on foreign resources is for the citizenry to adopt a considerably lower standard of living. In a democracy, however, heavy sacrifices of this sort can usually be sustained only for short periods of time, such as during a war. It is usually very difficult to maintain high taxes, except in periods of crisis. Yet what is a temporary crisis for other countries is the 'normal' situation in Israel, where war is virtually permanent and only the intensity of battle changes. Transforming the situation of public sacrifice into a permanent state of affairs requires a totalitarian regime. Israel's fragmented democracy is unable to contain the pressure exerted by the tremendous defense effort. The consequent spillover manifests itself in Israel's extraordinary current account (foreign currency) deficit, which in 1984 exceeded by about 60 percent the current level of U.S. aid (excluding the emergency aid of $1.75 billion).

That gap has been partly financed over the years by borrowing abroad. As a result, Israel's foreign debt accumulated, reaching $23.4 billion at the end of 1984. Clearly, the process that brought Israel to this level of international debt cannot continue. Presently, Israel's foreign-exchange denominated interest payments constitute 27 percent of total exports. This is a level which the International Monetary Fund considers to be dangerously high. Experience demonstrates that countries reaching foreign interest payments over 25 percent of exports find it difficult to service their foreign debt on schedule. However, Israel is not in any immediate danger of not being able to service its foreign debt. There are two reasons why Israel should not be compared to such cases as Mexico and Poland. First, more than 50 percent of Israel's net foreign debt, as of the end of 1984, was owed to governments and international institutions. This kind of debt has less of an effect on a country's standing in the financial markets than does commercial debt. Also, short-term debt constituted only 3 percent of Israel's total international debt. Second, Israel's private sector, both financial and other, owned foreign assets in the amount of about $10 billion. In particular, Israeli banks operate foreign subsidiaries, especially in the U.S.

The sense of guilt from the perception that Israelis were living on charity, together with the erroneous feeling that Israel was approaching the end of the line regarding foreign exchange, inspired policies which were bound to fail. Instead of realizing that Israel was faced with a long-term problem which must be dealt with by corresponding long-term policies, Israel's various governments, regardless of political leanings, tried to deal with the immediate symptoms. One such episode was the highly praised success of the post-1973 War government in bringing the current account deficit under control. But closer examination of the means which led to the improvement in Israel's balance of payments reveals that it was achieved mainly through two unsustainable moves. The first was a sharp drop

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*Besides U.S. grants, Israel receives additional amounts of unilateral transfers that should not be overlooked. The two major sources of these transfers are world Jewry donations and West German reparation payments. Together these sources contributed about $1 billion in 1984. Even after subtracting this amount from Israel's defense burden, the country still shoulders $3 billion, or 12 percent of GNP. This is more than double Britain's share.

in investment. That drop signalled the tradeoff that was going on between short-term improvement and long-term prospects. The second development was a sharp decline in Israel's import of defense material. This was partly due to the fact that the buildup in the wake of the 1973 War was tapering off. However, it was clear that Israel was deliberately postponing acquisitions without actually reducing the size of the defense forces. This meant that in the following years these foregone purchases would have to be made together with regular purchasing. This constituted a shifting of the burden to the future, and not a real reduction.

The Hazards of Devaluation

The main tactic chosen to achieve the short-term improvements was the devaluation of Israel's currency. This proved a very poor choice indeed. It is doubtful whether a policy of repeated or continuous devaluations can have a lasting beneficial effect where structural current account deficits are concerned. In Israel, the chances of success are even dimmer, due to the unusual openness of the Israeli economy, the balance-of-payments gap and the unique structure of Israel's institutional arrangements, particularly concerning labor relations.

Concerning the first point, Israel imports about 40 percent of its total resources and exports a proportion of these varying between 25 and 30 percent. These proportions are among the highest in the world, approaching countries such as West Germany, Switzerland and Sweden. They signify the degree to which Israel depends on international trade. More important in the present context is the significance of these figures for devaluations; the composition of imports has a lot to do with their prospects for success.

Israel imports all its fuel and raw materials and the lion's share of its capital equipment. Consequently, the average industrial product in Israel has an import component of about 50 percent. In other words, a dollar's worth of manufactured goods utilizes 50 cents worth of imports. Therefore, if Israel devalues by 10 percent, the prices of domestically manufactured goods must increase by 5 percent if additional costs are to be covered. This implies, in turn, a substantial fall in real wages. This very important finding will be discussed later in greater detail.

The second observation concerns the very wide gap in Israel's current account. This implies that it is unreasonable to rely only on manipulation of the exchange rate to correct economic ills. Such manipulations can probably succeed only if they are relatively small. Large current account gaps reflect structural problems in the economy, which must be dealt with on a different level and not by exchange rate manipulations.

The last point, and perhaps the most important one, is the built-in commitment to real wages, which was already embedded in the economy even before the State of Israel was established. Wage indexation was enacted for the first time by the British Administration of Palestine during World War II and was adopted by Israel after independence. Indexation was one way of formally expressing a social principle which relegates the protection of wages to first place on the social agenda. For instance, indexation arrangements made no discrimination between the various causes of wage-eroding price rises. Wages were to be protected from inflation caused by government mismanagement just as much as they were to be made immune to price-raising by legitimate government policies. Moreover, wages were to be protected even from occurrences over which the government had no control at all, such as the price shock administered by the oil crisis. The leap in oil prices should have caused a reduction in everyone's income, including wage earners. This would have freed resources employed in the production of domestic consumer goods, permitting them to be used for increased export production, and thus generating the additional foreign currency needed to pay for dearer oil. In any event, wages did not decrease and producers had to increase their prices a great deal in order to meet the higher energy costs. The alternative would have been unemployment, a taboo in Israel ever since the recession of 1965-66.

Against these powerful odds, economic policymakers in Israel decided to use devaluation as an almost exclusive policy instrument, beginning with the large depreciation of November 1974. The most curious aspect of this policy was that its perpetrators all but explicitly stated that it was designed to curtail real wages.

It seems obvious that without resolve to reduce government deficits and face the wage problem head on, devaluations used for corrective

purposes could not possibly have lasting effects. Indeed, there eventually developed a kind of race between wages and the exchange rate. Every discrete devaluation resulted in a temporary reduction of real wages. Consequently, the competitive position of exporters improved temporarily, imports declined, particularly of consumer goods, and wage earners found themselves struggling to make ends meet. A picture of improved trade balance was created; however, it did not take unions long to redress their members' grievances. Wages usually more than regained the lost ground, and the economy found itself back at square one -- or almost so.

In fact, each successive devaluation gave a push to the price spiral and intensified inflation, while nothing was achieved in terms of the foreign account. These increases in the inflation rate had many adverse effects on the economy. What is most important in the present context is the fact that the higher the rate of inflation, the more difficult it is to deal with the real aspects of the economy. At sufficiently high rates of inflation, the common measuring rod--money--becomes so volatile that business people, economists, policymakers, and others lose the ability to make intelligent calculations and decisions. Under these circumstances it is very difficult to anticipate the effects of measures aimed at the real economy. For example, attempts to reduce the government deficit may be defeated simply because inflation turned out to be different from what was expected.

One other important area where inflation played havoc was in the finance arena. At very high rates of inflation, rapid adjustment is called for in interest rates. It is a well known fact, however, that organizations of all kinds sometimes lag in their adjustment. In the financial world, this occasionally creates marvelous opportunities for arbitrage. (Arbitrage is the simultaneous purchase and sale of the same securities or foreign currencies in different markets to profit from unequal prices.) Israelis became more and more adept at exploiting such opportunities. Consequently, Israelis accumulated very considerable financial assets, which further hampered efforts to hold down consumption.

It was folly to attempt to use devaluation as the principal policy tool. However once Israel found itself in an almost hyperinflationary situation, it became impossible to dismount the racing tiger and to stop devaluing. Any attempt to stop devaluation without appropriate accompanying measures would have lead to disastrous consequences for the balance of payments of the kind experienced by Chile and Argentina. The dilemma confronting Israel in 1986 is how to end the vicious inflationary circle without incurring catastrophic costs in terms of the country's standing in world financial markets.

The Raging Policy Debate

The government embarked on its new economic policy in July 1985 following a bitter battle over the question of the exchange rate. The battle was not confined to learned discussions and policy debates. The fact that the question remained unresolved could be clearly surmised from the gyrating course charted by the policymakers. Upon coming into office, the government devalued; then followed a period of crawling inflation; next, prices were frozen by decree, but devaluation continued apace; finally, in July, the rate of exchange was frozen at 1500 old shekels (1.5 new shekels) to the dollar and has not exceeded that rate since.

In this way, the government achieved for the first time an unprecedented reduction in real wages by means other than devaluation. It is estimated that the average wage declined by some 25 percent compared to the average 1984 level. It goes almost without saying that no government other than one led by the Labor Party could have attempted such a far-reaching step. It is certainly too early to judge the extent of success. After all, devaluations generated similar results in the past, but the duration was always limited. There is good reason to suspect that this basic debate will be revived.

What will happen if unions manage to obtain enough redresss so that wages will become uncomfortably high from the point of view of policymakers? Clearly, there will be some demand for resumption of devaluations. Indeed, some of the better known economists in Israel have already stated that it is time to resume devaluation even though wages are the lowest since the end of 1979.

At the heart of the debate lies the question of whether or not Israelis should reduce their standard of living by a considerable proportion, thereby effecting a reduction in imports and a decline of the foreign account deficit. The proponents of this approach argue that Israel has to live within its means, and they warn of the calamity that would befall should it lose its international credit standing.

This is the traditional approach.

The opponents differ on practical rather than on ideological grounds. They, too, want to see Israel as an economically independent country. However they argue that it is unrealistic to expect such a state of affairs with the existing defense burden. Furthermore, they argue that low living standards are incompatible with the vision of high technology leading Israel's economic growth. It is unrealistic to expect Israel to attract the kind of highly educated manpower needed for industries based on advanced technology while offering wages characteristic of developing economies.

Another important difficulty visualized by opponents relates to the possibility of unemployment. A substantial reduction in living standards will lower domestic demand not only for imported items but also for domestically produced goods. Workers will be idled unless export markets can replace the domestic one. Although such substitution is possible up to a certain degree, it is doubtful that it can occur on the level and at the speed required by a sharp decline in domestic consumption. After all, Israel is already one of the most open economies in the world, and it seems unlikely, especially under the current international trade atmosphere, that large gains in exports can be realized. If they are not, unemployment will result. Many Israelis feel that Israel can ill afford considerable unemployment. The reasons for this vary, but suffice it to mention that Israel's labor force is one of the most educated in any country. Many Israelis possess skills which are highly marketable in other countries. They forego better wages elsewhere as long as they feel that they contribute to Israel's welfare. Once unemployed, their priorities are likely to change.

This is not simply a theory. In 1980, when a sharp devaluation achieved a considerable drop in consumption, emigration increased substantially. Living standards recovered in 1981, and emigration abruptly declined. This danger is a major consideration today. Since implementation of the new policy, unemployment has risen quite sharply. It remains to be seen what population statistics will tell us about the effect of increased unemployment on the immigration balance.

The question remains of how Israel can escape the pending threats in the economic arena without swallowing some bitter medicine, such as higher rates of unemployment. It is this problem which constitutes the main bone of contention between the two camps. It also raises the question of what role the U.S. should play in the process and how its defense aid to Israel should be viewed. These questions clearly affect more than just the economic arena, and, next to the Arab-Israeli conflict, they constitute the most pressing problem facing Israel in the second half of the eighties.

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