ONE

Introduction

In 1882, when Zionist activity began, there were about 25,000 Jews in Palestine. By 1922, the Yishuv, or Jewish community in Palestine, had a population of 84,000. The national income was $8 million, or almost $1,500 per capita; by 1945, the Jewish population of Palestine was 550,000, and the national income had reached $147 million, or approximately $2,678 per capita, in constant prices and exchange rates. This was achieved under Ottoman and then British rule. In 1948, Israel declared its independence and was invaded by all of its neighbors. The war of independence left it without resources to absorb the huge immigration – its raison d'être – that arrived immediately following the war. Between 1950 and 2009, Israel's GDP[1] rose 34-fold, and its GDP per capita increased almost sixfold in real terms. By 2009, the population reached 7.4 million, the national income was almost $203 billion, and income per capita came to $27,275, using the 2008 prices and exchange rates.[2]

What explains the extraordinary eighteenfold growth of the Yishuv's economy? How can the growth of the Israeli economy be explained? The simple answer is population growth fed by immigration; imports of capital that permitted fast rates of investment; and successful organization and high levels of motivation. At a deeper level lie the issues of structural change, technological development, and economic policy making against a

[1] The terms gross national product (GNP) and gross domestic product (GDP) are used frequently in this book. Gross national product is total value of all final goods and services produced within a country in a particular year, plus income earned by its citizens (including those located abroad), minus income of non-residents located in that country. Gross domestic product is the total value of all final goods and services produced in a country in a given year, equal to total consumer, investment, and government spending, plus the value of exports, minus the value of imports. Where other definitions are used, they are explained in the text or in footnotes.

[2] Calculated using measuringworth.com

complex background of sociological and political change. Israel has capitalized on its disadvantages: It has always been at war and has lacked an economic hinterland in the Middle East. It therefore developed technologies to provide its armed forces with "quality" to match Arab "quantity," which were deliberately released for use in the civilian sector often great success. It also orientated its exports to markets in developed countries. This was both because nearby markets were closed and because the technological nature of its production made it suitable for more sophisticated markets. The benefits of this integration into the global economy have not been universally felt in Israel, and socioeconomic gaps have widened, fed in part by ethnic and religious factors. It has also had to overcome, like many other countries, many policy errors and other costs.

The Economy, 1948–2010

"As Israel's economy has strengthened, its society has weakened." This view, widely held in Israel, is the main theme of this book. It examines the Israeli economy at the beginning of the twenty-first century in its political, demographic, and social context. Emphasis is given to the links between economic growth and social policy, to the consequences of immigration, Israel's defense effort, relations with the Palestinians, the economics of minorities, and the role of religion. The scale of development over the last fifty years is illustrated in Table 1.1. It shows that between 1950 and 2009, the population rose sixfold, the gross domestic product increased 34-fold, and gross domestic product per capita went up eightfold.

On 14 May 1948, the state of Israel was declared; the next day, its Arab neighbors and other Arab states declared war and invaded it. The immediate economic problems were acute: War and mass immigration had to be financed; the government was committed to provide basic commodities to the existing population and to new immigrant. The creation of government administration was relatively easy, because semigovernmental Jewish institutions that had developed during the Mandatory period became government departments.

During 1949, cease-fire agreements were signed with the neighboring Arab states, bringing to an end a year and a half of fighting. Between the declaration of independence and the end of 1951, a total of almost 590,000 immigrants had arrived. Thus in its first three years, the Jewish population of Israel doubled. From 1949, the majority of immigrants came from Middle Eastern countries and most of them had much lower educational levels than those who came from Europe or had been born in Palestine. Immediate

Table 1.1. *Israel: Population, national income, and national income per capita, 1950–2009 (2005 prices and exchange rates)*

	Population (million)	GDP ($ billions)	GDP change between dates (percent)	GDP per capita ($)	GDP per capita: change between dates (percent)
1950	1.27	4.49		3,546	
1960	2.19	12.90	187.3	5,896	66.3
1970	2.97	28.91	124.0	9,720	64.9
1980	3.88	48.53	67.9	12,516	28.7
1990	4.66	69.50	43.2	14,916	19.2
2000	6.30	119.47	71.9	18,966	26.7
2009	7.43	152.79	27.9	20,577	8.5

Sources: Central Bureau of Statistics, Statistical Abstract of Israel, 2009; Central Bureau of Statistics, First Annual Flash Estimates of the National Accounts for 2009 (Jerusalem: Central Bureau of Statistics, 2009).

needs were met by a policy of strict austerity based on the rationing of basic commodities: inflationary government finance accompanied by price controls. Housing and employment conditions for immigrants improved only gradually. In 1952, black markets and the inefficiency of the controlled economy resulted in the introduction of a so-called New Economic Policy. This included the devaluation of exchange rate, gradual relaxation of price controls and rationing, and temporary curbs on immigration to ease the absorption of new immigrants and reduce unemployment.

The first comprehensive data for the new state was published in 1950 and showed that the gross domestic product (GDP) was almost $4.5 billion and GDP per capita came to $3,546 in 2005 prices (see Table 1.1). Exports per capita were only $27 whereas imports were $237; the huge gap between exports and imports resulted in a shortage of foreign exchange and was an additional reason for the government to take control of foreign trade and payments.

From 1950 until 1965, Israel experienced a fast rate of growth: National income in real terms grew by an average annual rate of more than 11 percent, and per capita income by more than 6 percent. This was made possible by the combination of immigration and large capital inflows: United States aid, mainly in the form of loans; unilateral transfers from the Jewish community abroad; German reparation payments to the government of Israel; and restitutions to individuals and the sale of State of Israel Bonds abroad. Israel thus had resources for public and private consumption and investment that exceeded its national income by approximately 25 percent. This made possible a massive investment program, financed largely through the government budget.[3]

The scale of needs and the socialist, but pragmatic, philosophy of the main political party in the government coalitions both led to massive state intervention in the economy. Governmental budgets and strong protectionist measures to foster import substitution encouraged the development of new industries, especially textiles. Subsidies were given to help the development of new exports, beyond the traditional exports of citrus products and cut diamonds. By the early 1960s, the government realized that the growth of Israeli firms – and thus output and employment – was being restricted by the size of the local market. New markets were needed, and so Israel negotiated the first trade agreement with the then-European Community (EC). This provided nearly free access to EC markets for Israeli industrial products and limited access for agricultural ones. The agreement with the EC was expanded in 1975, and a more comprehensive free trade agreement was signed with the United States in 1985. The latter covered industry, agriculture, and services.

The balance of payments constraint remained and resulted in periodic deflationary policies designed to restrain domestic demand, reduce imports, and encourage exports. Once the balance of payments improved, the restraints were eased. In 1967, this occurred because the Six Day War boosted government spending on the military and led to a wave of almost euphoric confidence in Israel. The encouragement of domestic military industries led to the beginning of what has since been called the high technology revolution. Confidence in Israel and its new strategic position as a regional power in the Middle East also encouraged small but significant foreign investment in research and development of technology. Between 1967 and 1973, about 100,000 immigrants arrived from Western countries. Many of them had financial capital as well as higher education and were able to enter the labor market and finance their own immigration. There was also a small immigration from the Soviet Union, a result of the United States policy of détente. The feeling of security encouraged social unrest: The neglected second generation of immigrants from the Middle East and North Africa no longer deferred to the country's Labor leadership. The government responded to the demonstrations by developing social

[3] Halevi Nadav. A Brief Economic History of Modern Israel. *Economic History Net Encyclopedia*. http://eh.net/encyclopedia/article/halevi.israel

welfare programs. These were funded out of a growing budget deficit that did not seem to be a problem because the economy was growing.

Positive economic trends ended with the Yom Kippur War of 1973. This brought massive loss of life, injury, and huge military losses. Government spending on the military grew but tax revenues were affected by the reduced level of economic activity that resulted from the war. From 1975, when Israel returned the Sinai oilfields to Egypt, the balance of payments suffered from the increase in the oil import bill. This worsened when international oil prices rose sharply in 1979. The government tried to stabilize the economy and also introduced a major reform of the income tax system.

In 1977, the Labor Party lost power and for the first time, a right-wing Likud, government came to power. This change was the result of the alienation of many underprivileged Jewish voters from the community that had its origins in the Middle East, a more general rejection of an increasingly corrupt Labor Party, and a delayed protest against the conduct of the Yom Kippur War. The new government combined nationalists who wanted to expand Jewish settlement building in the West Bank, populists who wanted to increase benefits to the poorer section of the community, and liberals who wanted to reduce government interference in the economy. The economic policies followed were a combination of all of these, and the results were a rapid acceleration of inflation, larger budget and balance of payments deficits, and rising foreign debt. All this was accompanied by slow economic growth. The signing of the peace treaty with Egypt in 1979 transformed Israel's security position. The Lebanon War that began in 1982 compounded the economic problems, and by 1985, after a number of unsuccessful attempts to stabilize the economy, Israel was on the edge of economic catastrophe.

In July 1985, a comprehensive stabilization program was introduced that simultaneously dealt with all the aspects of the crisis: hyper-inflation, dollarization (the shekel had lost its function as a store of value), huge budget and balance of payments deficits, and a loss of international financial credibility that made borrowing abroad hard and very expensive. The program reduced inflation from an annual rate of approaching 500 percent in the first half of 1985 to 20 percent in the second half. The budget deficit was slashed and the balance of payments strengthened. The United States provided $1.5 billion in aid that gave the program credibility both inside Israel and abroad.

Israel has lived in the shadow of the 1980s economic crisis ever since. To prevent inflation, the exchange rate was kept stable for much of the period from 1985 to 1990. In the mid-1990s, the government and the Bank of Israel (the central bank) decided that inflation should be brought down to 2–3 percent annually: This was achieved with tight economic policies. Israel's economy was transformed. In 1986–1995, following the stabilization of the economy in 1985 and with mass immigration from 1990 onward, GDP increased by an annual average rate of 5.2 percent.

In the 1990s, one million immigrants arrived, largely from the former Soviet Union. They helped transform the economy by expanding the local market and thus creating economies of scale. From 1992, the availability of United States loan guarantees encouraged an inflow of capital to balance that of labor and thus provide the basis for economic growth.

The economic stabilization program of July 1985 began a major reduction in the role of the state and the introduction of a new, more liberalized economic order. The relationship between stabilization and liberalization is an important issue. The early 1990s brought significant moves to liberalize foreign trade and capital markets. In the years 1996–2003, economic growth decelerated to less than 3 percent, which, when population growth is taken into account, meant that GDP/capita was the same in 2003 as it had been in 1997. This is the main reason these years have been called the "second lost decade." The main reason for the lack of growth was the negative impact of monetary and fiscal policies designed to reduce inflation still further, the collapse of the hi-tech boom in 2001, and the Second *Intifada*, or Palestinian revolt. By 2004, economic growth had recovered and continued at a rapid rate until 2008. In 2004, the tax on income from investments at home and abroad was equalized. This encouraged Israelis to find higher returns abroad and contributed to a rise in investment income. The boom – centered on the high-technology sector – encouraged a huge increase in foreign investment and was largely export-based. This pushed the balance of payments current account into surplus, and as a result, the foreign debt became negative, meaning that Israel accumulated net foreign assets. The stream of income on these assets helped strengthen the current account of the balance of payments. In 2005, the Bank of Israel abolished the "exchange rate path" used to prevent excessive changes, but in 2009, it bought billions of dollars to limit the rise in the shekel against the dollar and other foreign currencies. Exports per capita reached $5,400 and imports $6,830. The 2009 current account of the balance of payments had a surplus of $7.3 billion; the foreign exchange reserves reached $60 billion, having doubled in two years, and since 2003, the exchange rate of the shekel had risen against the US dollar by 16 percent in nominal terms. At the end of 2008, the foreign debt was negative $55 billion, which meant that Israel had accumulated net foreign assets equal to about a quarter of its national income.[4] In 2010, Israel is expected to join the Organisation for Economic Cooperation and Development (OECD).

The strengthening of the economy while the society has become weaker is a reversal or a perceived reversal: For many years, Israelis felt that their society was strong but their economy weak. This seems paradoxical given that between 1948 and 2009, Israel attracted more than 3 million immigrants – a very large number for a country the population of which at the end of 2008 was 7.4 million. In 1948, when the state was created, two-thirds of the population was born abroad. In 2009, one-third of the population was made up of immigrants. The effects of immigration are central in Israel's economic history. Economic policy has been dominated by the search for capital that would permit the growth of employment and output, given the increase in the supply of labor made possible by immigration. In the last decade, this has increasingly come from foreign investment, something that has transformed Israel's economy, especially the balance of payments.

Israel has also experienced a profound change from a state-led economy to a much more liberalized and globalized one. It has developed a consumer society based on the Western model in which the satisfaction of individual wants rather than collective needs is paramount. Public spending on social programs has been reduced and the distribution of wealth has become more unequal. One of the main consequences has been an increase in poverty. The book analyzes trends that, though not unique to Israel, have had particularly severe effects due to the nature of Israeli society and the severe security problems that it faces.

Structure of The Book

Chapter 2 provides the historical background prior to the creation of the state. It examines the way in which the Jewish community in Palestine developed, combining a socialist ideology with a reliance on private capital. Both the effects of British rule (1917–1948) and the conflict with the Arabs are looked at as factors that help explain the structure of the economy and the ideological framework when the state of Israel came into being in 1948. This was the period in which three uniquely Israeli institutions were created: the Kibbutzim, or voluntary collectives; the Moshavim, or

[4] Bank of Israel. "Inflation Report." July-September 2009. no. 28. Table 7. Jerusalem: Bank of Israel. http://www.bankisrael.gov.il/deptdata/general/infrep/eng/inf-09–3e.pdf; Central Bureau of Statistics. Monthly Bulletin of Statistics. No. 10. 2009; Bank of Israel. Israel's External Financial Transactions. http://www.bankisrael.gov.il/deptdata/pik_mth/pikmth_e.htm

cooperative settlements; and the Histadrut, or General Federation of Labor. The Histadrut was not only a federation of trade or labor unions, but also an employer and provider of services on a scale that led it to be described as a state within a state; its headquarters in Tel Aviv were even nicknamed the "Kremlin" by Israelis. Another important institution that had its origins in the pre-state period was the public ownership of land.

Chapter 3 analyzes the development of the Israeli economy from 1948 to 1985. The economy passed through a number of distinct phases after independence. The first decade was dominated by the absorption of immigrants and state control of the economy. In the mid-1950s, the focus of economic policy moved away from agriculture to industry, within the framework of import substitution. The government encouraged Jewish entrepreneurs from abroad to invest in basic industries such as textiles and clothing. The economy grew rapidly in the 1950s and 1960s, although there were shortages of foreign exchange that necessitated deflation and periods of slower growth. These were years in which an egalitarian ethos prevailed and income inequality was much less than it is today. They were also years of austerity, at first so severe that many decided to emigrate. The share of government spending in GDP was much smaller than in recent years, partly because defense costs were lower and because the egalitarian income distribution limited the pressure for government intervention. Changes in government policy were generally pragmatic and were introduced when they would best serve the interests of the economy.

The Six Day War of 1967 was followed by a wave of optimism that resulted in high investment rates and rapid economic growth, but the Yom Kippur War in 1973 was a major blow to the economy. Apart from the loss of life and direct economic losses, it added to inflationary pressures and worsened the budget deficit and balance of payments. Although emergency steps were taken to stabilize the economy, the combination of economic liberalization and inflation led to severe instability in the late 1970s and early 1980s. Hyperinflation was the result, along with balance of payments and foreign debt servicing problems. The period 1974–1984 thus became known as the "lost decade." Numerous policy errors worsened the situation until, in July 1985, a radical and comprehensive stabilization program was introduced.

Chapter 4 examines macroeconomic developments, the sources of economic growth, and economic policy in recent years. It analyzes the development of the labor force, the capital stock, investment patterns, and the role of research and development, and then looks at the way in which the structure of the economy has changed and the mixed performance of productivity. It concludes with an examination of how the balance of payments and foreign debt have been transformed.

Chapter 5 deals with the globalization of the economy and the development of the high-technology sector. It emphasizes the role of foreign trade and its influence on economic growth and the labor market. Two sectors are compared: high technology that demonstrates the effects of globalization and the construction sector that has relied on cheap, imported labor and has, as a result, experienced very weak productivity growth. Conclusions are then drawn about the effects on economic growth and equity.

Israel's foreign trade relations were defined with the signing of free trade agreements with the European Community (EC) in 1965 and with the United States in 1975. Israel gained free access for its industrial goods and limited but adequate access for its agricultural products in EC markets. The EC agreement was later broadened by agreements to encourage joint technology development projects. The agreement with the United States was broader, covering industry, agriculture, and services. By the early 1990s, the government realized that free trade with rich countries only distorted trade and wasted foreign exchange because imports from cheaper sources were restricted whereas those from expensive countries were not. In the early 1990s, following the expansion of diplomatic and trading relations in Eastern Europe and Asia, Israel unilaterally eliminated quotas and reduced the taxes on imports from so-called third countries with which it did not have trade agreements. This led to a large increase in imports from India, China, and other countries; foreign trade had become liberalized to a great extent. The domestic effects were that consumers gained access to much lower-priced goods, and firms that could not compete reduced their activities or closed down.

One of the most important elements of Israel's economic structure is the very high level of defense expenditure that is examined in Chapter 6. Israel spends a larger share of its national income on defense than most developed countries and has done so for many years. The role of conscription and other hidden costs is detailed, as are economic aspects of Israel's defense relationship with the United States. The development of military industries and exports and the role of the military establishment in generating trained labor for the civilian high technology sector are also analyzed.

Chapter 7 examines Israel's relations with the Palestinians and the construction of Israeli settlements in the West Bank and Gaza. The economics of the relationship have been very one-sided: Israel was the industrial power and it imported unskilled or semiskilled Palestinian workers. The chapter suggests that apart from political consequences, many of Israel's policies have often been very damaging to its own economy.

The role of religion is the subject of Chapter 8, an issue that is almost unique to the Israeli economy: The Israeli government intervenes extensively in religious matters (and religious parties intervene extensively in politics) and allocates large resources for religious services and religious education. In fact, it goes much further and has subsidized the creation of a form of priesthood numbered in the thousands. This has had effects on the state budget, on the supply of labor, and on levels of poverty and on educational standards. Estimates of these costs are made.

The economics of Israel's Arab minority are examined in Chapter 9. After the creation of the state in 1948, the Arabs comprised about 20 percent of the population. This proportion remained constant throughout Israel's history, despite the large Jewish immigration. The economic and demographic factors affecting the Arab community are examined. In recent years, there have been changes in demographic patterns and in educational achievements that are of great potential significance.

Chapter 10 begins with an examination of demographic developments and changes in the ethnic composition of the population. The rapid increase in the population, largely the result of immigration, has been a major factor driving economic growth. Changes in the ethnic makeup of the Jewish population have had significant effects on Israeli politics and the values that dominate life in Israel. This took time to manifest itself: The children of immigrants who arrived in the 1950s helped alter the political course of direction from the 1970s. There is a paradox in Israel's political economy: Those who suffered most from economic liberalization often voted for the political parties that favored it. This can be explained in part by the ethnic element in voting patterns, a reflection of long-term social change. This was related to the waves of immigration that arrived in the country, each with a different background and values. It also reflects deep disillusionment with the strong state and trade union movement that dominated the economy until the 1970s. Although Israelis rejected the paternalism of these bodies, they have not totally abandoned the desire for a welfare state and other institutions that bind society together. The chapter then explores socioeconomic issues: income distribution, poverty, and welfare in the light of the globalization of the economy and government stabilization policies. The role of the Ultra-Orthodox and the Arab communities are also analyzed as explanations of income differentials and poverty levels. The role of the education system is examined.

Conclusions are drawn in Chapter 11. Given the burdens of defending the country and some self-inflicted costs, the performance of the economy has been remarkable. Pragmatic economic policy is a good thing as long as