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Democracy, credibility, and sound economics: The Israeli hyperinflation

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Abstract. The 1985 Israeli economic stabilization program provides a rare case of stable (as of late 1996) success under democratic auspices without major social disorder. Existing explanations for the success of the Israeli reforms overemphasize economics at the expense of politics. This paper analyzes the political causes of the early 1980s Israeli hyperinflation. The program's economic measures and performance are reviewed. The Israeli economic stabilization program succeeded because it was considered credible by the Israeli public. The social and political factors that contributed to the program's credibility are investigated and their importance is ranked. The applicability of the paper to other economic reforms under democratic auspices is highlighted and future research is outlined.

Introduction

Can democratic governments be counted on to adopt rational economic policies in the long-term public good? There are many reasons to think not.

1. The economic time horizon of democratic politicians is often not longer than their electoral time horizon, i.e., short term.
2. Democratic publics may not be well educated and reward short-term peformance even when it comes at the expense of the long term public interest.
3. Democratic governments cannot silence pressure groups that will often oppose sacrifice of their economic interests.
4. Opposition politicians will blame the government in office for economic failure, whether or not it is at fault.
5. Many key economic decisions are beyond the government's control; in response to the government's perceived irresponsibility or economic failure, investment may decline, capital may leave the country, etc. In short, the solution of eoconomic problems in democracies may be fraught with political difficulties peculiar to this form of government.

From 1973 to late 1985, the Israeli experience confirmed this pessimistic assessment of the relationship between democratic politics and sound economic policy. In July 1985 the Israeli government took the bull by the horns, reduced inflation to tolerable levels, and turned the country's economy around without abandoning democratic principles. The annual rate of inflation dropped to 20 percent almost immediately, and has since tended downward to a present level of around 10 percent. The accelerated growth in the Israeli foreign debt stopped, and the economy regained the high economic growth rates of the 1960s and early 1970s.

The Israeli hyperinflation generated a wide literature written mostly by economists.[1] While this literature mentions political factors, it emphasizes economic policies both in causing the early 1980s hyperinflation and in bringing it down. In these papers causality clearly flows from economics to reducing hyperinflation. Political factors are shortly discussed, typically treated as structural constraints. The most notable aspect of the Israeli disinflation (the fact that it succeeded under democratic auspices without major social disorder) is, however, not emphasized. While the economic literature acknowledges the role of policy credibility in the success of the economic programs, it does not focus on what constitutes credible macroeconomic policy, and the empirical sources of policy credibility in the Israeli case are almost not discussed. Many political scientists have discussed the politics of disinflation. Yet, the Israeli case has not been adequately addressed in this literature. Where the linking of political and economic factors in the Israeli disinflation appears in few works, studies omit important factors and fail to fully integrate socio-politico-economic explanations for the success of the Israeli disinflation.

We demonstrate that policy credibility existed in the Israeli case and investigate its domestic and international sources. The second contribution of our paper lies in extending the debate on the link between regime type and economic performance. This in itself is important because so few case studies of long term successful economic stabilization under democratic regime, without social disorder, exist.

A number of remedies were tried to combat the Israeli hyperinflation during the late 1970s and early 1980s without much success. The questions we pose are sharp. First, why did the particular reform effort in July 1985 succeed? Second, concluding that credibility played a crucial role in the 1985 success, what were the sources of policy credibility in the Israeli case?

While the economics of the July 1985 Israeli program were competently designed and implemented, the program succeeded largely because a socio-politico environment was created which was conducive to the needs and sacrifices associated with its implementation. Most important, the program was perceived by the Israeli public as credible and this, compared to other countries' and Israel's earlier experience, made the difference. Sources of economic policy credibility in the Israeli case are identified and ranked. In the first level of importance, policy credibility was generated using signalling sent from important actors, issue linkage to the Israeli withdrawal from Lebanon, and a sense of crisis conveyed to the public by leading political figures. Somewhat less important, Israeli civic culture and the formation of a National Unity Government also added credibility to the July 1985 economic program.

The first section of the paper reviews the economic and political literature on economic reforms. The second section presents a historical background of the Israeli experience. The third section evaluates the economic and political explanations of the program's success. The fourth section discusses the concept of macroeconomic policy credibility and demonstrates its presence in the Israeli case. The fifth section identifies and ranks the sources of credibility in the Israeli economic stabilization program. Finally, future research is highlighted alongside with concluding remarks.

Literature review

The role of socio-politico factors and regime type in economic reforms and as a cause of inflation is discussed by several researchers. Nordhaus (1978) argues that in democratic regimes politicians are able to exploit the economic tradeoff between inflation and output (Phillips Curve) and do so periodically before elections. In contrast, coming from a rational expectations perspective, Barry (1985) argues that elections may not cause inflation as the existence of a Phillips Curve and the assumption that rational economic agents are myopic are controversial. Hibbs (1977) claims that the inclination of democratic policy makers toward painful economic policies is not related to the timing of elections but rather to the interests of the political groups they need to accommodate.

The political science empirical literature on economic adjustment and stabilization, largely case study oriented, deals with various countries.[2] Ariff (1983), for example, analyzes the case of Malaysia. Sachs (1985) focuses on Latin America and East Asia. Haggard, Kaufman, Shariff, and Webb (1990) discuss middle income countries. Stallings (1989), and Haggard and Kaufman (1992) hypothesize that in a democratic regime, social divisions among parties may increase macroeconomic instability and undermine stabilization programs. Williamson (1994) argues that economic reforms require strong electoral mandate and clear ideological direction. To Williamson, Israel is a successful democratic reformer. Recognizing that 'Israel had an impressive stabilization in 1985,' he chooses not to address it (1994: p. 5). Haggard and Kaufman overlook Israel without explanation (1992: p. 309).

The Israeli case is most interesting, though, where it refutes Haggard and Kaufman's (1992) and Williamson's (1994) hypotheses. Haggard and Kaufman's hypothesis may explain Israeli domestic politics during the 1970s and early 1980s. However, if we were to test it at the program's inception (July, 1985), it would be rejected as then democracy bridged ideological division among parties, bonded social cleavages, and enabled the reforms. As for Williamson's argument, the Israeli reform was carried through by a government lacking strong, technically robust, personal leadership; without a strong electoral mandate; and without ideological direction. The negation of clear ideology and the presence of party conflict evident in the Israeli case reflect a reform alternative not highlighted in the Williamson study. This discussion suggests that there may have been intervening variables that were not accounted for in Haggard and Kaufman's and williamson's edited collections of case studies on economic stabilization programs and reforms.

Ceddes (1995) assesses the empirical evidence behing the conventional claim or wisdom that due to societal opposition toward painful stabilization measures, democracies have more difficulties in implementing economic stabilization programs and reforms than authoritarian regimes. Investigating many countries, not including Israel, she finds against the conventional wisdom. Interestingly, the Israeli economic reforms seem to support the conventional wisdom from the late 1970s to July 1985, but refute it since then.

Economic accounts of stabilization programs place inadequate emphasis on political factors. Helpman and Razin (1987), and Kiguel and Liviatan (1988) show in a series of case studies that stabilization programs which do not deal simultaneously with the full spectrum of macroeconomic policy making do not succeed. However, sweeping economic reforms require widespread social support. How to build such support is not dealt with. Patinkin (1993) argues that the Israeli stabilization success is explained by the use of heterodox economic policies and multiple nominal anchors. Leiderman (1993) argues that wrong fiscal policies caused Israeli's hyperinflation, and sound ones brought it under control. The adjustment of the budget is found to be the key factor in a successful disinflation. However, the most important question, in our view, is not addressed: why some governments are willing and/or able to adjust fiscal and monetary fundamentals, while others are not?

The earlier overly economic discussions of the Israeli disinflation have recently given way to discussions of the politics of the Israeli disinflation. Grinberg (1991: pp. 2–3), and Shalev (1992: p. 11) caution against rejecting the Israeli 1985 experience as exceptional. Keren (1995) emphasizes the distinction between populism aimed at low income groups which was used by the Israeli government in the early 1980s (headed by the Likud party), and the form of democracy employed by the government formed in late 1984 (headed during its first two years by the Labor party). He finds this to be the key factor in the success of the Israeli program.

Recently, references to policy credibility have become commonplace in the literature on the Israeli plan. However, the credibility has been taken for granted. Edwards (1991: p. 410) argues that establishing credibility is critical but the sources of credibility are not studied. Bruno (1992), one of the architects of the Israeli program, admits that while the notions of reputation and credibility of economic policies are most important determinants of their outcomes 'there is little in conventional upbringing of an academic economist that should make him or her particularly suited to apply these in practice as a policy maker (1992: p. 311).'

Barkey (1992) emphasizes the role of price controls imposed in the Israeli case. Credibility was established through the government holding the line against demands of special interest groups, the involvement of the prime minister in the process, and the formation of national unity government. Yet, the behavior of the Israeli public, a major actor in democracies, is not investigated, and it is not clear why the Israeli government was able to behave in the manner described. Bruno (1993) argues that in most cases building credibility is a gradual process in which policy makers are tested by the public. Yet, the Israeli case consists of an abrupt change in public mood. While programs attempted from 1979 to early 1985 failed as they were deemed incredible, the July 1985 attempt worked.

In summary, the recent analyses of the Israeli case, while stepping in the right direction, fail to go far enough. Important questions are not addressed or left unanswered. In particular, credibility is mostly taken for granted and data on its existence and likely causes are almost not presented.

Historical background

The severe economic ills that had come to plague Israel by the late 1970s and early 1980s had economic, political, and social underpinnings. In this section we focus on the socio-political causes of the hyperinflation.[3] The Israeli experience during these years was characterized by politicians who lacked economic courage out of fear for their political lives, and by a complacent public which long tolerated policies that felt good in the short term, despite their expected long term evils. In the early 1980s the Israeli government, fearing the loss of public support, focused on raising the standard of living.[4] This policy had severe implications since the increase in government spending accelerated the rate of inflation.

Maital and Benjamini (1980) claim that the political causes of inflation are related to the structure of the ruling coalition. This appears relevant to the Israeli case. The two Israeli governments from 1977 to 1984 consisted of small majority coalitions led by the Likud party which included competing interests: the Likud focused on enlarging the scope of Israeli settlements in the West Bank and Golan Heights; the national religious parties supported a large biblical Israel; the ultra orthodox religious parties pursued financial support for religious education and foundations; and, the centrist parties supported a peace dialogue with Arab countries and investing resources inside Israeli's pre-Six Days War's (1967) borders.

The Israeli annual rates of inflation and economic growth from 1960 to 1993 are presented in Figures 1 and 2, respectively.[5]

In the early-1970s, the Israeli annual rate of inflation was less than 25 percent and the economy was growing fast. However, in the late 1970s and early 1980s inflation accelerated rapidly and economic growth slowed down. From a moderate annual rate of inflation – 31 percent in 1976 – it grew to an annual rate of almost 375 percent in 1984. The pressures within the government and the labor market accelerated the rate of inflation.

Government ministries exerted pressures on the finance ministy claiming that the real value of their budgets deteriorated due to the accelerating inflation. Considering inflationary expectations, the rate by which inflation is created within the government accelerates as the demand of ministers to increase their budget is based on both current inflation and the anticipation that inflation will

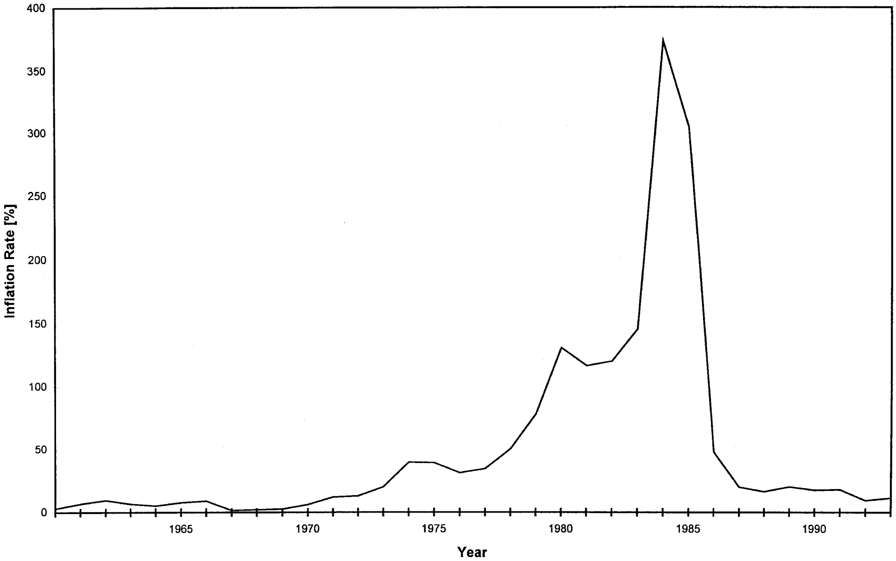

Fig. 1. Israeli annual rate of inflation.

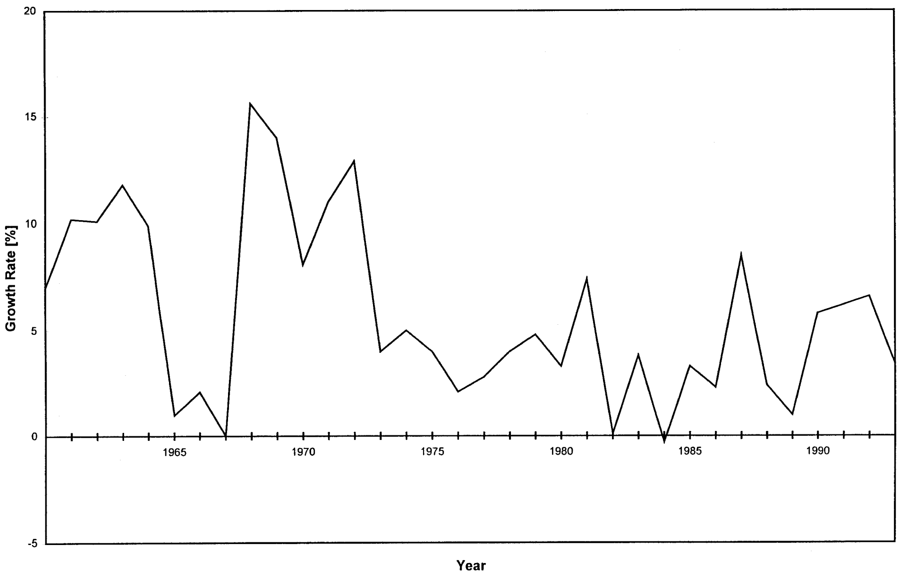

Fig. 2. Israeli annual rate of economic growth.

increase in the future. Since the Likud government did not enjoy a strong parliamentary majority, the Prime Minister and the Finance Minister (both from Likud) were exposed to financial pressures from other parties in the coalition which increased the deficit. The internal conflict kept earlier Finance

Ministers – notably Simcha Ehrlich and Iigal Hurwitz – from disciplining their partners in the governing coalition to maintain budget limits. Much pressure came from the religious parties. Realizing that their political power was larger than their share of the votes, they demanded financial benefits in return for their support of the Likud government in the parliament.[6]

The inter and intra-party effects were exacerbated by the political economy of the Likud. As argued by Keren (1995), Likud rode a wave of political support which relied on the lower classes, particularly Jews from non-European countries (Sepharadic). The period was one of great ethnic tension in Israel, and the Likud used it to win over the Sepharadic vote by allocating resources to a class of the population which did not receive them before. This policy probably had inflationary effects.

Another socio-political cause of the hyperinflation is related to Israel's labor market. In the early 1980s, the Israeli economy, wages and savings included, was indexed to the Consumer Price Index (CPI). Research on the economic effects of indexation show that while the populace is less sensitive to economic shocks than in a non indexed economy, indexed economies tend to have high rates of inflation.[7] The indexation accelerated a chain reaction of wage and price increases. However, since indexation insulated the public from most real effects of monetary shocks, there was no opposition to a moderate inflation (Artstein and Sussman, 1989).

As inflation accelerated, labor demanded increases in real wages, arguing that although nominal wages were indexed to the cost of living, real wages lagged behind inflation since they were based on the previous month's rise of prices. Devaluation, a tool frequently used to slow down inflation in small open economies with a current account deficit, accelerated the rate of inflation. The public incorporated expectations of a future devaluation into demands for wage increases, the duration of wage contracts shortened, contracts were broken before their expiration, and the labor force of one sector demanded a wage increase when wages in other sectors rose. The continual increase in nominal wages kept inflation going (Fischer, 1986).

Since the majority of the Israeli labor force was organized by one union, the General Labor Union (hereafter referred to by its Israeli name Histadrut), labor became a political actor that could not be ignored by the government. As the inflationary process progressed, the Histadrut demanded wage increases based on the anticipation that inflation would accelerate in the future. Similar to the process within the government, inflationary expectations proved to be self-fulfulling.

In 1979 Iigal Hurwitz, the Finance Minister, attempted to lower the rate of inflation by sharply reducing subsidies and the size of the public sector, largely cutting government's spending. In 1981 and 1982, the government tried populist stabilization measures. It slowed the rate of devaluations and limited the rise in the price of subsidized goods to five percent per month. Yoram Aridor, the Finance Minister at the time, substantially reduced tariffs and appreciated the exchange rate, hoping that the resulting surge in imports would increase customs revenues and reduce prices due to increased supply. While inflation temporarily declined to a rate of around 115 percent per year, the current account deficit significantly worsened. In mid 1984, the government considered pegging the Israeli currency (Shekel) to the Dollar and freezing the price of oil. These programs failed, resulting in a jump of imports which caused a decline in foreign reserves and an increase in consumption and prices.[8]

During the early 1980s the Israeli economy was caught in an adverse cycle. The government failed to persuade the public that its economic reforms policies were credible. The public expected near future policy reversal, and so increased current consumption many fold. The increased demand drove prices up on the expectation that prices would rise even more once a newly announced program would be reversed, which indeed occurred, and so on.

The Israeli reforms were announced in the beginning of July 1985. In August 1985, a month after the program's inception, the CPI rose 27 percent. In September, October, and November of 1985, the CPI rose four percent per month. Since then, the CPI growth rate stabilized around one and a half percent per month or 15 percent per year (see Figure 1). The disinflation caused an increase in unemployment, from 5.8 percent in 1984, to 7.1 percent in 1986. During the first six months of the program, the unemployment rate was higher, reaching 7.8 percent. In 1985 and 1986, the program created a surplus in the balance of payment. In contrast to other economic stabilization programs (e.g. Brazil, Argentina, Chile), the Israeli program was not associated with an uncontrolled increase in imports resulting in depleting foreign reserves.

Going back to Figure 2, following a −0.3 percent economic growth rate in 1984, the economy grew at a rate of 3.3 percent in 1985, 2.3 percent in 1986, and 8.5 percent in 1987. Investments grew in 1986 at a rate of 11.2 percent, and in the first half of 1987 at a rate of 14.7 percent. While during 1979–1985 the average labor productivity growth rate was small or negative, during 1986 and 1987 it grew at an annual rate of around 4 percent.[9]

The economics and politics of stabilization

Why did the Israeli economic stabilization program succeed? One explanation is economic. The program included the correct combination of macroeconomic policies. The plan was implemented accurately, and worked perfectly. The economic features of the program have been discussed by many authors and will only be highlighted here. The July 1985 Israeli program stabilized the economy using the following measures: (1) reducing the growth rate of the money supply; (2) curtailing government expenses; (3) enacting money and credit ceilings; (4) sharply devaluating the Shekel relative to the Dollar and freezing the exchange rate; (5) freezing wages for three months; and (6) reducing the number of subsidized goods and the size of subsidies.[10] Stabilization was also achieved by forming a committee that was given the authority to determine prices of various goods. Prices charged by private actors were monitored by a special police force. Provisions were made to punish actors charging higher than allowed prices, while such cases were made public.

And yet, the Israeli economic measures were not largely innovative. While it is true that previous attempts to stabilize the Israeli and other economies did not simultaneously use so many economic measures, an important question is left unanswered: why were such measures not utilized in Israel during the early 1980s and in other countries facing similar problems? What the economic approach cannot explain is how a government comes to have the political will and societal support to adopt painful economic policies. An understanding of the social process that drives economic reforms requires an approach cognizant of political factors.

Three political factors have a role in explaining the Israeli success story: (1) politicians were able to shield themselves from the electoral cost of short-term economic sacrifices by forming a broad coalition;[11] (2) the government was able to persuade the Histadrut and the business community associations to support the economic reforms. This national bargaining was possible because it took place within the boundaries set by Israeli democracy; and (3) most important, public cooperation was gained since the public believed that the government's economic policies were credible.

While in the long term economic stabilization programs are expected to increase overall public welfare, in the short term there are winners and losers from such programs. In addition to labor, which typically suffers a reduction in real income, the main losers are consumers of subsidized goods and services (typically the poor), and people who take subsidized loans from governmental sources (for example, home buyers). This was indeed the case during the late 1970s and early 1980s when labor and low income groups opposed attempts to cut subsidies and freeze nominal wages. Because of the democratic nature of the Israeli regime, the government could not have curtailed public liberties while stabilizing and reforming the economy.[12] Such measures were never utilized in Israel and probably would have resulted in the loss of pupular support and the eventual fall of the government. Particularly, this meant that as long as the public, the two large political parties, the Histadrut, and the business associations, did not agree on the need and ways to stabilize the economy, the program would be vulnerable to attacks from the opposition.

In the late 1970s and early 1980s Israeli society was divided along political and sectoral lines. The gap between the Likud and Labor covered (mostly) issues centered around the Arab-Israeli conflict. Given the nature of this gap, economic issues were (somewhat) pushed aside from the agenda of the Prime minister and/or were used to hurt the other party. Labor Party control of the Histadrut resulted in partisan politics flowing into the parliament sphere as historical friction existed between the Likud and the labor movement. Yet, while the two parties emphasized the difference between their social programs (presumably to assist their foreign agenda) they agreed on the basic need to solve the immediate economic problems facing the nation.

During 1983 and 1984 the security and economic situations worsened: the number of Israeli casualties in Lebanon grew, and the economy was breaking down. In the July 1984 elections neither the Labor nor Likud parties obtained enough votes to form a stable government. Facing these grave crises the two leading parties, under considerable public pressure (through letters to newspapers and demonstrations), formed a 'National Unity Government' which had a unique provision: during the first two years of its duration the Prime Minister would be from the Labor party while the Foreign Minister would be from the Likud. During the last two years of the government's duration these positions would be reversed. The defense and finance ministries were divided between the Labor (defense) and the Likud (finance).

The declared objectives of the Natinal Unity Government were to leave Lebanon and to stabilize the economy. The Labor and Likud parties agreed to postpone, to an unspecified time, discussions of issues related to the Arab-Israeli conflict, pledging to keep the status quo in this regard. The Labor-Likud coalition government was clearly less vulnerable to financial demands of smaller parties in the coalition as their political backing was no nonger needed to secure the government.

Parliamentary consensus in place, economic cooperation of the Histadrut, the business associations, and the public had to be ensured. During the early 1980s hyperinflation, business and the Histadrut were constantly at odds. Typically, labor would demand a wage increase which would be turned down by management. At times, localized labor strikes turned into nationwide labor-business-government controversies. Following government intervention, labor would get most of the demanded wage increase.[13] Firms, private capital owners, and investors supported the attempts to stabilize the economy as the hyperinflation affected their profits by reducing their ability to determine prices of goods and services and forecast future business conditions.

After extensive consultation, the Histadrut and the business associations agreed to a package wage/price control suggested by the government. In the agreement, the Histadrut agreed to freeze wages for three months, prevent strikes, and accept a short term rise in unemployment which was expected to follow a sharp disinflation. Government and business undertook to minimize job losses and assist the unemployed in finding jobs; while government undertook to compensate the poor.[14]

In effect, a three-tiered corporatist arrangement was created to deal with the politics of the crisis.[15] At the highest tier, political cooperation was achieved through forming a government of national unity between Likud and Labor. Economic cooperation at the macro level was achieved through a tri-partite wage/price agreement between the coalition government, employers, and the Histadrut. Most important, at the lowest tier, public economic cooperation was ensured by convincing the general population that commitments undertaken by government were credible.[16]

Theoretic and empirical aspects of credibility

In many contemporary macroeconomic models, how the public perceives the credibility of governmental policies is crucial to the prediction of their effects on rational individuals.[17] Kydland and Prescott (1977), and Barro and Gordon (1983) analyze the effect of monetary policy and demonstrate that policy credibility and government's reputation play an important role in the decision making process of both the government and welfare maximizing individuals. These authors assume that individuals make economic decisions based upon rational expectations of their future results. If individuals assume that declared economic policies are not credible, their actions may force democratic governments to change those policies.

Assume, for instance, that the public believes that the government will not be able to susain a defict reduction policy and will eventually finance its deficit by printing money. Rational individuals will then expect an increase in the rate of inflation. Therefore, they will demand a wage increase to compensate for the foreseen loss of real income, and spend current income expecting prices to further increase. However, this will cause a rise in aggregate demand followed by an increase in prices. If some goods are imported (and/or their production requires imported inputs) the increased consumption might deplete foreign reserves. These developments might force the government to abort its deficit reduction plans.[18]

The above example may explain the failure of the earlier Israeli economic stabilization attempts. However, on July 1985 the Israeli government was perceived committed to its announcements and its policies gained substantial public support. Before we hypothesize on the likely sources of policy credibility in the Israeli case, we first need to establish that the government's economic policies were indeed considered credible in the eyes of the public. Several empirical findings and one deductive reasoning support this claim.

First, a public opinion survey requested by the government a week after the inception of the program and administered by the Israel Institute of Applied Social Science, found that 61 percent of the public believed that the government would carry out the program, and 50 percent believed that the program was needed.

Second, an additional survey, conducted by 'Dahaf' (an Israeli firm) for the Israeli newspaper 'Yediot Aharonot' (Israel's most circulated paper) shows that while in early July 1985 45 percent of the public supported the program and believed that the government intended to implement it, in August 9, 1985 this number increase to 64 percent. The portion of those who did not believe that the government had the ability to carry through the program fell from 51 percent in July to 31 percent in August.[19] Hence, a month after the program's inception almost 70 percent of the public believed that the government intended, and had the ability to, implement the program.

Third, another indicator of the way the public perceived the chances of the program to reduce inflation is the measure of public expected inflation, computed by Yariv (1985), based on the price of indexed bonds which are close to maturity. While in June 1985 the monthly expected inflation rate for the next 3 months was 18.1 percent, in July the number dropped to 11–12 percent, in September it was 7.9 percent, and in December it was 2.2 percent. These numbers indicate a continuous increase in the level of public confidence in the program as it progressed.

Finally, purely deductive macroeconomic models predict that economic policies, in particular monetary policies, which are perceived as incredible by rational agents will fail. Coming from this perspective, the fact that the July 1985 Israeli stabilization program succeeded supports (ex-post) the claim that it was considered credible by the public. Otherwise, the Israeli economy would still be in the midst of an adverse economic cycle as in the late 1970s and early 1980s.

Sources of credibility

While the evidence we have presented supports the claim that the Israeli stabilization program was considered credible, it does not explain why it was perceived so. Policy credibility, unlike economic variables such as price and quantity, does not lend itself to easy measurement and is not a uni-dimensional variable. The following discussion provides several answers to the most important question concerning the success of economic reforms in a democratic setup; namely, what are the likely sources of policy credibility. We categorize and discuss the sources of policy credibility in the Israeli case in four groups presented according to the importance of their contribution to policy credibility: (1) credible signals sent by important actors; (2) the June 1985 Israeli withdrawal from Lebanon; (3) a sense of crisis and strong civic culture; and (4) the formation of a National Unity Government.[20]

Signaling

The July 1985 Israeli economic reforms were affected by the behavior of five major social actors: (1) the government; (2) the Histadrut; (3) the public; (4) the team appointed to design and monitor the stabilization program; and (5) the United States government. In the presence of incomplete information about actors' intentions, credible signaling became an important pilar of the program. Credible signaling, one which is backed by costly actions and commitments, ensured other actors' cooperation and was utilized in several ways.

First, the Israeli government announced the formation of a special expert team to design the economic stabilization program. The technocratic elite was thus removed from direct electoral pressure. The team included academic and public sector economists, some of whom were publicly known for their criticism of past economic policies of the government.[21] The formation of the team and the announcements that the government was committed to the team's plan signaled to the public that the government was determined to take all measures, including implementing unpleasant economic acts, in order to stabilize the economy. While in the early 1980s the suggestions of some economists were dismissed as too severe, now the government encouraged an objective evaluation of different options.

Second, the government did not spare efforts to signal that it intended to carry out the reforms. Both the Prime Minister, Shimon Peres from the Labor party, and the Finance Minister, Itzhak Moda'i from the Likud party, declared in public that the program was at the top of their priority list and put their prestige behind it.[22] Moreover, the Labor-Likud coalition agreement of September 1984 specifically declared that stabilizing the economy was one of its two major goals (the other was leaving Lebanon).

Finally, it was made common knowledge that the United States' government provided Israel with financial assistance to deal with unforeseeable problems in the balance of payments as the program progressed. Support for the economic adjustment measures from a country perceived by many Israelis as having a sound economic system signaled that the program had a chance of success. The importance of the aid from the United States and the effect it may have had on the public is emphasized by Immanuel Sharon (1990), one of the program's architects (then director general of the Ministry of Finance). Yitzhak Moda'i, then Israel's Finance Minister, argued in a 1995 interview that the 1.5 billion dollar transfer from the United States signaled to the public that the government could maintain a high level of imports to counteract a possible rise of demand as a result of the program.[23]

The withdrawal from Lebanon

The Israeli army entered Lebanon in 1982 in what was originally declared to be a short and decisive anti terrorist operation. Things got complicated when the army became involved in domestic Lebanese affairs while trying to mediate between different ethnic groups. As the number of Israeli casualties rose, the stay in Lebanon became extremely unpopular and the government adopted a guns and butter policy that fed inflation in 1982–1984.[24] In 1983–1985, the stay in Lebanon was costing Israel 1.25 billion dollar a year (Rivlin, 1992: p. 41). Keeping the army in Lebanon became a huge economic burden on a government whose intention to reduce its budget was declared in interviews of its leading economic figures.[25] In June 1985, the Israeli army left Lebanon as was promised at the time of the formation of the National Unity Government in September 1984. The withdrawal strengthened the government's position in implementing the stabilization program since it permitted a substantial cut in defense commitments, which in turn enabled the government to reduce its budget deficit and rein in inflation.

The withdrawal from Lebanon may have been related to the program's success in yet another manner. The campaign in Lebanon was a subject of heated public debate that focused on the Likud government's intentions when it started the war in 1982. Through issue linkage the withdrawal may have had positive externalities for the stabilization program.[26] The January 1985 decision to leave Lebanon faced opposition in the parliament, within the government, and in the public. The decision was implemented (as planned) in June 1985. The July 1985 decision to reform the Israeli economy also faced opposition. As both decisions were taken by the same government, the actual outcome of the decision to leave Lebanon, and the expected outcome of the economic stabilization program may have been linked by the public, lending credibility to the program. Since security issues are most important for Israeli citizens, leaving Lebanon as promised may have been perceived by the public as a sign of overall government's credibility, commitment to declared fiscal goals, and an ability to follow them through.

The need to leave Lebanon was mentioned in the statements of politicians and technocrat elites side by side with statements on the need to stabilize the economy. Accordingly, these statements might have been linked in the eyes of the public. The link was clear in the Labor party's and various other declarations. For example, in a pre-election interview the head of the Labor's economic team, Gad Yaacobi, mentioned the withdrawal from Lebanon in the same statement in which he discussed the Labor party's intentions to stabilize the economy.[27] The link between the withdrawal from Lebanon and the economic plan was also evident in a petition sent to the government by a group of social scientists on June 1984. The petition recommended two goals (and in that order): (1) leave Lebanon; (2) stabilize the economy.[28]

Israeli public opinion in January 1986 (five months after the economic reforms' inception) was investigated by Arian, Talmud and Hermann (1988). Based on a sample of 1172 Jewish respondents, the survey investigated topics related to national security and economic performance. According to the survey, 60 percent of Israeli public believed that security problems had a negative effect on Israel's economic situation. 70 percent agreed to make economic and social sacrifices in order to sustain Israel's political power. However, only 48 percent agreed to finance Israel's growing security expenses with additional taxes. Economic power was found to be a major contributor (second only to military power) to national security. 72 percent of the respondents answered that the economic situation was a major factor that raised doubts on their wish to live in Israel.

In summary, the Arian's et al. survey demonstrates that economic problems were directly linked to the way Israeli citizens perceived national political power in the 1980s. At the same time, Israeli citizens did not agree to finance an ever increasing government spending with additional taxes. Since the stay in Lebanon was perceived by the public as a major national security and economic hurdle, it is likely that the successful June 1985 withdrawal from Lebanon contributed to the credibility of the July 1985 stabilization program.

Crisis and civic culture

Most Israelis understood that in the early 1980s the economic situation was deteriorating.[29] As the inflation turned into a hyperinflation, indexation became less effective in keeping real income intact, the effects of indexation in feeding inflation became apparent, and public pressures to bring inflation down mounted.[30] The sense of crisis became so acute that on August 5, 1984, while naming Shimon Peres as his choice to form a national unity government, Haiim Herzog, Israel's President said that a national consensus existed in Israel that the country's economic situation was 'the most dangerous and difficult this state [Israel] has ever known.'[31] Itzhak Rabin, then Minister of Defense, said in September 1984 that fixing Israel's economy was the most important national priority.[32] The national print and electronic media during the period conveyed a sense of emergency. Being a free society, the economic situation was openly discussed in radio and television talk shows and in daily newspapers. It became common knowledge that Israel was going to run out of foreign reserves in a short time. This meant stopping imports, a thing which was intolerable for a country as dependent on imports as Israel.[33]

The sense of crisis was extremely acute in June 1985. The employees of 55 food factories, all local municipalities, truck companies, fuel stations, and taxies were on strike. The bank of Israel named the National Unity Government's policies as the principle reason for the economic crisis. And the head of the most influential parliamentary monetary affairs committee, Abraham Shapira, notified the press that he was going to 'put the committee on strike' for two weeks, protesting that the government had no clear economic plans how to solve the crisis.[34]

Israel is known for its robust civic culture and sense of nationhood. Being surrounded (at the time) by many unfriendly neighbors, Israelis knew that at times of crisis national unity is imperative. The feeling that there was no other alternative but to change the course of the economy helped to bring the two leading parties to the coalition table and assisted in creating a public atmosphere favoring nationwide economic reforms (Patinkin, 1993). Yet, it would be erroneous to attribute Israel's success in managing the political difficulties associated with its economic reforms only to its civic culture. A strong civic culture is not unique to Israel. Other countries with strong national identities such as Argentina, Russia, and Turkey have managed economic reforms less well. Civic culture as an explanation for Israel's economic stabilization success fails to account for the stabilization failures from 1979 to June 1985 and the success in July 1985, as the underlying Israeli civic culture was essentially static throughout the period.

National Unity Government

Scholars who argue that the formation of the National Unity Government contributed to the success of the program and enhanced its credibility are, in principle, correct.[35] The National Unity Government relayed a sense of elite unity to society and strengthened the power of state intervention in the economy. It is also likely that the public was aware that during the early 1980s the small parties in the Likud coalition were using their electoral power to gain financial benefits, a thing which increased the deficit.[36] In 1984 the political power of the small parties was neutralized by the Labor-Likud partnership. This may have contributed to the program's credibility since the National Unity Government did not depend on their political support (as long as Labor and Likud were able to push aside their disagreements).

However, similar to the civic culture argument, too much emphasis should not be placed here either. First, harder and more crucial political decisions were taken in Israeli politics (i.e. entering Beirut in 1982, staying in Lebanon after 1982, accepting Kissinger's 1974 peace plan, evacuating territories following the Israeli-Egyptian peace agreement, annexing the Golan Heights) without a broad-based coalition support. Second, the extent of the public belief in the stability of the National Unity Government to stabilize the economy is questionable as the Labor-Likud government had already failed in stibilization attempts from November 1984 to July 1985. Last, a previous Labor-Likud government in the late 1960s collapsed before the government reached its full term. While the late 1960s failure was caused by disagreements over the peace initiative advanced by the United States, similar disagreements were present in 1984, presumably were more pronounced than before.[37]

The public had also reasons to suspect that the National Unity Government was divided along inter and intra-party lines. First, within the Labor party there were several factions. The most salient were those centered around Shimon Peres and Yitzhak Rabin. Within the Likud party, Yitzhak Shamir's leadership was challenged by David Levy and Ariel Sharon. Second, the seven ministers that had voted against the program in the government were all from the Likud, while Yitzhak Rabin abstained. Third, in the parliament, 19 members of the coalition voted against the program and three members abstained. Some members of parliament from the coalition complained that the government was neglecting the poor. Other members argued against the proposed wage and price controls. Fourth, two previous Finance Ministers from the Likud (Yoram Aridor and Iigal Cohen Orgad) warned that the program was bound to fail.[38] Finally, as argued by Keren (1995), the key may not have been so much the creation of a National Unity Government, as the appointment of Shimon Peres as Prime Minister. That allowed for Histadrut-Government agreements that probably could not have been achieved between the Likud and labor. Hence, the extent of unity, and therefore credibility, which was conveyed by the National Unity Government is questionable.

Concluding remarks

The Israeli disinflation was followed by additional reforms, including budget cuts, financial market reforms, increasing the central bank's independence, and an ongoing privatization program. Looking back prior to late-1996, the results of the Israeli economic stabilization program have generally been stable. Following a relatively short recession during 1988-1989, the Israeli economy experienced several years of high economic growth rates, after which the economy settled on a steady growth of around 4 percent per year.

The economic instruments adopted in the Israeli case succeeded because an environment was created conducive to the needs and sacrifices associated with its implementation. Policy makers successfully signaled their commitment to reform. Importantly, the populace perceived government policies as credible. While we have identified possible sources of policy credibility in the Israeli case and ranked them, more research is needed to verify their relative contribution.

Future research on economic reforms in democracies should center on political rather than on economic issues. The economics of reducing high inflation were already known in the 1920s (and were partly implemented in Germany after World War I). What assures the success of such harsh economic measures in a democratic setup is a political environment conducive to their enactment. The causal variables are not economic. They are political.

Few governments have been able to implement the macroeconomic measures utilized in the Israeli case while gaining the confidence of the public in order to make them work. Understanding the reasons for the stabilization program's success and its politico-socio dynamics are, therefore, extremely important. Facing the economic crises in the former Soviet republics, Eastern Europe, and many developing countries, what is needed is a comparative study that will center on democracies that managed to carry out significant economic reforms and those that failed. Elaboration of the research program suggested by Williamson (1994) and others might extend the scope of the analysis. Emphasis needs to be placed on the constraints imposed by the political systems of each country. We especially urge a focus on the extent and sources of policy credibility and on the construction of popular support for economic reforms.

Democracy by itself does not seem to guarantee good or bad economic policy. Different types of regimes possess different strengths and weaknesses in confronting economic crises. Learning from the Israeli case, democracy can bring certain strengths to a radical economic program, such as national consensus and active cooperation that may be harder to muster in nondemocratic situations. However, the success of painful economic adjustments in democracies requires that the governments treat the public as an equal partner in the economic program. That is, the success of economic reforms in democratic countries requires that governments will rule not only for the people but also with the people.

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Notes

1. See, for instance, Shiffer (1986), Cukierman (1988), Bruno et al. (1991), Bruno (1993), Leiderman (1993), and Patinkin (1993).
2. See Nelson (1990) for overview.
3. See Liviatan and Piterman (1986), Fischer (1986), and Leiderman (1993) for economic interpretations of the causes to the Israeli hyperinflation.
4. See special issue of *Globs* (an Israeli business magazine – June 23, 1995) devoted to a ten year retrospective on the stabilization program, and Neubach, Razin, and Sadka (1990).
5. 1990–1993 inflation data are from Economist Intelligence Unit (various). 1960–1989 inflation data are from Israeli Central Bureau of Statistics (various) and from Neubach, Razin, and Sadka (1990). 1990–1993 economic growth rate data are from the Economist Intelligence Unit (various), 1981–1989 data are from the Israeli Central Bureau of Statistics (various), 1960–1980 data are from Bruno (1989) and from the Bank of Israel (1991).
6. For details, see D. Weissbrod and L. Weissbrod (1986).
7. See, for instance, Gray (1976), and Kleiman (1986).
8. See Liviatan and Piterman (1986), and Bruno and Fischer (1986).
9. Annual rate of unemployment, average labor productivity growth rate, investment, and monthly inflation data are from Neubach, Razin, and Sadka (1990).
10. See Bruno (1993) for details.
11. This is possible only in a parliamentary system. In a presidential system it is nearly impossible for two parties to share governmental responsibility. In this sense, parliamentary democracies can, at least potentially, respond better to economic crises.
12. See Skidmore (1977) for cases in which economic stabilization programs were accompanied by limitations of civil liberties. Haggard and Kaufman (1992) argue that the Bolivian success in dealing with the 1985 hyperinflation was accompanied by severe limitations of civil liberties.
13. See Shalev (1992) for details.
14. See Artstein and Sussman (1989), and Grinberg (1991) for details on this agreement.
15. Wiarda defines corporatism as 'A system of interest intemediation in which the major interests are granted quasi-monopolistic power and are integrated into the state rather than remaining apart from it as in liberal pluralism (1994: p. 200).'
16. Several scholars use corporatist theory to inform Israeli politics though they acknowledge that Israel has deviated from the tri-partite corporatist norm. For instance, Grinberg (1991), and Shalev (1992) argue that a dual labor market, the weakness of employer bodies, and the role of the Histadrut as an employer and labor union hindered the institutionalization of Israeli corporatism.
17. For a survey of the economic literature on credibility see Persson (1988).
18. This scenario is especially relevant to democratic regimes. Authoritarian regimes could outlaw wage increases and enforce price control by decree. However, some authoritarian regimes found it hard to enforce price stabilization in the long term. See Geddes (1995).
19. See, Yediot Aharonot, August 9, 1985.
20. Our ranking is subjective, however, we support it with empirical data. We are not aware of studies that have quantitatively ranked the sources of economic policy credibility in the Israeli or, for that matter, in any other case.
21. The team was headed by the director general of the Ministry of Finance (Immanuel Sharon). It included the economists Michael Bruno (Hebrew University), Eitan Berglas (University

of Tel Aviv), Mordechai Frenkel (Bank of Israel), Ammon Neubach (Economic adviser of the Prime Minister), Stanley Fischer (M.I.T.), and Herbert Stein (American Enterprise Institute).

22. See, for instance, Jerusalem Post, June 28, 1985.
23. See, Globs, June 23, 1995.
24. See Keren (1995).
25. The final structure of the budget cuts was announced in the Jerusalem post, July 3, 1985, at the eve of the program and after the withdrawal from Lebanon was completed.
26. Hardin (1982) discusses issue linkage in the development of norms and social conventions. Stein (1982) discusses the use of issue linkage to ensure economic cooperation. Patinkin (1993) argues in passing that the withdrawal from Lebanon may have contributed to credibility but does not elaborate.
27. See, Jerusalem Post, June 24, 1984.
28. See Ha'aretz (an Israeli daily newspaper), January 20, 1984.
29. See, for example, Patinkin's eye witness account of the sense of helplessness and 'the feeling of malaise that beset us from the constant changes in prices and exchange rate that were taking place, a malaise that was in part generated by fears that the increase in one's nominal income might lag behind the rate of inflation (1993: p. 112).'
30. See Kleiman (1986).
31. See New York Times, August 6, 1984. Note that in Israel, the President does not act in the name of any one party, but rather represents the public at large.
32. See Globs, June 23, 1995.
33. See Liviatan and Piterman (1986).
34. See Globs, June, 23, 1995.
35. See, for instance, Rivlin (1992), Barkey (1992), Patinkin (1993), and Bruno (1993).
36. See D. Weissbrod and L. Weissbrod (1986).
37. This was demonstrated a few years later when the Labor-Likud coalition collapsed following the Israeli-Jordanian 1987 London agreement which was supported by Labor and rejected by the Likud.
38. See Globs, June 23, 1995.

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