**Israel's economic disaster: All the solutions will be unpleasant, and only America can impose them**
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Taylor also secured an acting job for Lawford, who was broke, in *Malice in Wonderland*. Lawford's deal called for him to do two days' work for $2,000, a pittance, but still cash. Six months later, just a day or two before he was to report for work, Lawford's wife found him drinking vodka and smoking a joint. "He seemed terrified of going in front of the camera," his wife told reporters. "When I found him he was completely out of it." Lawford was treated at a hospital, and sent off to work. He collapsed on the set, and within a few days was dead.

"Stopping an addiction," Taylor said in her *New York Times* interview after Lawford's death, "is basically an ongoing process. . . . Although the cure rate at Betty Ford is about 75 percent, it's not like seven weeks there undoes years of drugs and alcohol. You have to re-create what you learned every day. Staying clean becomes a dedication. If you need to rekindle your promise, you have key people to call. Or you repeat the A.A. Serenity Prayer whenever you need to. And treatment at the center doesn't always work. Peter Lawford was there the same time I was. . . . He didn't make it."

But, upon his death, Lawford achieved something thousands in Hollywood aspire to. His sad story received massive magazine and TV coverage. Says a *People* magazine editor, "Right now that's all you have to do to make the cover—enroll in the Betty Ford Center, or die within a few months of leaving. It's a guaranteed cover. It's that chic."

All the solutions will be unpleasant, and only America can impose them.

# ISRAEL'S ECONOMIC DISASTER

## BY JEFFREY SACHS

INFLATION RATES of several hundred percent a year occur when governments take on commitments that stretch well beyond their means. The politics of ending high inflation is therefore the battle of who will bear the burden of bringing commitments and means back into line. In the 1980s this debate is international, since today's overstretched governments almost always have foreign creditors who are asked to bear some of the costs of the stabilization. The governments of Argentina and Brazil, for example, have massive debts to international banks, and demands are rising in those countries for some relief from the banks. In the case of Israel, the U.S. government has played the banker's role in the past decade. So it is the American taxpayer who is now being pressed for further concessions. The possibility of unlimited aid from the United States has allowed the Israeli government to continue believing that pain-free stabilization is possible. This illusion must be shattered, for Israel's benefit as well as our own. New aid increases from the U.S. should be tied firmly to major reforms in the Israeli economy.

Hyperinflation is a market vote of no confidence in a government's finances. When taxes and borrowing can't cover a government's desired expenditures, governments resort to printing paper currency. The government gets the goods it desires, but at the cost of flooding the market with greater and greater amounts of paper money, each unit of which ends up buying fewer and fewer goods.

The mechanisms of hyperinflation have been the same throughout history, whether the money financing is to support Galtieri's war in the Falklands or Israel's twin burdens of social welfare and defense spending. For Germany in 1923, or Argentina, Bolivia, Brazil, and Israel in 1985, rampant inflation results from a large budget deficit, a constellation of political forces that prevents tax increases or expenditure cuts, and an inheritance of heavy debt burdens on the government from past borrowing at home and abroad. (In Germany's case, there was also the burden of World War I reparations payments.) The inherited debt burdens the current budget with interest payments, and also sends the unmistakable signal that printing new money will be necessary to meet both current obligations and future bills when the existing debts come due.

Israel's current inflation is far from the world's worst in recent decades, though continuing political stalemate does not augur well for the future. The 1984 inflation rate of 374 percent put Israel in a solid third position, behind Bolivia (1,281 percent) and Argentina (627 percent). The famous hyperinflations of the 1920s reached rates of several thousand percent and beyond. But the lack of decisive Israeli action against inflation suggests that the situation will get worse before it gets better. Today's inflation is sharply higher than the plateau of about 125 percent during 1979-1983, which in turn was far above the average of about 50 percent during 1976-1979.

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Israel's fiscal crisis makes our own notorious problems look puny. Israel has been running central government budget deficits of more than 15 percent of GNP since 1977. By comparison, U.S. deficits have reached five percent of GNP only in the past two years. The Israeli deficits have been financed through a combination of money creation, domestic borrowing, foreign borrowing, and foreign aid. These have left the government struggling with a growing debt burden in addition to the problem of inflation. The debt of the Israeli government held by Israelis is a shocking 130 percent of GNP (compared to about 35 percent for the U.S.), and the government's debt held by foreigners is about 65 percent of GNP. At $16 billion, that amounts to a foreign public debt of $4,000 for every man, woman, and child in Israel. About two-thirds of that, $11.5 billion, is owed to the U.S. government.

The cause of Israel's budget deficits is enormous public expenditures rather than any reticence to tax. Public spending is a remarkable 70 percent of GNP, perhaps the highest in the capitalist world, and revenues are about 50 percent of GNP, also remarkably high by world standards. No other government in the world bears burdens as great as Israel's. Our own guns-and-butter problem pales in comparison. A tiny country in a region of implacable enemies, Israel spends more than 20 percent of GNP on defense, compared to about seven percent for the U.S. The public welfare burden absorbs another 20 to 25 percent of GNP. Among more traditional social welfare functions, this supports Israel's remarkable policy of sustenance for continuing waves of immigrants, most recently the rescue and absorption of 10,000 Ethiopian Jews. Israel also has a tradition of state subsidies to private industry. And added to these challenges are the enormous interest payments due every year on the government's past borrowing. Interest payments alone amount to almost 40 percent of the budget.

One reason Israeli governments have been slow to bite the bullet is fear that substantial budget cuts could induce a recession, with the serious implication of reduced immigration and increased emigration. Because of outmigration in the past few years, about one-tenth of Israel's population now lives abroad.

THE SAD FACT is that large budget deficits, the heavy military burden, and the resulting inflation have contributed to a deterioration of the economy that goes beyond the inflation problem. Ironically, instead of a sharp and short recession, which policymakers dread, there has been an even more damaging steady decline in the underlying strength of the economy. Economic growth, which averaged almost ten percent a year in the 1960s, is now barely two percent a year, and per capita GNP is hardly growing at all. Productivity growth in the business sector has also declined sharply. Government budget policies have helped to shield private consumers from the economic slowdown. The result is that investment, a major source of economic growth, has borne the heaviest burden. Investment spending has declined from 34 percent of GNP in 1973 to only 22 percent in 1983.

There are bright spots. Israel continues to develop high-technology industries that are vigorous competitors in world markets. The dynamic export sector is where Israel's future economic prospects are strongest.

SUCCESSIVE Israeli governments have been unwilling to face up to the fiscal crisis. Indeed, several finance ministers have denied the problem altogether. A favorite line of thinking, prominent in the policies of former finance minister Yoram Aridor in 1981-83, and again in the misguided "Package Deal" engineered by Prime Minister Shimon Peres last November, is that inflation is simply the result of prices chasing wages and wages chasing prices. If inflation were a matter of momentum, it would be simple enough to stop the process by intervening in the cycle and breaking one of the links. Better yet, break *all* the links in a "package deal" among labor, industry, and the government. No muss, no fuss, and certainly no budget cuts required!

Under Aridor, the strategy was to tie the value of the Israeli shekel to the dollar, thereby slowing the inflation of import prices and (with hope) domestic wages and prices as well. The main result of this strategy, though, was that imports became temporarily cheap, leading to a spending binge that dramatically increased Israel's foreign debt. This eventually forced a huge devaluation and an end to the strong currency strategy.

Peres's "package deal" also fell apart because it confused symptoms with underlying ailments. It is a good idea to coordinate a moderation of wage and price increases, if the attempt goes along with substantial budget reform and deficit reductions. But the "package deal" left the government budget out of the package. Like Aridor's policy, the results were favorable for a while, but then the policy collapsed. The annual inflation rate went from 752 percent in November 1984 to 55 percent in December and 85 percent in January 1985. With the prospect of pain-free disinflation, a near-euphoria set in. But then the inflation rate shot up again, to 359 percent in February, and reached more than 700 percent in April.

Many Israelis and much of the press blamed the breakdown on the government, for letting the foreign exchange value of the shekel sink too far, thus causing import prices to skyrocket and putting a strain on the agreed wage and price moderation. What these critics fail to comprehend is that a government with such an enormous deficit and such a large foreign debt has very little long-term choice about its currency's exchange rate. A government that is rapidly printing money inevitably will see its currency weaken compared to other currencies whose supply is increasing more slowly.

In any other country, Israel's budget policies would have led to a devastating economic crisis, with much sharper declines in living standards and perhaps even higher inflation than Israel has yet suffered. What has prevented these dire consequences so far is Israel's special relationship with the United States. But as inflation



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reaches 1,000 percent, a much deeper crisis cannot be ruled out. In the past decade the U.S. has given or lent Israel more than $15 billion. This year the administration has already proposed three billion dollars of new aid, with a possible supplementary loan of $1.5 billion. U.S. aid this year would then add up to more than $1,000 for every person in Israel, and more than 15 percent of Israeli GNP. And unless Israel's budget policies change, at least this much will be needed every year in the future.

The Israeli government argues that U.S. aid should be generous, and with few strings attached. This clearly suits its purpose of maintaining a precarious status quo in circumstances of political instability. But continued large-scale aid from the U.S. without serious reforms would be unwise for the U.S. and fraught with great hazards for Israel itself. Inevitably, American politicians will demand a growing role in Israeli strategic and political decisions in return for financing its government deficits. The resulting encroachments on Israeli sovereignty, as much as the growing weight of debt repayments, should be enough to steer both sides away from the present course.

ENDING HYPERINFLATION is never easy, and almost always requires a strong government leading the way. Many hyperinflations have ended only after the disaster of a military coup (Chile in 1973) or a civil war (Indonesia in 1965). Israel must find a democratic solution to its difficulties. Yet the current political situation is inauspicious, to say the least. The coalition government under Peres is deeply divided about almost everything. Finance Minister Yitzhak Modai is from the Likud, the junior coalition partner; and the Labor cabinet ministers use every opportunity to undercut his authority. His responsible calls for budget austerity generally have been ignored. Even when budget restraints have been enacted, the government has proven unable to keep spending in line with its own targets.

It's easy to sketch the broad outlines of necessary reform. The details, though, must ultimately be decided by elected politicians, not economists. Above all, the budget deficit must be sharply reduced, by at least ten percent of GNP. Given Israel's already enormous tax burden, most of the adjustment should come through spending cuts rather than tax increases.

One recent idea for enforcing fiscal austerity, developed by the U.S. and already adopted in Israel, is legislation limiting the authority of the Bank of Israel to print new money to support the budget deficit. In principle, the government will be forced elsewhere for its financing, and forced ultimately to reduce its borrowing. These restrictions will be phased in over several years, however, and it is still unclear whether this institutional change will have real bite.

A drastic tax measure that might be considered is a one-shot capital levy, perhaps on existing government debt. Right now domestic debt and foreign public debt add up to around 195 percent of GNP. The enormous interest payments on those debts may make it simply impossible to balance the budget through cuts in defense and social welfare spending alone. A capital levy used to pay off some debt would permit a major reduction in interest costs. If it worked, it would be preferable to yet higher income taxes or continued inflationary finance. The trick is to guarantee that the levy would not recur. (Otherwise, the result will be massive capital flight out of the country.) To make such a guarantee convincing, the onetime tax must be part of a package that conclusively eliminates the budget deficit.

THE SECOND ASPECT of any stabilization must be a low and realistic value for the shekel relative to the dollar. Shekels must remain inexpensive enough to keep Israel's dynamic export sector growing. After major budget cutting, there will be an initial sharp decline in aggregate demand for Israeli goods, with the government, today's big customer for output, having retired to the sidelines. To avoid unemployment, firms now selling goods to the government will have to reorient production to sell goods to the rest of the world. A competitive exchange rate is the best guarantee that labor can move into the export sector as government demand is reduced. Unfortunately, the reverse side of a cheap shekel is a high price for imports in Israel, and a consequent reduction in workers' living standards. But with an end to inflation, and with export-led growth, the prospects would be bright for a quick revival of living standards and renewed economic growth after the initial jolt.

How can such a desirable combination of policies be achieved? Answer: they should be insisted upon as a condition for new loans to the Israeli government. To its credit, the Reagan administration has made a valiant effort to impose just such "conditionality," as it is called. This effort is politically thankless, given the strong pressures in Congress to give new aid in large amounts without conditions. Already politicians are falling all over each other in attempts to be the most generous. Just one example is a new proposal by Senators Bob Kasten and Daniel Inouye to cut by more than half the interest charges on existing U.S. loans to Israel. That bit of largess would require a new four billion dollar appropriation this year. Such proposals make sense only in the context of fundamental reforms in Israel.

The U.S. political system may well prove incapable of enforcing any conditionality agreement with Israel. Is it likely that aid would be cut off if Israel failed to meet the conditions? A more realistic course is for the U.S. to make any aid above normal levels conditional on Israel's agreement to submit to the supervision of the International Monetary Fund. This is the standard requirement that we impose when renegotiating the debts of other countries. No doubt the IMF would prefer to leave this hot potato in our hands. After all, congressional pressure certainly reaches as far as IMF headquarters in Washington. But at least with the IMF in charge, the direct responsibility for overseeing Israel's painful adjustments would be beyond the corridors of Congress itself. This would be a healthy discipline for all parties involved. □



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