

יועצי השקעות ישראל | Israel Investment Advisors

The Economic Legacy of Shimon Peres

Brian J. Friedman, CFA
September 30, 2016

I first visited Israel in the summer of 1984, prior to my senior year of high school. Like most teen tours we visited the Old City of Jerusalem, hiked the Negev, floated on the Sea of Galilee, and ate falafel with hummus. Unlike most teen tours, however, we arrived as the Israeli inflation rate accelerated well past 400%. During our six-week trip, the Israeli shekel lost 1/3 of its value and fell another 50% by year-end. To preserve our limited funds – and to score some really good souvenir deals - my friends and I became savvy currency traders (sometimes with the black market dealers lurking on every street corner). As an impressionable American 17-year old, the experience was remarkable.

At the same time, Israel was in the final weeks of a cacophonous election campaign. I was thrilled by the political atmosphere. My friends and I were dimly aware that Ronald Reagan was campaigning for a second term back in the United States. Israeli teens, however, seemed quite politically engaged. In late July, Shimon Peres' Alignment party narrowly beat Yitzchak Shamir's Likud party. After months of political maneuvering neither Peres nor Shamir could form a government, so they joined forces in a historic grand coalition. Peres became Prime Minister for two years and then rotated the job to Shamir for the final two years of their term.

In 1987 I spent my junior year of college at the University of Tel-Aviv. During the intervening three years, hyperinflation was eliminated, and Israeli economic growth was 7%. How had this been accomplished? Why did Israel experience hyperinflation in the first place? In a thesis paper I wrote that year, I examined the history, structure and transformation of the Israeli economy. When Israel was a small scale society of only 600,000 people, its quasi-socialist system performed quite well. From 1948 through the late 1960s, Israeli Gross Domestic Product (GDP) grew by an average 10% per year. What changed in the 1970s and 1980s?

Stagnation and Crisis

By the early 1970s a larger Israeli population (about three million people in 1970) exposed the inefficiencies of the mature socialist system. Economic growth stagnated, exacerbated by global stagflation and mounting military expenditures in the aftermath of the 1973 Yom Kippur war. State-owned enterprises, Histadrut (the major Israeli labor union) companies and the kibbutzim were losing money, propped up by escalating state subsidies and higher taxes. By the early 1980s the Israeli economy was in crisis.

Life became very difficult for the average Israeli in the early 1980s. Per capita income for Israel's 4.2 million people was a meager \$6,000 per year. Government expenditures and debt exceeded 60% and 160% of GDP respectively, similar to Greece during the Euro crisis. Despite a costly military burden compounded by the 1982 Lebanon war, only 20% of government expenditures were allocated for defense. The remainder supported generous subsidies and social insurance programs. The Israeli government subsidized certain food products, insolvent public sector companies and the kibbutzim. The banks collapsed in 1983, prompting an expensive government bailout and takeover.

Prime Minister Peres and the Economic Stabilization Plan

The economic crisis and the Lebanon war pushed the two leading Israeli political parties into the national unity coalition government. In July 1985 the Israeli government led by Prime Minister Peres implemented a successful "Economic Stabilization Plan", which reduced the inflation rate, cut government spending and restructured public sector companies. Although difficult to discern at the time, the Economic Stabilization Plan inaugurated Israel's long climb out of distress to economic success.

In the 1990s Israel shifted from a socialist to a market economy, and economic growth accelerated in response. To further cement its new capitalist foundation, Israel gave its central bank – The Bank of Israel – more independence to maintain its disinflationary policies. As a result, the inflation rate dropped in Israel from 20% per annum in the late 1980s to almost zero at present, allowing interest rates to fall as well.

Although not always consistent or without acrimony, successive governments (both Labor and Likud) kept deficits and debt relatively under control. Over time Israeli government debt declined from 160% of GDP to 65% at present (vs. 72% in the United States). Since the early 2000s Israel consistently reduced its debt burden, while also reducing personal and corporate tax rates. Israel is the only developed country in the world where the debt to GDP ratio is lower today than prior to the financial crisis in 2008.

From Privatization to Competition

Privatization of public sector companies began in the 1990s and accelerated in the 2000s. Privatization removed the state from a dominant position in economic life, but in many cases merely transferred monopolies from state to private ownership. In 2013 the Israeli government initiated the next wave of economic reform with the "De-concentration Law", designed to inject more competition into the Israeli economy by breaking up monopolistic business groups.

While the next major wave of structural economic reforms is just getting underway, Israel is a much more dynamic and prosperous country today than it was 30 years ago. The gains in prosperity are the

payoff of past reforms and the down payment on future reform. With the benefit of hindsight, we now know that Prime Minister Peres' Economic Stabilization Plan was the crucial economic pivot point. As successive governments doubled down on his initial reforms, Peres remained an optimistic advocate of the dynamic transformation, despite his early grounding in the socialist Labor Zionist movement.

Israeli culture is skeptical bordering on cynicism. Shimon Peres was often derided by his countrymen for his optimism. I have visited Israel regularly since my first trip 30 years ago. I share Shimon Peres' optimistic outlook about Israel. Perhaps as outsiders we can witness the momentous change in Israel more vividly than Israelis caught in the struggles of everyday life. Shimon Peres was the rare individual that could view problems as opportunities and maintain perspective even when faced with difficulties and defeats.