Do International Advisers Matter?
Case Studies of Israel's Economic Policies

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When and Why Do International Advisers Influence Economic Policy?

We use a qualitative methodology to address this question:

- We use the (limited) research literature on advisers to generate *possible scenarios* and *purposive grounded hypotheses*.
- *Purposive sample*-case studies of six famous foreign economists who advised Israel from 1950 to 1985: Kalecki, Lerner, Kahn, Friedman, and Fischer and Stein, based on detailed archival research/new historical facts.
- We present the case studies in the context of the *possible scenarios* and *purposive grounded hypotheses*, then show that the case studies *confirm our purposive grounded hypotheses*.

A Theory of the Adviser-Policymaker Relationship (1)

Let A = Adviser, P = Policymaker.

Agency Problem:
A's interest ≠ P's interest

A's interest = his perception of the public interest
P's interest = political interests mixed with the public interest
(Acemoglu and Robinson 2013)

Information Problem:
A's information > P's information
A's cost of failure < P's cost of failure

Due to P's lack information regarding consequences of policies, A can manipulate information in framing his policy recommendations' so that P loses control over the direction of policy (Aghion and Tirole 1997).

A Theory of the Adviser-Policymaker Relationship (2)

Scenario	Interests	Outcome
I. Crisis	Good policy (=advancing the public interest) is good politics.	P follows A's advice even in the absence of (IMF-style) conditionality
II. Convergence	P's original policy/interests ≈ A's perception of the public interest.	A recommends the policy already chosen by P. This creates the illusion of influence by A.
III. Divergence	P's original policy/interests diverge significantly from A's perception of the public interest.	P ignores/rejects A's advice.

In the real world, a policy advice episode may combine elements of different scenarios.

Purposive Sample:
Foreign Economic Advisors in Israel, 1950-1985

Advisor	Years	Official?	Formal?	Implemen-tation/ Outcome	Note
Michal Kalecki	1950	No	Yes	None	
Abba Lerner	1953-56	No	Yes	None	Member, Economic Advisory Staff and adviser to FM Eshkol
Richard Kahn	1957/62	No	No	None	
Milton Friedman	1977	No	No	Partial/ poor	Invited by Begin Government
Stanley Fischer and Herbert Stein	1985	Yes-US State Dept.	Yes	Almost complete/ successful	Played key role in July 1985 Stabilization

Scenario I-Crisis: Fischer/Stein 1983-1985

- In late 1983, US Secretary of State George Shultz asked Fischer and Stein to work with Israeli economists and policymakers ("persuasion among friends").
- **Until the crisis peaked in June 1985, their advice was ignored (Scenario III-Divergence).**
- The July 1985 stabilization resembled previous stabilization plans:
  - March 1985-Fischer and Stein's "Ten Points"
  - December 1984-Emanuel Sharon's proposal (authorized for discussion by PM Peres)
  - July 1984-a plan presented by Israeli economists (including Elchanan Ben Porat and Haim Ben Schachar)

Why did the Peres government wait so long to listen to Fischer/Stein? Only in June 1985 did it finally acknowledge the reality that Israel was in crisis: **Foreign currency reserves had dwindled to $2.6 billion, below the "red line" of $3 billion.**

Scenario II-(Initial) Convergence: Kalecki 1950

When the Progressive and General Zionist parties expressed strong opposition to MAPAI's quasi-socialist policies, **Ben Gurion's government turned to Kalecki, expecting him to validate the status quo**.

Kalecki's report advocated **more, not less, government intervention**:

- Retain the fixed exchange rate and maintain "the strictest possible" exchange controls
- Retain price controls
- Reduce imports, increase exports, reduce capital imports
- Use export premiums to save foreign currency
- The state should organize investments, but "[investment for] modernization [of industry] is a luxury that the Israeli economy cannot afford for the time being"."

Scenario II-(Initial) Convergence: Lerner 1953-1956

Lerner was a member of the Economic Advisory Staff, appointed by the government in May 1953 and headed by US economist Oscar Gass.

Lerner's macroeconomic views were **compatible with MAPAI's interests**:

- **Functional Finance-accumulation of public debt is not harmful** as long as it promotes full employment (1943).
- Support for direct creation of jobs by means of **public works** (1944,1951).
- Under a full employment policy, **the import surplus is not harmful** (1951).

Soon after his arrival in Israel, **Lerner advocated intervention and controls to overcome "market" and "effective demand" failures**, which he called **"secular stagnation."** These ideas, and his well known emphasis on attaining full employment, **were compatible with MAPAI's interests**.

Scenario II-(Initial) Convergence: Friedman 1977

May 17	"Political Revolution"-Begin's Likud Party defeats Labor Party
Ca. May 19	The designated Finance Minister, Liberal Faction leader Simcha Ehrlich, invites Friedman to advise. **Ehrlich begins to work on floating the currency/currency liberalization, as advocated by the Liberals and Begin since the 1950s.**
July 3-8	Friedman visits Israel, meets Begin, Ehrlich among others. **Recommends extensive free market reforms. Ehrlich does not discuss his planned reform with Friedman.**
July 17	**Ehrlich announces cuts in defense and subsidies**, in order to impress the US government ahead of Israel's aid request. **Friedman: "These were not my suggestions, but they are a step in the right direction."**
October 28	**Reform-exchange controls abolished, export subsidies and import tariffs reduced, IL devalued 47% and then floated.** VAT increased from 8% to 12%. **Friedman is ecstatic ("Entebbe Again!"). Begin and Ehrlich deny having taken his advice.**

Scenario III-Divergence: Kalecki 1950

Circumstances shifted dramatically in 1951:

- In the July 1951 election, **the electorate expressed strong dissatisfaction with the status quo,** giving the General Zionists 20 MKs, up from 7. **MAPAI understood the message.**
- In 1951, **Israel's international position deteriorated**: The trade deficit widened by 27%; external foreign currency reserves declined by 48.5%.

The New Economic Policy of February 1952 was diametrically opposed to Kalecki's views. It consisted of:

- (Nominal) devaluation
- Import liberalization
- Increased capital flows
- Most rationing and price controls abolished
- Absorption of demand by raising the domestic price level
- Reductions in credit and the budget deficit

Kalecki: "Instead of simply ignoring my advice, **the Israeli government did exactly the opposite**."

Scenario III-Divergence: Lerner 1953-1956

Lerner's views began to deviate from MAPAI/Histadrut interests:

- **Reconsider the draft Bank of Israel law**, which grants the BOI too little independence, gives its Governor too much discretion, and assigns the BOI multiple functions that are beyond the scope of monetary policy. Lerner did not back down despite **strong criticism from David Horowitz.**

- **To attain economic independence in the next ten years**, halve export prices, double import prices, and increase labor productivity **by "working harder" and real wage reductions.**

- **Abolish the COLA**,* which is inflationary and harmful to workers, **and replace it with a Wage Authority** that links increases in the average wage to productivity growth.

***In 1956, Lerner made two failed attempts to mobilize the public directly regarding this issue**.

Scenario III-Divergence: Kahn 1957/1962

While in Israel for private and academic visits, Kahn met with Israeli policymakers such as Foreign Minister Golda Meir and BOI Governor David Horowitz.

- He advocated **major COLA reform**: Reduce protection against real wage erosion through the COLA, and **move closer to the Swedish wage setting model, in which the COLA plays only a minor role.**

- In 1957, he predicted that the EEC customs union would harm Israel's trade, and that **Israel's application for EEC Associate Membership would be rejected.** In 1962, **he stated that Israeli policymakers were overoptimistic regarding the chances of attaining EEC Associate Membership.** They also overestimated the potential benefits of an Israel-EEC commercial agreement.

Kahn's advice **contradicted the interests of MAPAI/Histadrut** and was therefore ignored.

Scenario III-Divergence: Friedman 1977

Dec. 1977	Ehrlich seeks a zero deficit but Begin sides with recalcitrant coalition partners; planned deficit/GDP=10%. **Thereafter, no further free market reforms are passed.**
1978	**Privatization revenue target=$100 million** **Actual privatization revenue= $10 million**
April 1979	Inflation (previous 6 months, annual rate)=74%. **Capital controls are re-imposed; almost nothing remains of the "revolution."**
Nov. 7, 1979	Ehrlich is forced to resign. **Inflation (1979q3, annual rate)=132%.**

Summary and Conclusions

Scenario	Supporting Case Studies	Note
I. Crisis	Fischer/Stein 1985 (also Zelekha 2003)	Fischer/Stein prescriptions were **rejected until a crisis was perceived**; **once a crisis was perceived they were mostly implemented.** Once the crisis ended, their prescriptions were partially and gradually undermined.
II. (Initial) Convergence	Kalecki 1950, Lerner 1953-56, Friedman 1977	**Advisers were invited after certain major policy decisions had already been made.** Friedman was kept on the dark regarding planned reforms.
III. Divergence	Kalecki 1950, Lerner 1953-56, Kahn 1957/62, Friedman 1977	A**dvisers were excluded once their recommendations deviated from the ruling party's interests.** Friedman was publicly rejected.

For Further Research

- Larger samples—more countries, episodes/advisers and policy recommendation
- Impact of interactions between Israeli and foreign advisers, if any
- The role of IFI's (IMF, World Bank): Did Israel implement IFI recommendations in noncrisis situations, in the presence of conditionality (e.g. reduction of export subsidies in Oct. 1977, as advised by the IMF) ?

Thank You!