ECONOMIC FREEDOM AND ITS ENEMIES

By Sever Plotzker

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When the British left the country, they didn't leave us a single pound sterling, says David Brodet, Chairman of Bank Leumi. Previously, Brodet has served as director-general of various economic ministries, including the Finance Ministry, as chair of numerous committees charged with equally numerous reforms, as the Israeli representative responsible for economic relations with the Palestinians, etc., etc. It is unlikely that there is any other economist in Israel with the same abundant practical experience in economic policy. This makes him particularly suited to sketch the path taken by the Israeli economy as it went from what he calls, "slavery to freedom."

Upon leaving the country, the British left behind more than just an unresolved national conflict. They also left a state-in-the-making with almost no means of subsistence. According to Brodet: "There were shortages of everything. Israel was established in an atmosphere of enormous shortages. There wasn't enough food, there was no fuel, and there was no foreign currency."

An impoverished state with no future?

"In 1948, the per capita gross domestic product was the equivalent of $4,000 today. In other words, it was just one-tenth of the per capita GDP in the country's 70th year, which is anticipated to be $40,000. We have scrambled up from being an impoverished economy with no chance of success to a very respectable position among the ranks of the developed nations."

But as economist Brodet recalls, the Israeli economy was at its nadir, not in 1948, but in 1951-1952. During the first three years of independence, Israel's population almost doubled, growing from 800,000 to 1.5 million. As a result, the per capita GDP per year plunged sharply by 40%, to $2,500. That is less than the per capita GDP today in the Palestinian territories, including Gaza.

How did we get out of this slump? Brodet notes four critical decisions made by Prime Minister David Ben Gurion, which laid the foundations for future growth. The first decision was to obtain foreign currency, or "hard currency," from every possible source. Ben Gurion realized that without foreign currency, Israel would never extract itself from its backwardness. That is why he signed the Reparations Agreement with "the other Germany" and created a contribution mechanism among American Jewry, which included the aggressive marketing of Israel Bonds.

The second critical decision was to rein back the defense budget and keep it in line with economic constraints. Ben Gurion rejected demands by his highly regarded Chief of Staff, Yigael Yadin, when he asked for an enormous budget – by those standards – for the IDF. Brodet says: "Ben Gurion made it clear to Yadin that the young State of Israel had economic and social needs too, or as he put it, that building up the nation is no less of a priority than defending the nation. The defense budget for 1953 was set at just 7% of GNP. Insulted by this, Yadin resigned.

The third critical decision was to establish a development strategy for the coming years based on agriculture, population distribution, and labor-intensive industries. "Agriculture," Brodet explains, "was intended to be the leading branch of the economy. It provided food for Israel's growing population and raw materials – i.e., cotton – for textile factories in the new development towns built near agricultural centers. Agriculture, construction, and textiles are all labor-intensive branches of the economy. Apart from food, housing, and clothing, they also provided creative employment opportunities to the masses of immigrants. Relying on them at the time was the demand of the hour."

For the most part, the contribution of Israel's second finance minister, Levi Eshkol, is evident in the implementation and ethical aspects of this strategy. Brodet says: "Eshkol recognized the great importance of professional governmental institutions, which are critical to the management of states. He reorganized the Finance Ministry with all its many divisions and advocated for the creation of the National Insurance Institute and an independent Bank of Israel."

Popular discourse takes a disparaging view of the sovereign State of Israel's economy in its first decade. Like most other economists, however, Brodet relates to economic decisions made by the country's leaders with respect and admiration. Even the temporary rationing of staples from 1949 to 1952, commonly known as the "austerity regime," was subjected to a professional purge in the 1960s in breakthrough studies by young professors in the Hebrew University's Department of Economics. While the austerity regime did suffer from drawbacks and distortions and lasted longer than was absolutely necessary, it is doubtful whether it would have been possible to run a different economic policy in those years of scarcity. Brodet says that, "Israeli governments in the 1950s showed that they understood the complexity inherent in running a modern economy and therefore adopted a long-term view and a set of national priorities. The positive impact of this could be felt until the mid-1970s. By the eve of the Yom Kippur War [1973], Israel's per capita GDP reached the equivalent of $14,000 today. At the time, Israel was described as an economic miracle, alongside Japan and West Germany. Dulik [David] Horowitz, first Governor of the Bank of Israel and a noted economist in his own right, spread the story of Israel's economic success all around the world.

You skipped over the dramatic recession of 1965-1966.

"The recession stemmed from fears among Israel's economic leadership that the country was facing a renewed shortage of dollars. Reparations were running out, financial aid from American Jewry was declining, and foreign investors avoided Israel because of the Arab boycott. It was obvious that the country's development strategy was in need of fundamental change. It had to transform itself from a closed economy, based primarily on relatively simple work – an economy which exported little and strived to replace imports with locally produced goods – into a market open to international trade, which gradually abandoned burdensome protectionist policies designed to encourage locally produced goods, and which sought ways to specialize in export branches based on scientific and technological innovation, while reducing the role of agriculture, construction, and textiles."

It was revolutionary even in today's terms. In the 1970s, Israel manufactured everything, or at least tried to manufacture everything, from automobiles, radios, and televisions to clothing and processed food. "The national ethic," as Brodet recalls, "was economic independence, in the sense of providing most goods and services locally. It wasn't easy to replace that with a new ethic, in which Israel would be integrated into the global economy, or what we now call 'globalization.' It wasn't easy, but it was necessary."

The change of Israel's economic strategy began with an event which did not receive any special attention at the time. This was the signing of a modest agreement with the European Economic Community in 1965 by which there would be a gradual, mutual reduction of tariffs. As Brodet explains, "Even as early as when Eshkol, Sapir, and Rabinovitz served as finance ministers, Israel's governments realized that if we stay out of the Common Market, we will not have any export markets and we will be unable to make the breakthrough to export-led growth." That is why, after ten years and two wars, Israel signed a comprehensive free trade agreement with the EEC in 1975. Brodet believes that this was the most important benchmark in Israel's transition from a closed economy to an open one. "Imports," he explains, "stopped filling the role of a national enemy. After the Yom Kippur War, when defense costs approached 30% of the GNP, it became very clear to the country's economic leadership that without a massive influx of imports, Israel would not return to a path of growth and development. At the same time, massive imports demand foreign currency, which can only be raised by the large scale export of Israeli brain power."

According to Brodet, these are the underlying principles of Israel's economic worldview. Despite frequent changes in governments, prime ministers, and finance ministers, they have not changed. "Yes to globalization, no to isolationism; yes to innovation and knowledge-based industries, no to old technologies and the industries based on them; yes to the promotion of exports, and no to reliance on the limitation of imports; yes to an educated and skilled workforce, no to unprofessional labor resulting in low productivity."

Have 30 years of progress toward economic freedom come to an end?

In the sixth decade of its independence, Israel has achieved total economic freedom, thanks to the internalization of these principles and the steady implementation of a global strategy, and despite the various pitfalls and crises. The worst of these was the deep-rooted and unnecessary crisis of 1977-1983, the result of the Begin government's rash decision to implement total liberalization of the foreign currency market prematurely. On the other hand, one million immigrants from the former Soviet Union and the international consequences of the Oslo Accords played an important role in attaining economic freedom.

And what is freedom?

"Foreign currency reserves in excess of $100 billion, an annual surplus in balance of payments in excess of $10 billion, foreign investors competing over the acquisition of Israeli companies in knowledge-based industries, and complete freedom from the anxiety of overseas debt: that's a bird's eye view of Israel's economic freedom today. That's the journey we've taken."

Have we reached the Promised Land?

"We're not there yet. Look at the exceptional poverty rates, the high inequality indices, the dearth of education, health, and transportation infrastructures, and the disappointing levels of productivity. That is why it is incumbent upon us to reassess the paradigm of market development. We must take a closer look at the near and distant future. We must be bold in exposing the difficulties lurking in the Israeli development model."

What I take away from David Brodet's remarks is that economic freedom is very difficult to achieve and very easy to lose.