The package deal

Israel's 1985 stabilization and the end of an inflation spiral

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Abstract

In July 1985, with inflation running at an annualized rate near 500 percent, Israel's national unity government adopted an emergency package: an orthodox core - a budget cut of 1.5 billion dollars, 7.5 percent of GDP, a devaluation of about 20 percent followed by a fixed rate, and deep subsidy cuts - joined to a heterodox wrapper: a wage agreement signed by the Histadrut union federation and the employers after a general strike, price controls imposed by emergency regulation, and a 1.5-billion-dollar American grant. Recorded annual inflation fell from 449.7 percent in 1984 to 185.2 in 1985, then 19.7 in 1986 and 16.1 in 1987, while GDP growth rose from 0.9 percent in 1984 to 4.0, 4.2 and 7.1. In September the currency shed three zeros. This case examines how a democracy stopped inflation without recession, what held afterward, and what Sri Lanka's 2022-24 disinflation can conditionally borrow from it.

Why this case for Sri Lanka

Sri Lanka's recent inflation was stopped the other way. Consumer-price inflation peaked at 69.8 percent in September 2022, and by December 2024 the index was falling 1.7 percent year on year - the fourth consecutive month of deflation, driven largely by energy price reductions on Central Bank data. The instruments were demand compression, fiscal consolidation under the IMF's Extended Fund Facility of about 3 billion dollars, approved on 20 March 2023, and a new central bank law - the Central Bank of Sri Lanka Act No. 16 of 2023, passed by Parliament in July 2023 and published on 15 September 2023 - that made price stability the bank's primary mandate - with no wage-price agreement anywhere in the mix, and with GDP contracting 7.3 percent in 2022 and 2.0 percent in 2023 before growing 5.0 percent in 2024 on World Bank data. Israel in mid-1985 faced inflation at an annualized pace near 500 percent and stopped it without a recession, in a package that paired a negotiated wage agreement and regulated price controls with a deep budget cut and a fixed exchange rate. The comparison is about which instrument does the work when the state cannot print its way out: crushing demand, or changing wage- and price-setters' minds at once.

The starting point: a spiral everyone fed

Israel's inflation, on the Bank of Israel's own series, ran 132.9 percent in 1980, 105.1 in 1981, 131.5 in 1982, 190.7 in 1983 and 449.7 in 1984. By mid-1985 monthly inflation was running at 15 to 20 percent on the NBER's account, and the Journal of Economic Perspectives retrospective describes the pace the program inherited as an annual rate close to 500 percent - a measure distinct from the 449.7 percent recorded for calendar 1984 on the annual series. The mechanics were self-reinforcing: a large budget deficit, wages indexed to prices through cost-of-living allowances, prices indexed to the exchange rate, and the exchange rate chasing both - every actor protecting themselves and, in doing so, feeding the spiral. The political opening came from deadlock: the July 1984 election produced no winner, so Labour and Likud formed a national unity government with Shimon Peres as prime minister under a rotation agreement. A coalition spanning both major blocs made a negotiated package politically possible - but the Histadrut and the employers still had to sign for themselves.

The decisions: cut, fix, freeze - and bring the unions and employers in

The emergency program adopted on 1 July 1985 had an orthodox core and a heterodox wrapper, as the World Bank's retrospective classifies it. The core: an announced budget cut of 1.5 billion dollars, 7.5 percent of GDP, below the 1984 budget; a devaluation of about 20 percent to 1,500 shekels per dollar on 2 July, then a fixed rate; deep subsidy cuts that raised basic food prices by as much as 75 percent; and tight monetary policy. The NBER's account also records cuts to import duties and export subsidies inside the same package - protection was being traded away as the rate was fixed, so the traded-goods sector could not rely on the price system to defend it. The wrapper: a negotiated wage agreement and controlled prices. A one-day general strike answered the package on 3 July; on 16 July, after an all-night bargaining session, the Histadrut federation and the employers' organizations signed a temporary wage agreement, and price controls were imposed by emergency regulation. Two moves locked expectations: a special American grant of 1.5 billion dollars, in two equal 1985 and 1986 installments, which rebuilt the central bank's reserves, and a new currency - on 4 September 1985 the new shekel replaced the shekel at one to a thousand.

The decision chain: dates

When	What happened
1980-1984	Inflation climbs on the Bank of Israel series: 132.9 (1980), 190.7 (1983), 449.7 percent (1984)
September 1984	National unity government takes office after deadlocked elections; Peres prime minister under rotation
1 July 1985	Cabinet adopts the emergency stabilization program: 1.5-billion-dollar budget cut, devaluation then fix, subsidy cuts, price controls
2 July 1985	Shekel devalued about 20 percent to 1,500 per dollar (about 25 percent including days-earlier adjustments), then fixed
3 July 1985	One-day general strike shuts shops, airport and government offices against the austerity
16 July 1985	All-night bargaining: Histadrut and employers sign a temporary wage agreement; strike averted
4 September 1985	New shekel becomes the currency at 1 to 1,000 old shekels
Late 1985	First 750-million-dollar US grant tranche lands; monthly inflation falls from 15-20 percent to 1-3 percent
1986-1987	Annual inflation 19.7 then 16.1 percent; GDP growth 4.2 then 7.1 percent (World Bank)
1992	Crawling exchange-rate bands replace the fixed rate, en route to inflation targeting (IMF)

Measured outcomes I: the spiral breaks

The disinflation was immediate and enormous. The program's stated aim was to cut monthly inflation from around 15-20 percent to virtually nil, accepting 2-3 percent a month at first; the NBER's account records 1-2 percent a month within a few months, and the Journal of Economic Perspectives retrospective records the annual rate falling from close to 500 percent to less than 20 percent within two months - corresponding, respectively, to average compounded monthly rates of 16.1 and 1.5 percent - with minimal adverse employment effects. On the Bank of Israel's annual series: 449.7 percent in 1984, 185.2 in 1985, 19.7 in 1986, 16.1 in 1987. Just as important: no recession. GDP growth - 0.9 percent in 1984 - reached 4.0 percent in 1985, 4.2 in 1986 and 7.1 in 1987 on World Bank data, and the NBER's two-year review found no visible unemployment cost. Foreign-exchange reserves rose on the American grant. The operational budget deficit fell by about 8 percent of GNP in six months (World Bank) - delivered, not just announced.

Two things carried the expectations burden, on the IMF's retrospective analysis: the devaluation itself and the first 750-million-dollar tranche of the American grant, which was highly publicized. The grant mattered because it was a grant rather than a loan - reserves rose without new obligations, which made the fixed rate credible to defend. The Bank of Israel's annual report records the fall in inflation as concentrated in the second half of 1985: the first half still ran at the old pace, the second at the new one. That asymmetry is the case's central exhibit. A freeze is an announcement; what made this one bind was that the workers, employers and shopkeepers setting prices could see the fiscal arithmetic underneath it had already changed (desk interpretation).

Measured outcomes II: the price of the freeze, and what held

The freeze was not painless and was never meant to be permanent. Employment costs were bounded rather than absent: the NBER's two-year review found no visible unemployment cost, while the Economic Policy assessment records a modest rise in unemployment. The designers treated the freeze as scaffolding - its job was to hold prices still long enough for the budget cut to become credible, then come down (desk interpretation). Subsidy cuts raised food prices up to 75 percent at the start; the wage agreement held only to April 1986, after which indexation resumed in modified form; and price controls were lifted gradually. The durability problem also stayed visible: inflation was still 16.1 percent in 1987, and only in 1992, with inflation well below 20 percent, did Israel move from the fixed rate to crawling bands and eventually inflation targeting on the IMF's account - stabilization was a decade-long project, not an event. The symbolic instrument deserves its own verdict: the Bank of Israel describes the new shekel's three dropped zeros as intended to simplify payments, and the redenomination stopped no inflation by itself; its function was to make the break visible (desk interpretation). The record's own summary is complementary: the NBER credits the combination of a real fiscal cut with the wage agreement that held the new anchor while expectations reset, and the IMF's analysis credits the devaluation and the first grant tranche with carrying expectations.

Transfer limits: what Israel 1985 does not prove

First, the cushion was a gift. The 1.5-billion-dollar American grant reflected a strategic relationship no debtor can order up; Sri Lanka's equivalent support, the IMF's Extended Fund Facility, is a conditioned loan, which changes both the politics and the room for error. Second, someone could sign for labor. The Histadrut then represented most organized workers and a unity government spanned the aisle; a fragmented union landscape cannot deliver a signed freeze, and Sri Lanka's disinflation accordingly ran without one. Third, in this case the freeze rested on a delivered fiscal anchor - the World Bank credits an 8-percent-of-GNP deficit reduction in the first six months, and the package's own design treated the budget as the anchor and the wage agreement as the hold on expectations (desk interpretation). Fourth, the inflation's composition matters: Israel's spiral was indexation-driven, so breaking indexation broke the spiral, while Sri Lanka's 2022-23 inflation was heavily import-and-energy-driven and its 2024 deflation was delivered largely by electricity and fuel price reductions on Central Bank data - a wage-price freeze would have targeted the wrong lever (desk interpretation). Fifth, even the comparison with the other 1985 stabilization separates the wrapper from the core: Bolivia's Decree 21060, signed eight weeks later the same summer, stopped a far faster hyperinflation with an orthodox package alone - a float, a fiscal cut and no signed wage-price freeze - and paid for it in output and jobs, as this series' Bolivia case records. Israel's recession-free outcome is what the signed freeze is usually credited with, and the two cases together are why the wrapper is taken seriously (desk interpretation).

Sixth, much of the primary record (Bank of Israel reports, NBER papers by program architects) comes from the institution and economists who ran the stabilization; outcomes above were cross-checked against World Bank and IMF series where possible.

Conditional lessons for Sri Lanka

These are design observations, not prescriptions.

1. Announce the fiscal number, then deliver it visibly. Israel's credibility came from a delivered 8-percent-of-GNP deficit cut in six months, not the announcement. Sri Lanka's EFF framework publishes fiscal targets; the transferable practice is measuring and publishing delivered consolidation at the same frequency as the targets.

2. Give the break a visible symbol. The new shekel marked the regime change for every shopper. Sri Lanka's analogue is legal rather than numismatic - the Central Bank of Sri Lanka Act of September 2023 - and symbols only work when the substance is already moving (desk interpretation).

3. If incomes policy is ever used, it must be signed, temporary and dated. Israel's wage agreement had a union federation able to sign and an expiry - April 1986 - after which modified indexation resumed. An unsigned price freeze by decree alone has no Israeli precedent in this case's record.

4. Match the instrument to the inflation. An indexation spiral yields to a freeze; an imported-energy price shock yields to supply and tariff policy, as Sri Lanka's 2024 deflation via electricity price reductions shows. Choosing between them is diagnosis, not doctrine (desk interpretation).

5. Arrange the external cushion before the freeze. Israel's grant rebuilt reserves as the rate was fixed. Sri Lanka's EFF disbursements - about 3 billion dollars over four years from 2023 - are staged and conditioned; the lesson is to lock the cushion's credibility before asking price-setters to hold still (desk interpretation).

The case's real claim is narrow: between 1984 and 1986 Israel cut recorded annual inflation from 449.7 percent to 19.7 percent without a recession, in a package where the fiscal cut was delivered and the wage agreement was negotiated with the union federation and employers whose pay it bound. For Sri Lanka, which disinflated through contraction instead, the case is a study of the instrument that was not available - and of the conditions that would have to exist before it could be.

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