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Directorate of Intelligence

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Israel: Aridor's Economic Policy Turnaround

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An Intelligence Memorandum

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Israel: Aridor's Economic Policy Turnaround [redacted]

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An Intelligence Memorandum

Information available as of 7 June 1982 has been used in the preparation of this report.

This memorandum was prepared by [redacted] the Office of Near East–South Asia Analysis. Comments and queries are welcome and may be directed to the Chief, Arab-Israeli Division, NESA, [redacted]

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This report has been coordinated with the Directorate of Operations and the National Intelligence Council. [redacted]

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Israel: Aridor's Economic Policy Turnaround

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Summary

Yoram Aridor has been the most effective of Prime Minister Begin's finance ministers. Along with his success in taking the economic issue from the opposition prior to the election in 1981, he achieved more rapid economic growth, lower inflation, and an increase in foreign exchange reserves. He has also pushed through the Cabinet, with significant help from Defense Minister Sharon, a budget calling for a real reduction in government expenditures and has put the country's labor organization on the defensive in wage negotiations. Minister of Economics Meridor and Bank of Israel Governor Mandelbaum, both in positions that could be used to challenge Aridor, have kept in the background.

In the period ahead, however, Aridor will have to build on last year's successes if he is to retain his political influence. He will find this extremely difficult. The 11-percent price hike in April triggered a no-confidence vote that Prime Minister Begin won by only a one-vote margin. Aridor has taken an important step in dealing with inflation by securing Cabinet approval for real government spending cuts, but the major factor influencing future inflation will be the outcome of current wage negotiations between the Histadrut—the national trade union federation—and the Manufacturers' Association. Aridor has done little to tackle Israel's productivity and investment problems. If they are not dealt with, the economy's ability to sustain growth in the future will be increasingly limited. Inflation and balance-of-payments problems are likely to lead to requests for more US aid.

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Israel: Aridor's Economic Policy Turnaround [redacted]

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Finance Minister Aridor has used his enhanced political influence, acquired as a result of his role in helping Prime Minister Begin win reelection, to implement policies that his predecessors had advocated but had never been able to carry out. After taking steps that temporarily eased the inflation rate before election day, Aridor turned to more orthodox methods—budget cuts and wage restraints—to reduce inflation over the longer term. Both Simcha Ehrlich and Yigael Hurwitz—Begin's first two finance ministers—had advocated such policies but were thwarted by cabinet opposition. [redacted]

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Preelection Economic Policies: Aridor's Triumph

Aridor took office in January 1981, a few weeks before elections were called, and immediately initiated a barrage of short-term measures that removed the word austerity from the Israeli political lexicon. He succeeded Hurwitz, who had become increasingly frustrated by the Cabinet's unwillingness to accept much of the austerity program he launched in November 1979. When elections were called in February 1981, public opinion polls showed that the opposition Labor Party held a massive lead over Begin's Likud bloc. We believe Labor assumed it could be swept to victory in part by reminding voters of Israel's triple-digit inflation rate. [redacted] 25X1

To improve the position of Begin's Likud bloc, Aridor:
- Reduced the purchase tax on such consumer goods as color television sets, cars, and cameras and eliminated those on toys and sporting equipment.
- Revised tax brackets to increase the disposable income of middle-income Israelis and granted tax breaks to those working evening and night shifts.
- Increased subsidies on dairy products, bread, meat, fuel, and public transportation.
- Instituted a new savings scheme that guaranteed a real rate of return of 5 percent annually on funds deposited for two years. [redacted] 25X1

Aridor did nothing to attack the underlying causes of Israel's inflation, but his moves temporarily reduced the rate just before the election. The inflation rate for May, announced two weeks before election day, was a relatively low 3.3 percent (an annual rate of 48 percent). The improvement was due to the reduction in purchase taxes, which are included in the consumer price index, and to increased subsidies. We believe Labor's inability to successfully counter Aridor's tactics was one of the factors in its defeat at the polls. [redacted]

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Postelection Policies

With his political influence enhanced by the election results, Aridor has increasingly turned to policies that his predecessors had advocated but were never able to implement. His budget for FY 1982 (April 1982 to March 1983), as approved by the Cabinet, calls for a real spending reduction of 5.6 percent. The Knesset—miffed that the budget was submitted later than usual—is now reviewing these proposals, having passed a three-month interim budget that is consistent with Aridor's FY 1982 plans. The Cabinet also authorized Aridor to draft legislation that, if approved, would give him unprecedented power over spending and hiring in other ministries. [redacted] 25X1

Defense Minister Sharon has been an invaluable ally in Aridor's efforts to reduce government expenditures. Attempts by previous finance ministers to cut back spending have foundered because other defense ministers have been able to block cuts in the traditionally sacrosanct defense budget. With Sharon cheerfully advocating defense spending cuts—domestic defense spending has been cut by 2.3 percent in real terms for FY 1982, and the overall defense budget, including military imports, has been slashed by 17 percent—other ministers are finding it difficult to resist cuts in their own budgets. Sharon has long advocated a lower level of defense spending. [redacted] 25X1

Aridor has repeated Hurwitz's call for a 100-percent cost-of-living adjustment, with any additional wage gains tied to increased productivity. The change is aimed at keeping real wages constant, curtailing a major impetus to inflation. This has put the Histadrut, Israel's trade union federation, on the defensive. Under the current linkage formula, wages have been adjusted quarterly to compensate for 80 percent of the rise in the consumer price index, and the Histadrut has been successful in bargaining for wage gains that more than compensate for the difference. Except in 1980, real wages have risen each year since 1976; the real increase in 1981 is estimated at 13 percent. [redacted] 25X1

The Deputy Secretary General of the Histadrut told a US Embassy officer that the federation would have agreed to the same formula again. It, however, cannot appear to demand less for its members than Aridor is willing to give and is now demanding 100-percent linkage coupled with freedom to bargain for additional increases at industry and plant levels. This would ensure continued real wage increases. [redacted] 25X1

Aridor has publicly threatened to introduce legislation imposing 100-percent linkage if the Histadrut and the Manufacturers' Association do not agree. According to the US Embassy, Aridor's minimum objective is to achieve 100-percent linkage for government employees in order to limit the government's wage bill. Recent press reports—confirmed by US Embassy sources within both the Histadrut and the Manufacturers' Association—indicate that the linkage formula for other workers will vary between 80 and 90 percent, depending on inflation. Since the Histadrut would not agree to this formula without freedom to bargain at industry and plant levels, real wages could continue to rise. [redacted] 25X1

After increasing subsidies significantly before the election, Aridor is following through on his postelection pledge to reduce them gradually—although he let them rise during November and December to keep inflation for the year to a minimum. Tampering with subsidies has always been hazardous. Hurwitz tried without success to cut them, and an attempt by his predecessor, Ehrlich, to eliminate them eventually cost him his job. So far Aridor has eliminated subsidies on fuel, which had not been subsidized until the preelection period, and those on basic foodstuffs, such as bread, milk, and eggs, have been reduced. [redacted] 25X1

On 17 March an adviser to Aridor announced that prices on subsidized items would be raised by slightly more than the increase in the consumer price index each month; the policy may have been implemented even earlier since the price hikes that accompanied the announcement were the third in three months. The government, however, did not raise prices again until 4 May, apparently because it wanted to hold down the consumer price index increase for April when the CPI rise is traditionally higher than normal. In addition, Aridor was probably reluctant to raise prices just before Passover and Independence Day. Although a step toward greater fiscal responsibility, the inflation rate could accelerate in the short run as these price hikes spread through the economy. [redacted] 25X1

Policymaking

Aridor has been given virtually free rein to make economic policy decisions. Begin, who neither understands nor takes an interest in economic issues, rarely becomes involved in disputes among Cabinet members involving the economy. The two people in positions that could be used to challenge Aridor—Minister of Economics Meridor and Bank of Israel Governor Mandelbaum—have kept low profiles. [redacted] 25X1

The potential power struggle between Aridor and Meridor never materialized. Meridor—a longtime close friend of Begin—emerged in the final weeks of the campaign as Begin's choice to be "economic czar," and a new ministry was established for him. Meridor has not actively involved himself in economic decisionmaking, however; his public image has suffered from press reports of scandal involving his association with an Israeli entrepreneur who has a criminal record. [redacted] 25X1

In January Aridor selected Moshe Mandelbaum, who has embraced Aridor's policies, to be Governor of the Bank of Israel—Israel's central bank. Mandelbaum's predecessor, Arnon Gafny, was not reappointed when his term expired in October, reportedly because he had been publicly critical of many of Aridor's policies. Mandelbaum indicated at a press conference at the time of his appointment that, whereas the Bank of Israel had been previously critical of national economic policy, he would now clear his views with the Finance Ministry. He specifically criticized the Bank's currency devaluation policy—a major bone of contention between Aridor and Gafny—as inflationary. Mandelbaum has been very discreet, and we do not believe he is playing an active role in his first few months in office. [redacted] 25X1

Impact

Aridor has been the most effective of Begin's finance ministers. His role in helping Begin win reelection and the fact that he is a member of Begin's party have combined to give Aridor the political support necessary to implement policy—assets Ehrlich and Hurwitz both lacked. As a result Aridor has been able to influence economic activity to a degree his predecessors could not. [redacted] 25X1

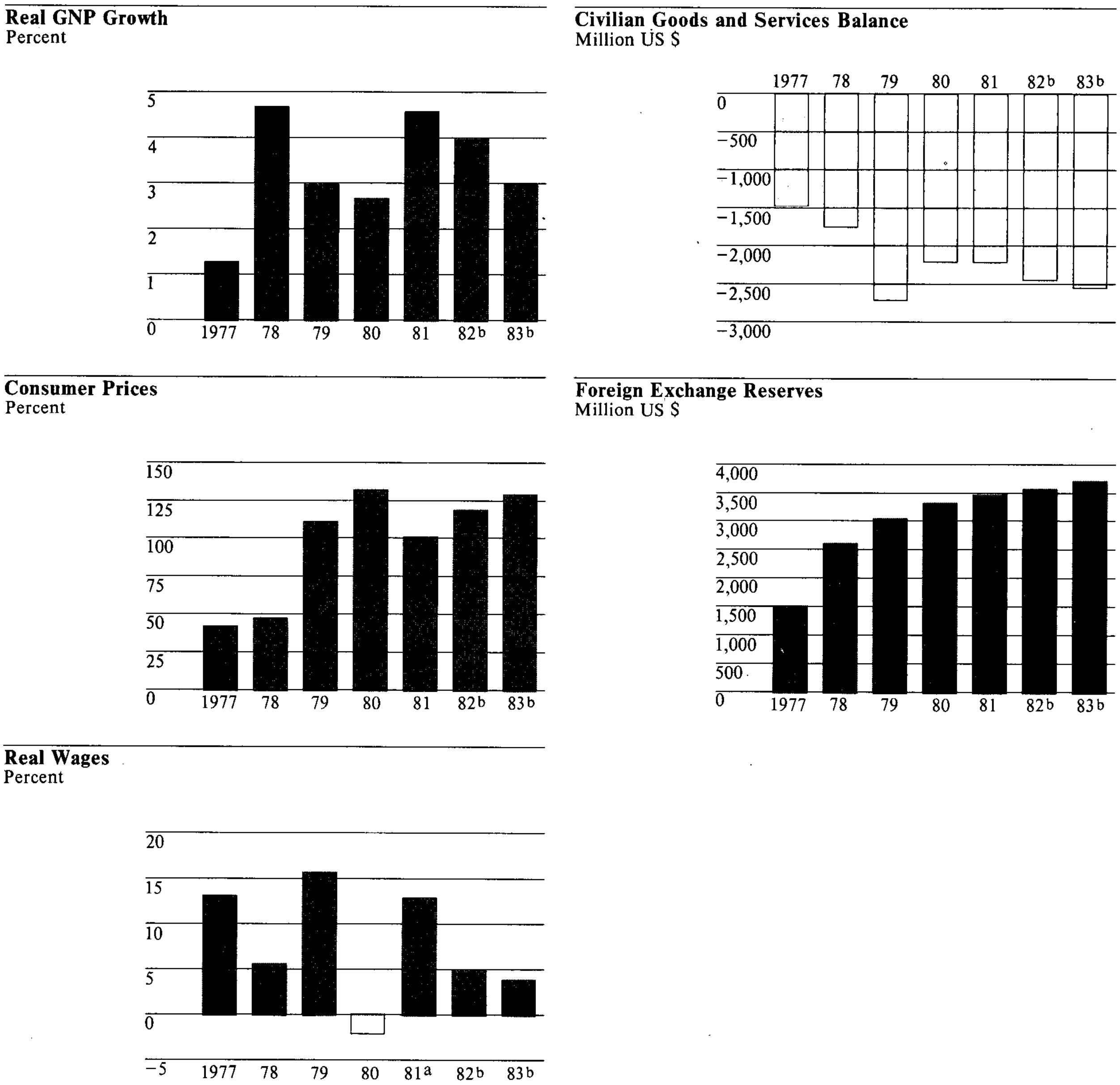
Aridor's spendthrift economic policies before the election contributed to a 23-percent real increase in government spending and pushed the budget deficit for FY 1981 to $2.7 billion compared with $765 million in FY 1980. Subsidies rose 80.9 percent in real terms. Aridor apparently was successful in coercing ministers to reduce their spending in the second half of the fiscal year by holding up contracts until the minister acquiesced. The lagged impact on the money supply of the earlier deficit spending, however, was reflected in resurgent inflation in September and October. In response Aridor again used higher subsidies to limit the rise in the consumer price index in November and December, holding last year's inflation rate to 102 percent compared with 130 percent in 1980. [redacted] 25X1

Government spending in combination with a 10-percent increase in private consumption pushed economic growth in 1981 to 4.6 percent compared with 2.7 percent the previous year. The boost in consumption was spurred by large real wage gains. [redacted] 25X1

Unemployment increased slightly last year to 5.1 percent despite rapid economic growth. Until 1980 Israel traditionally experienced tight labor markets, with employers reluctant to lay off workers during periods of slack economic growth for fear of being caught short when demand strengthened. In 1980, however, we believe employers assumed that the government would stick to the austerity program launched by Hurwitz. Since then they have evidently discovered that they can operate efficiently without the laid-off workers [redacted] 25X1

Figure 1

Israel: Economic Indicators



[a] Estimated.
[b] Projected.

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Israel's foreign payments have benefited from falling oil prices, an increase in the diamond surplus, and growing defense exports. These factors prevented the goods and services deficit from sharply deteriorating last year when Aridor's preelection purchase tax cuts led to a buying spree—particularly for cars and color television sets. Consumer durable imports doubled in the first half of 1981 compared with the same period in 1980. The surplus in the diamond trade, however, increased by $366 million when imports fell more sharply than exports as cutters worked off large inventories. Oil price declines reduced Israel's oil bill by about 7 percent. [redacted] 25X1

To cover Israel's current account deficit, the Begin government has increasingly relied on borrowing from foreign banks—primarily in the United States. Unilateral transfers and Israeli bond sales account for a significant portion of foreign exchange inflows. Although Israel passed legislation designed to attract foreign investment several years ago, the results have been extremely disappointing. We believe investors who wish to exploit the Middle East market are reluctant to locate in Israel because of the continuing Arab boycott. [redacted] 25X1

Capital inflows have enabled foreign exchange reserves to increase from about $1.5 billion at the end of 1977 to $3.5 billion at the end of 1981—equivalent to seven months of nonmilitary merchandise imports. [redacted] 25X1

Shortcomings

A combination of policies designed to restrain domestic demand while providing incentives for investment in productive capital and more efficient utilization of Israel's manpower is required if Israel is to attack its economic problems. While Aridor has taken the first steps to tighten fiscal policy, he has done little to tackle Israel's productivity and investment problems. If these problems are not dealt with, the economy's ability to sustain growth in the future will be increasingly limited. [redacted] 25X1

Lagging productivity has added to inflationary pressures. Productivity declined by 1 percent on average each year between 1975 and 1980, far short of the target of 4- to 5-percent annual growth. These shortfalls in efficiency were due to a reduction in the share of GNP for new plant and equipment; the traditional hesitancy of Israeli employers to lay off workers for fear of being caught short when demand strengthens; and greater use of unskilled Arab labor to compensate for the increase in military conscription since 1973. Moreover, very high marginal tax rates tend to inhibit overtime. [redacted] 25X1

In order to protect Israelis from inflation, the government has devised a pervasive system of indexation. Most financial assets, as well as wages, are linked to increases in the consumer price index. Long-term savings are

Israel: Balance of Payments

Million US $

	1977	1978	1979	1980	1981 [a]	1982 [b]	1983 [b]
Civilian goods and services deficit	−1,480	−1,760	−2,718	−2,214	−2,219	−2,450	−2,550
Civilian exports	5,665	6,735	8,289	10,119	10,841	11,250	11,850
Goods	3,404	4,075	4,717	5,800	5,929	6,125	6,450
Services	2,261	2,660	3,572	4,319	4,912	5,125	5,400
Civilian imports	7,145	8,495	11,007	12,333	13,060	13,700	14,400
Goods	4,475	5,282	6,916	7,454	7,459	7,850	8,250
Services	2,670	3,213	4,091	4,879	5,601	5,850	6,150
Self-financed military imports	210	293	250	250	497	−141	−76
Military import payments	1,325	1,690	1,420	2,018	2,404	2,055	1,958
US military assistance	1,115	1,397	1,170	1,768	1,907	2,196	2,034
Debt repayment	730	900	893	1,025	1,730	1,545	1,470
Financial gap	2,420	2,953	3,861	3,489	4,446	3,854	3,944
Sources of financing	2,613	4,057	4,299	3,777	4,591	3,954	4,085
Unilateral transfers	1,153	1,231	1,400	1,471	1,521	1,575	1,700
US economic assistance	822	875	980	785	785	785	785
Israeli bonds	355	430	436	432	400	375	400
Other capital including borrowing short-term	189	1,407	1,456	1,082	1,885	1,219	1,200
Net foreign investment	94	114	27	7	0	0	0
Change in reserves	193	1,104	438	288	145	100	141

[a] Estimated.
[b] Projected.

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fully linked, and government-issued bonds are indexed at either 80 or 100 percent. Savers are thus guaranteed a real rate of return. Investors, who are reluctant to invest in physical projects because of uncertainty over expected cost and price increases, instead put their money in these "safe" investments. As a result, investment in plant and equipment has declined from 20 percent of GNP in 1971 to only 14 percent in 1981.

While some of Aridor's preelection moves ostensibly were designed to increase productivity and investment, they have had little real impact. Aridor reduced taxes to a maximum 35 percent for those working evening shifts and to 25 percent for those on night shifts to encourage Israeli workers to overcome their well-known reluctance to work during off hours. At the time a US Embassy official believed that this would encourage the

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Triple-Digit Inflation: Causes and Effects

Israeli inflation has been above single-digit levels since 1969:
- *Prices jumped sharply after the 1973 war; inflation was in the 30- to 40-percent range during the mid-1970s.*
- *Inflation accelerated again in late 1978, reaching a peak exceeding 130 percent in 1980.*

The major impetus for inflation has come from union ability to negotiate real wage gains. Other factors include:
- *An extensive indexation system that, while protecting most Israelis from higher prices, perpetuates the inflationary spiral.*
- *Sluggish productivity growth.*
- *Depreciation of the currency, which boosts the price of imported goods and services.*

Under the government's comprehensive indexation system:
- *Salaries are adjusted quarterly to compensate for 80 percent of price hikes.*
- *Pensions, welfare payments, and long-term savings are fully linked to the consumer price index.*
- *Government-issued bonds are indexed at either 80 or 100 percent.*

In the long run this approach carries heavy costs:
- *Government tendency to temporize by resorting to indexation reduces incentive to attack underlying causes of inflation.* 25X1
- *Plant and equipment investment is debilitated as investors divert their funds to financial assets where a real rate of return is guaranteed.* [redacted]

[redacted] 25X1

[redacted] tax evasion and that workers would claim to have worked these shifts when, in fact, they had not. There is no evidence to suggest that the official was wrong, and since low-income workers are already in the 25-percent tax bracket, there is no incentive for them to work nights. While the response to the new savings plan was strong, a large portion of the funds was shifted out of other financial assets. Little new savings were generated to finance new investment. [redacted] 25X6

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Preliminary data suggest that productivity may have increased on the order of 2.5 percent last year, since GNP rose by 4.6 percent while employment went up by only 2 percent. This is likely to be an aberration, however, which could be explained by employers' reluctance to hire new workers. We believe many worried that Aridor might reverse course once the election was over, and that they then discovered they did not need additional employees. Last year's increased productivity was therefore probably a one-time phenomenon. While total investment declined last year in real terms, investment in machinery and equipment rose by 10.8 percent. Although this is a positive step, until investment spending increases over a long period—which Aridor has done little to encourage—productivity gains cannot be sustained.

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Pitfalls

To retain his influence and support, Aridor has to reduce the inflation rate—prices have risen at an annual rate approaching 140 percent through April—without damaging economic growth. While he was able to accomplish this feat last year by increasing subsidies, this approach probably will not work over a long period because the deficits generated are themselves inflationary. The Begin government survived a no-confidence motion triggered by the 11-percent price rise in April by a margin of only one vote.

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Aridor has taken a major step in dealing with Israel's economic problems by getting the Cabinet to approve real spending cuts, but it remains to be seen whether his FY 1982 budget will survive. The delay in final Knesset approval of the budget may give opponents time to alter it, although such attempts have not yet materialized. Furthermore, based on past experience, ministers may spend more than the budget authorizes simply through ineptness; the Defense Ministry is the only ministry with a reputation for sound fiscal management. Aridor's ability to directly control other ministries' expenditures will be enhanced if the legislation he is drafting on spending and hiring is enacted.

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The outcome of the wage negotiations will be a major factor in Aridor's ability to achieve his goal of an 85-percent inflation rate this year. If the Histadrut is free to engage in additional bargaining over and above indexation at industry and plant levels, it is unlikely that employers will be any more successful in holding the line on wages than they have been in recent years. Real wage gains will fan inflationary fires.

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If Aridor fails to hold the line on the budget and real wages, the foreign payments deficit for civilian goods and services will continue to widen. To prevent this, export volume gains would have to outstrip substantially the growth in import volume. This is unlikely, however, because the growth in domestic demand—in addition to boosting imports—would allow Israeli manufacturers to expand sales without looking to export markets. [redacted]

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Implications for the United States

Some Israelis believe that indexation has nullified the effectiveness of standard economic tools—such as interest rates and the government deficit—according to a State Department official. These Israelis believe that, given political realities—Israelis will not accept higher unemployment, for example—little can be done to solve Israel's economic problems. A small group ready to try to tackle the inflation and investment problems exists, but they have no clearly defined way to accomplish this. The common denominator among them seems to be a need for additional US aid. [redacted] 25X1

Debt servicing is a major concern to the Israelis; more than half of the debt owed the US Government is from defense loans that were used to pay for US military equipment that did nothing in the Israeli view to increase the productive capacity of the Israeli economy or increase its ability to earn foreign exchange to repay the debt. The Begin government has already made a number of proposals to the United States aimed at reducing debt servicing costs and increasing defense exports. These include:

- Restoring the share of Foreign Military Sales (FMS) credits that is forgiven to 50 percent—the proportion prior to FY 1981.
- Provide military loans at concessional interest rates as an alternative to increasing the forgiven share. 25X6

[redacted]

- Allow third countries to use a portion of their FMS funds to buy military equipment from Israel. [redacted]

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