United States General Accounting Office

GAO

Report to the Chairman, Committee on Appropriations, U.S. Senate

February 1992

ISRAEL

U.S. Loan Guaranties for Immigrant Absorption

GAO/NSIAD-92-119

GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-247481

February 12, 1992

The Honorable Robert C. Byrd
Chairman, Committee on Appropriations
United States Senate

Dear Mr. Chairman:

As you requested, we reviewed the $400 million housing loan guaranty program authorized for Israel in May 1990 and evaluated the effect on Israel's debt burden of the U.S. government's granting the additional $10 billion in loan guaranties that Israel requested in September 1991. Our objectives were to (1) examine the use of the $400 million loan guaranty to see whether it was used in accordance with applicable agreements and understandings between the United States and Israel, (2) determine whether Soviet Jewish immigrants are being offered special incentives or are receiving subsidies to settle in occupied territories, and (3) evaluate whether Israel's basis for estimating the future immigration of Soviet Jews is reasonable.[1] With regard to the proposed $10 billion loan guaranty program, our objective was to analyze the impact of the guaranties on Israel's debt-servicing capabilities.

Results in Brief

Israel is expected to certify in February 1992 that it used the $400 million U.S. loan guaranty to finance about 12,300 loans valued at about $425 million for Soviet immigrant housing mortgages within Israel's pre-1967 borders. Such use would be consistent with the key provisions of the guaranty. The program was implemented by attributing the loan guaranty to local currency expenditures for mortgages; however, because of the fungibility of money, other Israeli government funds were made available for use as the government determined, including use in the occupied territories.

As part of the assurances given by the Israeli government in connection with the release of the loan guaranty, Israel agreed to provide periodic data on its settlement activities and spending in the occupied territories. Incomplete information was provided on settlement activities, but Department of State officials provided no evidence that any information on government spending in the occupied territories was provided.

[1]The term "Soviet immigrants" in this report refers to immigrants from the former Soviet Union.

Israel has not directed or required Soviet immigrants to settle in the occupied territories, and it does not offer special incentives that are unique to Soviet immigrants for settling there. However, Israel's stated policy is to encourage settlements in the occupied territories, and it offers numerous incentives and allowances to all Israelis, including Soviet immigrants, who will settle there. The State Department estimates that as many as 8,800 of the Soviet immigrants who entered Israel in 1990 have settled in the occupied territories, including East Jerusalem.

We found that the Israeli government has a reasonable basis for its estimate that about one million Soviet Jews will immigrate to Israel during the current wave. There is no consensus, however, on how quickly this level will be reached. Israel estimates that about 200,000 additional immigrants will arrive each year through 1994, but Israeli officials we interviewed said the influx could be more than 200,000 or less than 100,000 per year.

Our analysis indicates that if the United States provides the $10 billion in loan guaranties requested by the Israeli government, Israel will likely be able to fully service its external debt and to continue its past record of payment under most foreseeable circumstances. However, the large size of these guaranties makes them more risky to the U.S. government. The level of risk involved, if these loans are guarantied to Israel, will depend to a great extent on Israel's implementation of its absorption plans[2] and the economic reforms urged on it by U.S. and Israeli experts. The more fully and rapidly the reforms are adopted and the more closely Israel follows its strategy to employ new immigrants in the private sector rather than in the public sector, the stronger Israel's ability to repay the loans will be.

Background

Israel is in the midst of an immigration wave that it expects will reach about one million people and increase its population by over 20 percent within a relatively short period. From late 1989 through 1991, more than 380,000 immigrants arrived in Israel, 332,000 of whom were from the former Soviet Union. The Israeli government estimates about 600,000 more immigrants will arrive by the end of 1994, at a rate of about 200,000 annually.

The Dire Emergency Supplemental Appropriations Act of 1990 (P.L. 101-302), enacted on May 25, 1990, authorized a $400 million housing

[2]Various agencies of the Israeli government have developed plans to deal with absorbing immigrants. The plans of the Bank of Israel and the Ministry of Finance are the most prominent, and in this report are referred to as the "Israeli government absorption plans."

loan guaranty program for Israel in response to its request for help in coping with the housing needs of Soviet immigrants who began to come to Israel in late 1989.[3] The loan guaranty was administered under the Agency for International Development's (AID) Housing Guaranty Program.

Israel expects that it will cost an additional $60 billion (in 1991 dollars)[4] from 1992 through 1996 to absorb the immigrants, and it has asked the U.S. government to guaranty the repayment of $10 billion to be borrowed in $2 billion increments over 5 years from commercial sources. According to Israel's absorption plans, these funds are to provide housing, infrastructure, jobs, clothing, food, education, transportation, training, and other services to arriving immigrants Israel expects that over this period of time its private and public sectors will need to borrow a total of about $21 billion to $25 billion from external sources—including the $10 billion—with the rest of the absorption costs funded from internal sources. According to Israeli officials, because of the large sums involved, it is unlikely that Israel will be able to borrow from external sources anywhere near the desired amount, or on the terms Israel believes it needs, without these loan guaranties.

Use of the $400 Million Loan Guaranty

U.S. policy has been to oppose Israeli settlements in the territories captured by Israel in 1967.[5] Consistent with this policy, the Israeli government was prohibited by the loan guaranty agreement from using the proceeds from the $400 million guaranty program for activities in the occupied territories. Israel complied with this prohibition by attributing the expenditure of an equivalent amount of Israeli currency (shekels) for mortgage loans to Soviet Jews buying homes within Israel's pre-1967 borders. Israel is expected to certify in February 1992 that it has financed 12,303 loans valued at about $425 million for Soviet immigrants within its pre-1967 borders. However, the actual use of the foreign exchange (dollars) borrowed by Israel cannot be determined because money is fungible—funds made available through loan guaranties made other Israeli funds available for use as the Israeli government determined. The dollars were deposited with the Israeli Ministry of Finance and became

[3]The United States also makes grants to the United Israel Appeal to help settle Jewish immigrants in Israel. For fiscal years 1980 through 1989, the United States contributed $204 million for this purpose, and in 1990 and 1991, as the number of immigrants increased, it contributed $30 million and $51 million, respectively.

[4]$70 billion in current dollars.

[5]In this report, we use the State Department definition of the occupied territories: that is, all territory captured by Israel during the 1967 war—the West Bank, the Golan Heights, the Gaza Strip, and East Jerusalem.

commingled with other money, thus losing their separate identity. (See app. I for more information on the 1990 housing guaranty program.)

Israeli Housing Strategy

We found that the $400 million guaranty program had no discernible effect on Israel's housing policies and did not influence the Israeli government's decisions on where to build new housing or on how much settlement activity to undertake in the occupied territories. The primary effect of the loan guaranty was to give the Israeli government access to borrowed funds at a lower interest rate.

In accordance with Israel's political and security objectives, the Israeli government's strategy is to encourage population dispersal throughout all parts of the country. This strategy includes encouraging housing construction and settlement in the periphery of the country and in the occupied territories. Although it is Israeli government policy not to direct Soviet immigrants to settle in these territories or to provide incentives only to Soviet immigrants to encourage them to move there, the government provides strong financial incentives to encourage any Israeli, including immigrants, to do so. As a consequence of this Israeli government policy, much of the new housing being built is being constructed in the periphery of the country and in the occupied territories, and the Israeli population in these areas is expected to rise over the next few years.

Incentives to Live in Occupied Territories

Despite Israeli government support, many Israelis have been reluctant to live in the periphery of the country and in the occupied territories. Consequently, the government's housing program provides substantial incentives and subsidies to encourage developers to build in these areas, where there is a relatively high risk that they will be unable to sell the homes. These incentives for developers include (1) a program whereby the government will purchase up to 100 percent of housing units within a development project in the periphery of the country and in the occupied territories if these units remain unsold; (2) discounts up to 100 percent on the assessed value of the land and on the costs for infrastructure improvements, such as roads, water and sewage systems, and electricity in peripheral areas and in the occupied territories; and (3) accelerated construction grants of up to $15,000 per unit in multiple-story buildings if the developer completes the building within 7 months.

Incentives are also offered to Israeli citizens, including new immigrants, to settle in the occupied territories and in the periphery of the country. These incentives include (1) preferential mortgage treatment, (2) a 7-percent income tax liability reduction, (3) government-constructed religious study centers, (4) subsidies for children living in the territories but attending school within Israel's pre-1967 borders, (5) larger grants to support social services than those provided within Israel's pre-1967 borders, and (6) subsidies for businesses to create employment opportunities in settlement areas.

The Israeli government's reliance on subsidies and incentives to encourage developers to build in less desirable locations, including the occupied territories, is costly. U.S. and Israeli officials estimate that builders may be unable to sell as much as 40 percent of the newly constructed housing units and will probably exercise the government purchase commitments. The proposed Israeli 3-year budget for fiscal years 1992 through 1994 allocated almost $1.9 billion to cover these costs.

Israeli government officials could not say how many Soviet immigrants currently live in the occupied territories but estimated that about 1,500 of the immigrants who entered Israel in 1990 chose initially to live in the West Bank and Gaza, excluding East Jerusalem. The State Department's estimate is much higher; the Department believes that about 8,800 of the 185,000 Soviet immigrants who entered Israel in 1990 live in the occupied territories. We were unable to reconcile this disparity. (See app. II for further discussion of Israel's housing strategy and incentive programs.)

Immigration Estimates

Israel appears to have a reasonable basis for estimating that about one million Soviet immigrants will arrive during the current immigration wave, which began in late 1989. About 332,000 had already arrived at the end of 1991, and Israel expects about 200,000 to arrive annually over the next 3 years. Israel bases its estimate on continuous monitoring of the situation of Jews in the former Soviet Union, the number of Soviet Jews who have requested "letters of invitation," and the number who have exit permits and immigrant visas. While the basis for Israel's overall immigration estimate appears reasonable, the rate at which Soviet Jews will immigrate to Israel is less certain. Some Israeli officials believe that arrival rates could vary from fewer than 100,000 to more than 200,000 a year, depending on economic and social conditions in the former Soviet Union and economic conditions—particularly employment—in Israel. (See app. III for more information on Soviet immigration.)

Israel's Debt Service Capability

We believe that if the Congress authorizes the $10 billion in loan guaranties requested by the Israeli government, the Israeli government will likely be able to fully service its external debt and to continue its past record of payment. However, this is not without some level of risk to the U.S. government, due in part to the large size of the guaranties given to one country. The level of risk could be minimized if the Israeli government fully implements its major absorption plans. Key elements of these plans include the rapid achievement of many structural reforms and a strategy to employ immigrants in the private sector, not in the public sector or in public works programs. If Israel follows these plans, it will have only a modest decrease in its solvency (its long-term ability to carry external debt) until 1995, followed by increasing solvency; Israel's liquidity (its short-term ability to service external debt) will decline moderately for several years and then continue the rapid improvement of the past 6 years.

The level of risk to the U.S. government increases if Israel does not fully implement its absorption plans, but it will probably still be able to fully service its external debt. In this case, the decline in Israeli solvency will be greater, lasting until 1995, than it would be if the plans are fully implemented. If Israel implements its employment strategy but does not adequately accomplish structural reforms, the decline in its solvency will be moderate. If Israel does not follow its employment strategy, the decline in its solvency will be significantly greater.

While the U.S. government should expect that guarantied loans will ultimately be repaid at no cost to it, legislation now requires the Congress to appropriate funds to cover the risks of potential defaults. The Federal Credit Reform Act of 1990, as contained in the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508), applies new accounting methods and procedures to U.S. guaranties and other credit programs. Beginning in fiscal year 1992, the Office of Management and Budget is required to calculate, on a net present value basis, what the U.S. government could reasonably expect to lose over the life of a credit transaction. The calculation takes into account such factors as the cost of money at the time the loan is issued, the interest rate charged by the lender, and the risk that the United States may be required to make payments in the future if a lender is not paid under the terms of the loan.

During the past 7 years, the U.S.-Israeli Joint Economic Development Group has been perhaps the most important mechanism for the State Department to assess the Israeli economy's fundamental problems. This advisory panel, which is cochaired by a senior government official and assisted by two nongovernmental distinguished economists as well as other government officials from each country, has reinforced the influence of reform-minded officials in the Israeli government. However, structural reforms have not been implemented as extensively or as rapidly as U.S. representatives have advocated.

Additional incentives for the Israeli government to implement its absorption plans could be provided in two different ways. First, the U.S. government could condition annual disbursement of the guarantied loans on annual certification that Israel was making satisfactory progress in implementing its absorption plans. Second, some or all of the expected costs of the guaranties could be passed on to Israel at the time of the annual disbursement. This could be done either by requiring escrow funds from Israel equal to expected costs or by requiring that Israel pay part or all of the U.S. government's expected costs at the time of the loan guaranty disbursement. This would give Israel added incentive to implement reforms. If reforms are quickly and fully implemented and the employment strategy is followed, Israel can expect its future fees or escrow to be lower. Setting the fee at 100 percent would pass on all of the expected costs to the Israeli government. (See app. IV for further discussion of Israel's absorption plans and its ability to service its external debt. See app. V for an overview of Israel's economy.)

Matters for Congressional Consideration

If the Congress decides to authorize the $10 billion in loan guaranties for Israel, to be disbursed in $2 billion annual increments, it may wish to consider the following actions to strengthen Israel's capacity to repay the loans and reduce the risk of loss to the U.S. government:

- Require that before the annual disbursements of the loan guaranties, the U.S. component of the U.S.-Israeli Joint Economic Development Group certify that Israel has (1) made satisfactory progress in implementing needed structural reforms and (2) followed the absorption plans' strategy and not significantly increased nondefense public sector employment or public works projects.
- Require that at the time of each disbursement of loan guaranties, Israel either (1) pay a fee to the U.S. Treasury in an amount equal to a set percentage of the loan loss reserves the Office of Management and Budget sets aside for the disbursement or (2) place in escrow at the U.S. Treasury an amount equal to the loan loss reserves that the Office of Management and Budget sets aside for the disbursement.

Scope and Methodology

We conducted our review in Washington, D.C.; New York City; Boston, Massachusetts; Tel Aviv; and Jerusalem. In Washington, D.C., we interviewed and obtained records and documents from officials of the Department of State, AID, and the Israeli Embassy. In New York, we met with Israeli government officials, and in Boston and in Washington, D.C., we interviewed and obtained information from noted economists. While in Israel we met with Israeli government officials at the Ministry of Finance, the Bank of Israel, the Ministry of Construction and Housing, the Ministry of Absorption, the Ministry of Industry and Trade, the Central Bureau of Statistics, and the Office of the Prime Minister. We also met with Jewish Agency officials,[6] economists, and representatives from Israel's business, labor, and banking sectors.

Our evaluation of the impact of $10 billion in loan guaranties on Israel's ability to service external debt involved analyzing (1) the efficiency and functioning of the Israeli economy, including structural reforms implemented recently and those being considered; (2) Israel's solvency and liquidity during the recent past and projected future; (3) ratings by others of Israeli sovereign risk; and (4) market prices and characteristics of the Israeli government's external debt. We projected the effect of $10 billion in U.S.-guarantied loans and of other planned external borrowing on Israel's debt burden. We present in this report five different scenarios, all of which assume that the underlying trends concerning Israel's external debt size and composition will continue and that Israel will be able to borrow absorption funds as planned. Important distinctions among these five scenarios were the degrees to which the Israeli government implemented structural reforms and whether it followed its employment strategy. Our projections did not consider the geopolitical risk associated with Israel's ability to service its external debt.

We conducted our work from September 1991 to January 1992 in accordance with generally accepted government auditing standards, except that State Department officials who could speak authoritatively on what information Israel was expected to provide as part of the assurances associated with the 1990 housing loan guaranty program and whether such expectations had been met declined to meet with us.

We did not obtain written agency comments; however, we discussed this report with State Department and AID program officials and have included their comments where appropriate.

[6]The Jewish Agency is a private organization focused on assisting Jews to immigrate to Israel and participating with the Israeli government in resettling them in Israel.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 5 days from the date of this letter. At that time, we will send copies to the Secretary of State, the Administrator of the Agency for International Development, and other interested congressional committees. We also will make copies available to others upon request.

This report was prepared under the direction of Harold J. Johnson, Director, Foreign Economic Assistance Issues, who may be reached on (202) 275-5790 if you or your staff have any questions. Other major contributors to this report are listed in appendix VI.

Sincerely yours,

Frank C. Conahan

Frank C. Conahan
Assistant Comptroller General

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Abbreviations

AID	Agency for International Development
GNP	gross national product
OECD	Organization for Economic Cooperation and Development

Israel's $400 Million Housing Loan Guaranty Program

The Dire Emergency Supplemental Appropriations Act of 1990 (P.L. 101-302), enacted on May 25, 1990, authorized a $400 million housing loan guaranty program for Israel in response to its request for help in coping with the housing needs of a growing wave of Soviet immigrants who had begun to arrive in Israel in late 1989. The loan guaranty was administered under the Agency for International Development's (AID) Housing Guaranty Program, which helps developing countries meet their shelter and infrastructure needs.

According to AID officials, the Israeli program is not a traditional housing loan guaranty. The program is many times larger than a typical housing loan guaranty administered by AID. Also, AID's housing guaranty programs typically have a developmental focus. For example, a typical program provides housing for low-income households and assists governments in developing their housing policies. The Israeli program does not have such goals. Also, the requirement that the program be focused on families living below the median income was waived for Israel.

The Congress significantly reduced the fees typically charged housing guaranty recipients that are used to cover AID's administrative costs and build a reserve fund for paying any future claims. Typically, a 1-percent up-front fee and a fee of 1/2 percent per annum of the unpaid principal balance of the guarantied loan would have been required. Based on these percentages, fees for the Israeli program would have been $4 million up front and about $45.9 million in fees over the life of the program. The Congress set the fees for Israel at $2.8 million up front and not more than $125,000 per annum over the 30-year life of the program.

Israel Provided Program Assurances

After the Congress authorized the Israeli program in May 1990, the Department of State began preparing for the negotiation of assurances from the Israeli government that these funds would be used in a manner consistent with the legislation and U.S. policy. According to State Department officials, this process did not begin in earnest until September 1990 for a variety of reasons: a new Israeli government was formed in June 1990, and Persian Gulf war hostilities began in August 1990. In September 1990, State Department and Israeli officials discussed the housing loan guaranty and associated assurances, and these discussions culminated in an October 2, 1990, letter from Israel's Foreign Minister to the Secretary of State.

The letter stated that the Israeli policy not to direct Soviet immigrants to settle in the occupied territories would continue, that there were no special incentives exclusively for Soviet immigrants to encourage them to settle in the occupied territories, and that Israel would not use the guarantied funds for financing activities in the occupied territories. In addition, the letter discussed assurances concerning information to be provided on housing activities. The letter stated:

> As I know you will be reporting to Congress on this loan program, let me say further, I am prepared to agree that we will provide you periodically with the Government's building plans for housing for immigrants including special financial incentives. I will also use my best efforts to provide annually as complete information as possible on the Government of Israel's financial support for settlement activity, and periodically as well to inform you of any government settlement activity.

In response to these assurances, the Secretary of State authorized AID to begin its technical work on the program. Later in October, Israel's Foreign Minister sent a second letter that, according to a State Department official, stated that he wanted to make sure that the earlier letter had made no commitment, either directly or indirectly, for Israel to refrain or be restricted from building in East Jerusalem or in any other place, including Judea, Samaria, and Gaza.[1] A State Department spokesperson, in an October 19, 1990, press conference, said that the second letter "does not alter or change the first negotiated letter." Neither the State Department nor Israeli officials would provide us a copy of the second letter.

The State Department provided documentation showing that between November 1990 and mid-February 1991, the Israeli government furnished information on (1) its building plans for housing immigrants and (2) its financial incentives programs. Specifically, Israel reported the number of housing starts and completions by government housing districts, explained its absorption and mortgage system, and described various aspects of its construction industry. Israel also provided some limited information on settlement activity in the West Bank, such as the number of housing starts and completions for 1990 in existing settlements, and it reported that no new settlements had been started during the year.[2] On February 20, 1991, after receiving this information, the Secretary of State authorized release of the guaranty and determined that it could be transferred in one disbursement. The loan guaranty was released by AID in March 1991, and the Israeli government completed its financing arrangements with the loan

[1] Judea and Samaria are the biblical names for the West Bank.

[2] Similar information was not provided for the Golan Heights, East Jerusalem, or the Gaza Strip.

underwriters on March 28, 1991. The loan proceeds were transferred to the Israeli Ministry of Finance on April 9, 1991.

The State Department provided no evidence that the Israeli government has furnished any information on its financial support for settlement activities. The Israeli government reported that providing such information is difficult because its budget system does not distinguish between expenditures in the occupied territories and expenditures within its pre-1967 borders. State Department officials stated that, while housing construction in the occupied territories has visibly increased since about June 1990, the exact number of units and the amount of financial resources directed to the settlements are unknown to them. They stated that the Israeli government has shown no interest in publicizing comprehensive data on settlement activity and, in some cases, has organized data in a way to make separating commitments for Israel proper and for the occupied territories nearly impossible.

Status of the Program

The Israeli government complied with the U.S. prohibition against using the guarantied loan proceeds in the occupied territories by attributing the entire amount to local currency expenditures for Soviet immigrant home mortgages. For a mortgage to qualify for attribution to the AID program, (1) the recipient had to be a Soviet immigrant arriving after January 1, 1990, and have applied for a mortgage after April 1, 1990; and (2) the home's location had to be within Israel's pre-1967 borders.[3]

The Accountant General's Office in the Ministry of Finance hired an Israeli accounting firm to verify the eligibility of the housing mortgages it had attributed to the $400 million loan. The accounting firm selected for verification a random sample of about 10 percent of the mortgages declared eligible under the $400 million program. The firm reviewed mortgage bank files to verify compliance with program eligibility criteria. It did not make site visits to locations of the homes purchased because this was not required in its contract with the Accountant General. On the basis of its review, the accounting firm certified that during the eligibility period, April 1990 through May 1991, 12,303 qualifying mortgages had been issued, for a total of $425.138 million. Israeli documents indicate that these mortgages represented about 86 percent of all government-issued mortgages to Soviet immigrants during this period. The government of Israel expects to provide its certification of compliance in February 1992.

[3] The Israeli government excluded the city of Jerusalem as an eligible location for a mortgage under this program.

AID is also verifying program compliance through site visits to 124 randomly selected mortgagees. On the basis of our analysis, we believe that AID is using a reasonable approach for verifying whether the Israeli government has complied with the specific terms of the project agreement. The survey firm AID hired to conduct the verification used a cluster sample approach to select locations for visits. The survey consisted of a 20-minute questionnaire with mortgage recipients that addressed program eligibility and collected other housing data. During our fieldwork in Israel, we accompanied an AID consultant and the local survey contractor during the pretesting phase. The homes we visited were occupied by Soviet immigrants who had met the eligibility criteria for the housing guaranty program.

Although the Israeli government chose not to tie the loan proceeds to imports of goods and services from the United States, during 1990 and 1991 Israel contracted for $147 million in caravans and prefabricated and mobile homes from the United States and to date has imported approximately $122 million worth. The Israeli government recently indicated that the construction industry had caught up with demand and that there would be no further purchases of foreign-produced housing, although other housing construction materials would still need to be imported.

Technical Assistance

Included in the Israeli housing loan guaranty program is a $1 million technical assistance component financed equally by AID and the Israeli government.[4] This component focuses on identifying key constraints and policy problems that affect the cost, availability, affordability, and quality of housing in Israel and assisting the Israeli government in addressing them.

The first project, which will focus on financing housing in Israel, was expected to begin in January 1992. AID is planning other projects to focus on construction financing, the environmental impact of absorbing one million Soviet immigrants, reform of the National Building Code, and local community planning. Israeli government officials told us they believed that the projects would help them improve the efficiency of their housing sector and that they had found AID's previous assistance useful.

[4]The technical assistance component was not financed from the $400 million loan guaranty. The U.S. share ($500,000) was financed by fees AID received to cover program expenses, and the Israeli share ($500,000) was provided by the Israeli government.

Israeli Housing Construction and Mortgage Policies

When Soviet immigrants began to arrive in Israel in large numbers during late 1989 and 1990, Israel's most pressing problem appeared to be providing housing for them. In 1990 Israel estimated that about 300,000 new housing units would be needed within 5 years to house the country's rapidly growing population. Until 1990 only about 20,000 homes were being started annually, and the Israeli housing industry was in a slump. In response, the Israeli government took on a much larger role in the housing sector than it had previously, adopting policies and providing financial incentives aimed at both increasing housing construction and making housing more affordable. In accordance with the country's political and security objectives, the government's strategy is to encourage population dispersal throughout all areas of the country. This strategy includes encouraging housing construction and settlement in the periphery of the country and in the occupied territories.

By 1991, housing starts were keeping up with demand, and construction completion time had declined dramatically, from over 24 months in 1989 to about 12 months in 1991. As a result of the steps taken by the Israeli government, the anticipated housing shortage for immigrants has not occurred. While providing sufficient housing is a continuing absorption concern, it is not an immediate crisis. However, other issues have emerged over the costs associated with Israel's housing strategy.

Increased Role of Government in the Housing Industry

To meet the immediate housing needs of immigrants, the Israeli government purchased prefabricated housing and mobile homes. At the same time, the government began to substantially increase its sponsorship of new housing construction by providing financial and other incentives intended to encourage developers to build housing, particularly in Israel's periphery and the occupied territories, where demand for housing was weaker.

This increased government sponsorship represented a change in policy from the previous decade, during which the government's role in home construction declined. Until the late 1970s, the government sponsored or financed at least half of the housing starts in Israel, but by the end of the 1980s, its activities had dropped to 14 percent of the total. In 1990 about 55 percent of housing starts were sponsored by the government; this increased to 73 percent during the first 9 months of 1991.

Housing starts—public and private—more than doubled from 19,850 in 1989 to 42,890 in 1990,[1] and an estimated 80,000 housing starts were expected in 1991. The share of housing starts in the occupied territories increased. According to one Israeli government report, in 1990 about 4 percent of public housing starts, 810 housing units, were located in the West Bank and Gaza; data for the first 9 months of 1991 show that the percentage increased to almost 10 percent and the number of housing units to about 4,500. Another Israeli government report states that during 1990 and the first 6 months of 1991 construction began on 18,000 housing units in the West Bank and on 2,740 units in the Gaza Strip and Golan Heights. The Israeli government's 1992 budget shows that it plans to finance 15,000 new housing starts in 1992, including 5,000 in the occupied territories.

Incentives Provided to Developers

The government's incentives to developers are credited with achieving the increase in housing starts. The incentives essentially reduce overall construction costs, diminish risk for builders, and promote accelerated construction. A major incentive is the government's commitment to purchase up to 100 percent of housing units in the periphery of the country and in the occupied territories if they remain unsold. Under this program, the government agrees in advance to purchase some or all of the units at a given site should the developer be unable to sell them. The government purchase price is based on an index of construction prices, including a profit margin plus additional costs specific to the project. Although the concept of a purchase commitment is not new, before the current building program began, the government would rarely agree to purchase commitments in excess of 30 percent of the total number of units. The government has also permitted developers to begin exercising the purchase option during construction, allowing developers to receive 50 percent of the commitment when the building's shell is completed, with subsequent payments being made at various stages of completion.

The government has revised its land-use policy and has made more land available for housing. It offers discounts to developers of up to 100 percent on the assessed value of the land in the peripheral areas and the occupied territories, and it also offers discounts of up to 100 percent of the costs for infrastructure improvements, such as those made to roads, water and sewage systems, electricity, and communication lines. The discounts are

[1]These figures exclude mobile homes. Most government-sponsored housing is constructed of stone or concrete and grouped either in six- to eight-story apartment buildings or in semidetached one- to two-story houses.

intended to reduce the overall price of government-sponsored housing, thus making the units more affordable for immigrants and other Israelis.

The government also offers an accelerated construction grant of up to $15,000 per unit in multiple-story buildings if the developer completes the building within 7 months. For each month thereafter, the graduated bonus declines by approximately 10 percent. The intent is to decrease substantially the time involved in constructing new housing. This incentive is credited with reducing housing construction time from an average of over 24 months in 1989 to about 12 months in 1991.

Government-Financed Mortgages Available to Israelis and Immigrants

In addition to offering incentives for the housing industry to expand its construction and to make housing more affordable, the Israeli government provides low interest mortgages and grants to enable more Israelis, including immigrants, to purchase homes. About 75 percent of mortgage loans are funded by the government, and almost all Israelis are eligible to receive government housing assistance of some type. Mortgage programs exist for immigrants, young couples, those living in substandard conditions, and tenants of public housing projects wishing to purchase their apartments.

Of the various mortgage programs, the immigrant program offers the largest mortgages. Under the immigrant program, the size of the mortgage and the repayment terms are based on the location of the housing and family characteristics such as number of children, the country of origin, and marital status. The average price of homes purchased by immigrants is about $60,000, with individual mortgages of about $35,000. Immigrants have recently begun to use a so-called "double mortgage," whereby two families purchase a single unit together, each family with its own independent mortgage. Since July 1991, the real interest rate (adjusted for inflation) for home mortgages has been set at 4.5 percent, and a portion of the mortgage is in the form of a grant.

Israel Encourages Settlement in the Occupied Territories

Israel has coupled its housing and mortgage policies with a strategy that encourages settlement in the periphery of the country and in the occupied territories. The strategy is based on political and security objectives and on the government's long-standing policy of encouraging population growth outside of the more densely populated central part of the country. Although it is Israeli government policy not to direct Soviet immigrants to settle in the occupied territories or to provide special incentives for them to move to the occupied territories, the government provides strong financial incentives to encourage any Israeli, including immigrants, to move there. As a consequence of this government policy, much of the new housing is being constructed in the periphery of the country and in the occupied territories, and population in the occupied territories is expected to rise over the next few years.

Incentives Reflect Israel's Policy on the Occupied Territories

Since 1967, a succession of Israeli governments have supported housing construction and settlement in the occupied territories, citing various security, religious, and nationalistic justifications. On June 8, 1990, the Israeli government stated that "settlement in all parts of the land of Israel is a right and an inseparable part of national security; the government will act to strengthen, broaden, and deepen settlement." The Israeli government has annexed the Golan Heights and East Jerusalem, and while it has not annexed the West Bank or the Gaza Strip, it refers to them as "the administered areas of Judea, Samaria, and the Gaza District."[2]

Israeli and U.S. officials informed us that, despite the government's support, Israelis have been reluctant to live in the periphery of the country and remote regions within the occupied territories because they are not near employment centers. Consequently, the government's housing program provides incentives and subsidies to encourage developers to build in areas where there is a relatively high risk that they will be unable to sell the homes. According to an AID study, the estimated land and infrastructure subsidies in the development areas, including the West Bank, translate into about a $20,000 savings over a similar unit in areas where subsidies are not provided.

In addition to the incentives and subsidies for building new housing in the occupied territories, the government offers other incentives to Israeli citizens, including new immigrants, to settle in the occupied territories and the periphery of the country:

- preferential mortgage treatment;
- a 7-percent reduction of income tax liability and no income tax withheld if employed by a company located in the occupied territories;
- government-funded construction of religious study centers in settlements;
- subsidies for children living in the occupied territories but attending school within Israel's pre-1967 borders;

[2]Under the Israeli government's land use policies, about one-half of the land in the West Bank has been dedicated for Israeli use, although Israeli settlements currently occupy only a fraction of this land. About one-third of the land in Gaza has been reserved for Israeli use.

- higher per capita aid grants to local councils to support social services than is provided within Israel's pre-1967 borders;
- the highest category of incentives for businesses in the settlements' industrial parks, including 40-percent grants for the purchase of equipment, subsidized infrastructure, and reduced taxes; and
- lower penalties for farmers in the occupied territories who exceed water quotas.

Population Expected to Increase in Occupied Territories

According to the State Department, more than 200,000 settlers now reside in some 200 settlements in the occupied territories, including expanded East Jerusalem.[3] The State Department estimates that about 8,800 of the 185,000 Soviet immigrants who arrived during 1990 now live in the occupied territories. Jews now make up approximately 13 percent of the total population of the occupied territories.

U.S. and Israeli officials anticipate that the number of immigrants and other Israelis moving to the occupied territories will increase over the next few years, particularly in settlements within easy commuting distances of Tel Aviv and Jerusalem. These officials expect home prices to continue to increase within Israel's pre-1967 borders, thus encouraging more Israelis to live in the occupied territories, where housing prices are lower and mortgage terms are more favorable. Moreover, U.S. and Israeli officials anticipate that the Israeli government will sell or rent at below-market prices the housing units it must buy from builders under its purchase commitments. The recent decrease in the number of new mortgages is partially attributed by Israeli officials to people's expectation that housing prices will drop as the government begins to sell units it acquired under its purchase commitments.

The number of Soviet immigrants entering the housing market is also expected to begin to increase substantially. Israeli statistics show that most immigrants do not purchase a home during their first year in Israel, but that many become homeowners after about 3 to 4 years. Immigrants have already become the principal borrowers under government-sponsored mortgage programs. Although immigrants represented less than 9 percent of all borrowers under these programs in 1989, they now constitute almost 45 percent.

[3]The Israeli government does not maintain population statistics for East Jerusalem.

Israel's Housing Strategy Is Costly

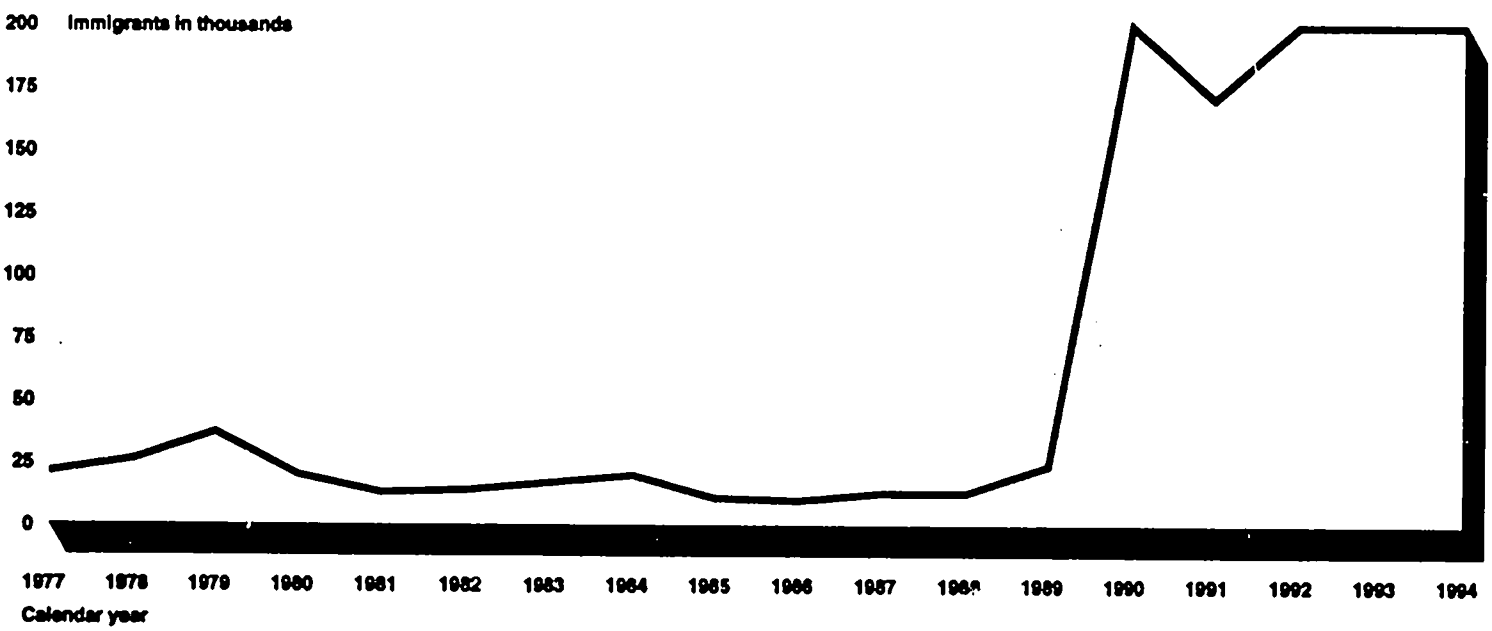
Some Israeli government officials and others have raised concerns about the high cost of the government's housing strategy. The Israeli government's reliance on subsidies and incentives to encourage developers to build in less desirable locations, including the occupied territories, is not only costly during the period of construction, but has long-term budgetary consequences if the developers cannot sell the housing units. U.S. and Israeli officials estimate that builders may not be able to sell as much as 40 percent of the newly constructed housing units and will very likely exercise their government purchase commitments. The proposed Israeli 3-year budget for fiscal years 1992 through 1994 sets aside almost $1.9 billion in 1991 dollars to cover these costs.

The high cost of housing to the government is a central issue in an ongoing debate within Israel over the number and location of new housing projects. At the same time there is a controversy between the Ministry of Finance and the Ministry of Construction and Housing about the signing of certain construction contracts in 1991 and the diversion of $400 million intended for construction in the central area of Israel to the peripheral areas, including the occupied territories. In the midst of this controversy, the Housing Ministry announced its plan to build additional units along both sides of Israel's pre-1967 borders in 1992.

Immigration of Soviet Jews to Israel

Israel is in the midst of what is projected to be one of its largest immigration waves since it was founded in 1948. Between late 1989, when the immigration wave began, and the end of 1991, about 380,000 immigrants arrived, 332,000 of whom were from the former Soviet Union. As shown in figure III.1, this influx represents a reversal from Israel's low immigration rates during the last half of the 1970s and most of the 1980s.

Figure III.1: Immigration to Israel



Note: Figures for 1992 through 1994 are Israeli government estimates.

Source: Israeli government statistics.

The Israeli government closely monitors the situation of Jews in the former Soviet Union and elsewhere and has projected that by the end of 1994 about one million Jews will have immigrated to Israel, including those who have arrived since late 1989. While there is a general consensus that the immigrant total is likely to be accurate, estimates of the rate of arrival vary significantly—from far more than 200,000 in a single year if severely unstable conditions arise in the former Soviet Union to fewer than 100,000 arriving annually. The timing of the flow of Soviet immigrants to Israel will significantly affect its ability to effectively absorb them as well as the timing of the absorption costs.

Basis for Immigrant Estimate

The government of Israel based its estimate of the size of the current Soviet immigration wave largely on the estimated number of Jews in the former Soviet Union and the number who have requested letters of invitation from Israel. (A "letter of invitation" was required by the former Soviet Union to initiate the immigration process.) At present, there is an identified population of approximately two million Soviet Jews. As of November 1991, Israel had extended about 1.03 million letters of invitation to Soviet Jews. This represented the number of potential immigrants to Israel during the current wave, which began in late 1989. Of those who had not yet emigrated from the former Soviet Union, about 33,000 had exit permission and an Israeli immigrant visa as of October 31, 1991, and thus could emigrate at any time. An additional 44,000 held an exit permit as of that date but did not yet have an Israeli immigrant visa.

Rate-of-Arrival Estimates Vary

Although the pool of potential Soviet Jewish immigrants is larger than one million, whether and when Soviet Jews decide to immigrate to Israel can only be estimated. The decision to immigrate to Israel is personal and greatly depends on economic and political developments in the former Soviet Union and on Israel's success in absorbing the immigrants. The Israeli government anticipates Soviet immigration to average 200,000 yearly from 1992 through 1994. Its estimate is derived from its ongoing monitoring of various factors, including

- the domestic situation in the former Soviet Union (its economic, political, social, and ethnic aspects, such as official and grass-roots anti-Semitism);
- the attitude of authorities in the former Soviet Union toward Jews;
- the influence on Soviet Jews of news about the absorption and integration of immigrants into Israeli society;
- the immigration policies of Western countries;
- the emigration policies of the newly independent states of the former Soviet Union;
- demographic data on the Jewish population in the former Soviet Union and the assimilation processes in the Jewish communities throughout the former Soviet Union; and
- local and foreign organizations' activities geared toward discouraging emigration from the former Soviet Union in order to develop local Jewish communities, culture, and education in the former Soviet Union.

Israeli officials monitoring Soviet immigration provided a range of estimates of the annual immigration rate, the range stemming primarily from differences of opinion on the situation in the former Soviet Union and on the impact of Israel's unemployment and underemployment situation. Estimates of more than 200,000 annual arrivals over the next 3 years assume that life in the former Soviet Union will become unbearable and that Jews will want to leave even though prospects of employment in Israel are uncertain. Estimates of fewer than 200,000 annual arrivals assume that Soviet Jews will be more concerned about their ability to earn a living in Israel than they will be about their situation in the former Soviet Union.

The uncertainty about the ability of the immigrants to find suitable employment in Israel is a major factor making it difficult to estimate annual immigrant arrivals. Employment problems in Israel are cited as one of the principal reasons that monthly immigration rates declined in 1991. From a high of over 36,000 Soviet immigrant arrivals in December 1990 and an average of about 16,600 monthly during the year, the 1991 average dropped to about 14,200 monthly, with fewer than 10,200 arriving monthly during the latter part of 1991.

Although the highly educated and skilled Soviet immigrants are finding housing easier than the Israeli government had expected, they are having problems finding jobs in Israel, especially in their previous occupations.[1] Unemployment among recent Soviet immigrants is estimated at between 40 and 70 percent, and recent Soviet immigrants we spoke with in Israel cited unemployment as their chief concern. An Israeli official stated that, on average, it takes an immigrant about 1 year to find employment. However, to find employment in an immigrant's field of expertise takes about 2 to 3 years after entering the labor market. A recently published poll taken in Israel showed that 52 percent of recent Soviet immigrants in Israel were advising their families and friends in the former Soviet Union to postpone their immigration. The unemployment rate in Israel has risen from 8.9 percent in 1989 to about 11 percent in November of 1991.

[1]Among Soviet immigrants who arrived in Israel in 1990, approximately 25 percent are engineers, 15 percent are technicians, and 6 percent are physicians.

Israel's Ability to Service Its External Debt

We believe that it is likely that the Israeli government will be able to fully service its external debt and continue its past record of payment if it fully implements its major absorption plans. However, the $10 billion in loan guaranties would not be without some level of risk to the U.S. government. The large size of the requested guaranties makes them significantly riskier than these guaranties would be if they were equally distributed among several equally creditworthy countries. The level of risk to the U.S. government, if the guaranties are granted to Israel, depends upon the degree to which Israel implements its absorption plans.

Key elements of the absorption plans include the rapid achievement of many structural reforms and a strategy to employ immigrants in the private sector, not in the public sector or in public works programs. We believe these plans, if fully implemented, will enable Israel to efficiently use the $10 billion in U.S. loan guaranties because Israel's economy will be more efficient and funds will not be spent on expensive public employment programs. In this case, Israel will have only a modest decrease in its solvency (its long-term ability to carry external debt) until 1995, followed by the type of increasing solvency that has occurred over the past 6 years. In addition, Israel's liquidity (its short-term ability to service external debt) will increase moderately for a few years and then decline.

If Israel does not follow its absorption plans, the level of risk to the U.S. government will increase, but Israel will probably still be able to fully service its external debt. In this case, the decline in Israeli solvency will be greater than it would be if the plans are fully implemented. If Israel implements its employment strategy but does not adequately accomplish structural reforms, the decline in its solvency will be moderate. If Israel does not follow its employment strategy, the decline in its solvency will be significantly greater. Israel's chances of following its employment strategy depend on the rate at which it implements economic reforms. The slower and narrower the scope of Israel's structural reforms, the less efficient its economy will be, and the greater the rate of unemployment will be. Emigration from Israel will probably rise, as will political pressure to abandon the employment strategy. However, if Israel does not implement its plans, Israeli liquidity will deteriorate a moderate amount for several years and then improve. The more Israel follows its plans, particularly its employment strategy, the better its liquidity will be.

Effect of Absorbing Immigrants

The absorption of one million immigrants from the former Soviet Union will entail high initial costs, but it will offer economic and other benefits over a much longer span of time. The one million immigrants will be rich in human capital, and retaining them (as well as retaining resident Israelis) will require that they live in acceptable housing and that, within a reasonably short time, they find jobs that are acceptable relative to their previous standards. Success in this area will depend on the degree to which Israel is able to generate output and exports, which in turn depends on Israel's quick implementation of needed structural reforms and pursuit of its employment strategy. Success in generating output and exports will in turn fuel Israel's ability to generate more acceptable jobs and housing. If output, particularly in the form of exports, grows quickly, Israel will be able to pay back the external absorption loans with relative ease. The slower that Israeli output and exports grow, the less successful immigrants will be in finding acceptable jobs. Unless Jews have very strong incentives to leave the former Soviet Union, their emigration may slow. Although Israel's need for external funds will then be less, the burden of paying back these funds will probably be greater.

To span the time between the initial costs and the subsequent benefits, the Israeli government expects to borrow about 24 percent of the absorption costs from external sources through long-term loans. The Israeli government has requested the largest and most critical source of these external funds in the form of $10 billion in loan guaranties from the U.S. government, $2 billion per year from 1992 to 1996. Israel's ability to attract and retain these immigrants and the ease with which it will be able to service external debt depend in large part on its economy's efficiency, the Israeli government's policies, and the growth rates of its trading partners.

Israeli Plans to Employ Immigrants

Various branches of the Israeli government have developed plans to deal with this immigration, although those of the Bank of Israel and the Ministry of Finance are perhaps the most prominent. In this report we refer to these two coordinated plans as the "Israeli government absorption plans," although neither has been fully implemented. These plans include a strategy to increase employment overwhelmingly in the private sector; they recognize that employing large numbers of immigrants in the public sector or in large-scale public works programs is too costly. Both plans emphasize the importance of previous structural reforms and additional reforms to make the Israeli economy more efficient and competitive in the world market.

Cost of the Absorption

On the basis of its assumption that one million people will emigrate from the former Soviet Union to Israel during the current wave, the Israeli government estimates that for the 5-year period 1992 to 1996 absorption costs will be about $60 billion in 1991 dollars ($70 billion in current dollars) comprised of the following: (1) $15 billion for housing; (2) $10 billion for social services such as school construction, teaching, welfare, and initial absorption costs; (3) $10 billion for economic infrastructure such as telecommunications, electricity, roads, and ports; and (4) $25 billion for job creation, such as providing incentives to businesses to hire these immigrants.

Planned Funding of the Absorption

The Israeli government expects that its private and public sectors will raise between $21 billion and $25 billion (current dollars) for the absorption from external sources between 1992 and 1996 and that the rest will be raised internally. The Israeli government expects to borrow $16 billion to $17 billion from external sources:

- $10 billion ($2 billion per year) in the form of U.S. government-guaranteed 30-year loans, with a 10-year grace period (a period without payment on the principal);
- $4 billion to $5 billion in loans from or guarantied by other governments; and
- $2 billion ($400 million per year) raised through nonguarantied loans from foreign banks and foreign subsidiaries and branches of Israeli banks.

The Israeli government expects that the private sector will raise an additional $5 billion to $9 billion (current dollars) abroad, including export loans from foreign export banks. The Israeli government's plans assume that the U.S. government will continue to grant $3 billion in economic and military assistance during each of these 5 years, although the real value of this aid will decline with the inflation of the dollar. According to Israeli officials, because of the large sums involved, it is unlikely that Israel will be able to borrow from external sources anywhere near the desired amounts, or on the terms Israel believes it needs, without the $10 billion in loan guaranties.

For two reasons, it is not possible to determine with any degree of certainty where the absorption funds guarantied by the United States will be spent. The first is the fungibility of money; funds intended for one purpose free up funds for another. The second is that dollars raised by the Israeli government will be sold to the private sector for shekels; the Israeli government cannot estimate with any degree of assurance how much foreign exchange different sectors will require to pay for investment goods from abroad and for other uses.

Size and Composition of Israel's External Debt

From the end of 1985 to June 1991, "gross liabilities" (which include public and private external liabilities) grew slowly from $29.4 billion to $31.8 billion. "Liabilities" (which are gross liabilities minus Israeli commercial banks' foreign assets) grew even slower during this period, and government-owed debt grew only about 10 percent. On June 30, 1991, Israeli liabilities totaled $23.9 billion and consisted of $16.9 billion in medium- and long-term debt owed by the Israeli government, $2.8 billion owed by the banking system, and $4.2 billion owed by the nonbanking private sector. "Net liabilities" (which are liabilities minus Israel's foreign reserves and loans by Israeli exporters to foreigners) totaled $14.8 billion in June 1991.

On June 30, 1991, the $16.9 billion of external debt owed by the Israeli government consisted of the following:

- $4.3 billion directly owed to the U.S. government;
- $1.5 billion owed to other governments, mainly Germany;
- $5.7 billion in large part guarantied by the U.S. government;
- $5 billion in Israeli bonds; and
- $400 million in loans owed foreign banks and foreign branches and subsidiaries of Israeli banks.

Measures of Israeli Risk

One of the major determinants of whether the Israeli economy can readily absorb one million immigrants and minimally increase its debt burden over the next few years is the ease with which the private sector is able to create meaningful jobs for these new Israelis. Enough new jobs will be created only if the Israeli economy is sufficiently efficient. That is, the economy must send appropriate wage and price signals, and participants must quickly and appropriately respond to them without incurring excessive cost or risk. (See appendix V for an overview of the Israeli economy.)

During the past 7 years, the U.S.-Israeli Joint Economic Development Group has been perhaps the most important mechanism for the Department of State to assess the Israeli economy's fundamental problems. This advisory panel, cochaired by a senior government official and assisted by two nongovernmental distinguished economists as well as other government officials from each country, has reinforced the influence of reform-minded officials in the Israeli government. However, structural reforms have not been implemented as extensively or as rapidly as the U.S. representatives have advocated.

The Israeli economy is more efficient than it was immediately after the stabilization program of 1985 due to the implementation of a large number of structural reforms.[1] However, these reforms have been unevenly implemented among the various sectors. Where the Bank of Israel has been able to impose reforms by administrative action, reform implementation has been greater than it has been when reform actions have depended on having laws passed or obtaining the agreement of labor (which has protected the interests of those already employed). Knowledgeable observers point to the capital, money, and foreign exchange markets, as well as to the international trade sectors, as areas in which a smaller number of additional structural reforms are needed. Areas in which the most structural reform is needed are the labor market and privatization.

Some of the more important reforms implemented in recent years include

- eliminating all duties on imports of manufactured goods from the United States and the European Community in accordance with free trade agreements;
- eliminating nontariff barriers on imports from third countries (countries other than the United States or outside the European Community) and planning to reduce customs duties on these countries' imports steadily over 5 to 7 years;
- selling off land owned by the state on the open market, without a minimum sales price;
- reducing corporate tax rates to levels comparable to those in some other industrialized countries;
- legislatively prohibiting the Bank of Israel from funding the government deficit by printing money;
- instituting many regulatory changes for financial markets that caused them to become more flexible and market-oriented than they had been in the past, when they were extremely segmented and subject to many quantitative restrictions;

[1]Israel's stabilization program of 1985 involved a large decrease in its government's deficit, a sharp devaluation on the foreign exchange market, and some lessening of the indexation of wages and assets. (See app. V for additional information.)

- allowing private employment agencies to compete with the previous government monopoly;
- eliminating the linkage of public sector employees' wages with those of employees of state-owned businesses; and
- changing national wage agreements so that wages are no longer fully indexed to inflation.

According to various economists, Israeli government officials, and other knowledgeable observers, some of the more important reforms still needed include

- legislation reducing the minimum wage from the current relatively high level of 45 percent of the Israeli average wage;
- obtaining labor-management agreements that eliminate the linkages of wages among different sectors and among different occupations in the private sector;
- obtaining labor-management agreements that eliminate the high additional wages paid for working second and third shifts;
- privatizing most of the many state-owned enterprises quickly;
- lessening individuals' marginal tax rates from their present high maximum of 51 percent (previously 60 percent) to significantly lower levels;
- privatizing the banks acquired during the 1983 Bank Shares crisis (these banks have 85 to 90 percent of Israel's commercial bank deposits) by the date previously planned, October 1993;
- increasing further (1) the flexibility of the capital market by eliminating the requirement that provident funds (certain retirement plans) invest their assets in government bonds (now these funds must invest 50 percent of their assets in these bonds, down from 70 percent previously) and (2) the ability of the Histadrut (Israel's large trade union) to purchase special government bonds for its pension plan; and
- reducing business taxes on employees.

The amount of private business investment that occurs in Israel over the next few years depends on the pace and breadth of economic reforms and other factors and is very important in determining how efficient the Israeli economy is in generating private sector jobs for the immigrants. A representative of Israeli manufacturers told us that the most important actions the government could take to increase investment in Israel's manufacturing industry and spur additional hiring of immigrants would be to greatly reduce budget deficits, have a stable macroeconomic program, and lower Israeli inflation to levels experienced by countries that are members of the Organization for Economic Cooperation and Development (OECD). These actions will also lessen the chance that Israel will again experience hyperinflation.

Additionally, large increases in government investment in infrastructure are needed, particularly for roads in Israel's populated center. One recent study estimates that building better highway access around Tel Aviv would pay for itself in lessened congestion within 6 months. However, it is important that these reforms and infrastructure investment be implemented without increasing the Israeli government's budget deficit.

Israel's Past Debt Burden

Analysts use a number of measures to assess a country's debt burden. For example, the ratio of external debt to gross national product (GNP) and the ratio of external debt to exports of goods and services both provide some measure of a country's solvency. The higher these ratios, the lower is solvency. The ratio of debt service to exports of goods and services measures a country's liquidity. The higher this ratio, the lower is liquidity. There are different measures for each of these ratios, depending on which measures of external debt are used—gross liabilities, liabilities, or net liabilities. The ratio of debt service to exports of goods and services also depends on whether the servicing of short-term debt (which matures within 1 year) is included or excluded. Table IV.1 presents six measures of Israel's solvency and one measure of its liquidity from December 1985 to December 1991. Data on debt servicing of short-term debt was not available.

Table IV.1: Israel's Debt Burden, 1985-1991

Figures in percentages

Ratio[a]	1985	1986	1987	1988	1989	1990	1991[b]
Gross liabilities/GNP	127.0	106.4	92.7	74.1	72.2	64.9	56.9
Liabilities/GNP	100.0	83.6	73.9	58.0	55.1	48.1	42.5
Net liabilities/GNP	79.6	63.2	53.1	43.8	37.6	31.1	25.7
Gross liabilities/exports	268.1	256.9	225.6	201.2	185.1	175.6	170.3
Liabilities/exports	211.0	201.8	179.8	157.6	141.0	130.1	127.2
Net liabilities/exports	168.1	152.7	129.3	119.0	96.3	84.1	76.9
Debt service of liabilities (excluding short-term debt)/exports	27.5	26.4	22.8	21.9	17.5	15.8	15.6

[a]Ratios are based on (1) external debt as of December of each year and (2) exports of goods and services, GNP, and debt-servicing for the entire year.

[b]Figures for 1991 are estimates.

All of these measures of Israel's long-term ability to carry external debt and its short-term ability to service external debt improved substantially over the period. The liabilities-to-GNP ratio declined dramatically, from 100 percent in December 1985 to an estimated 42.5 percent in December 1991, while the gross liabilities-to-GNP ratio declined proportionally slightly less, and the net liabilities-to-GNP ratio declined proportionally somewhat more. The liabilities-to-exports ratio substantially improved, from 211 percent in December 1985 to 127.2 percent in December 1991. The ratio of debt service of liabilities (excluding short-term debt) to exports of goods and services also improved substantially, from 27.5 percent in December 1985 to an estimated 15.6 percent in December 1991.

Israel's Future Debt Burden

We evaluated the effect of the planned absorption loans on Israel's debt burden under a wide variety of scenarios using three assumptions: (1) most underlying trends concerning the size and composition of Israel's nonabsorption external debt would continue, (2) Israel would be able to borrow absorption funds as the Israeli government has planned, and (3) in the future Israel would pay the same interest rates and have the same maturity distribution on nonabsorption loans as the Israeli government projected for June 1991 external debt.

Table IV.2 summarizes Israeli GNP and export growth, and table IV.3 depicts the effect on Israel's debt burden from 1992 to 1997 for five of the scenarios we analyzed. Three of these—(1) an optimistic scenario, (2) a moderate scenario, and (3) a pessimistic scenario—assume no government programs that hire immigrants directly or finance public works programs that do. The two other scenarios—(4) a moderate scenario and (5) a pessimistic scenario—assume government make-work programs. Israel's debt burden is greater because its export and GNP growth are both lower the more pessimistic the scenario number. That is, its debt burden is least in the first scenario, when GNP and export growth are highest, and greatest in the fifth, when growth is slowest.

Table IV.2: Average Israeli GNP and Export Growth Rates, 1992-1997

Figures in percentages

Scenario	Real GNP growth	Real export growth
Optimistic	7.6	6.2
Moderate	6.2	4.9
Pessimistic	5.5	4.1
Moderate with government program	4.6	2.9
Pessimistic with government program	3.8	2.1

Table IV.3: Israel's Future Debt Burden

Figures in percentages

Ratio[a]	1992	1993	1994	1995	1996	1997
Liabilities/GNP						
Optimistic	45.7	48.2	48.7	48.7	47.2	41.8
Moderate	46.8	50.4	52.4	52.7	51.4	45.0
Pessimistic	46.8	51.0	54.0	55.7	54.2	46.9
Moderate with government program	47.5	52.2	55.5	57.2	56.4	49.5
Pessimistic with government program	47.5	52.9	57.5	61.0	59.7	51.8
Liabilities/exports						
Optimistic	138.7	148.2	151.7	153.5	150.7	135.2
Moderate	141.9	154.9	163.0	166.1	164.3	145.7
Pessimistic	141.9	156.9	168.2	175.7	173.2	152.0
Moderate with government program	145.0	162.3	175.6	184.2	183.6	163.3
Pessimistic with government program	145.0	164.5	182.0	196.7	194.9	170.9
Debt service of liabilities (excluding short- term debt)/exports						
Optimistic	20.6	24.6	24.7	24.1	23.4	20.7
Moderate	21.1	25.7	26.5	26.1	25.5	22.4
Pessimistic	21.1	26.0	27.4	27.6	26.9	23.3
Moderate with government program	21.5	26.9	28.6	28.9	28.5	25.1
Pessimistic with government program	21.5	27.3	29.6	30.9	30.3	26.2

[a]Ratios are based on (1) debt as of December of each year and (2) exports, GNP, and debt-servicing for the entire year.

Table IV.4 presents gross liabilities, liabilities, and debt servicing on medium- and long-term external debt for the five scenarios we present as well as net liabilities for scenario 2.

Table IV.4: Israel's Future External Debt and Debt Service Under the Five Scenarios

Dollars in billions

Debt and debt-servicing[a]	1992	1993	1994	1995	1996	1997
Gross liabilities	$37.5	$42.9	$48.0	$53.2	$56.9	$56.2
Liabilities	29.0	34.0	38.7	43.5	46.8	45.6
Net liabilities[b]	18.4	22.5	26.1	29.4	31.3	28.4
Debt service- liabilities	4.3	5.6	6.3	6.8	7.3	7.0

[a]Debt as of December and debt-servicing for the year.

[b]Net liabilities figures are for the moderate scenario (without government programs). Corresponding figures for the other scenarios are very similar.

In the first scenario, Israeli solvency declines modestly until 1995 and then increases, while Israeli liquidity declines moderately for 3 years before increasing. In the second and third scenarios, Israeli solvency declines moderately until 1995 and then improves, while Israeli liquidity declines somewhat more than it does in the first scenario before increasing. In the last two scenarios, the Israeli government's abandonment of its planned strategy of employing immigrants largely in the private sector results in a fairly significant decline in Israel's solvency until the end of 1995, when it increases. Abandonment of the employment strategy causes Israeli liquidity to suffer a larger though still moderate decline until 1995, followed by increased liquidity.

One of the fundamental differences between the optimistic scenario and the others is the degree of the Israeli economy's efficiency, which in turn depends on the amount of reform implemented during the next few years. If reforms are actively and swiftly implemented, it is more likely that Israel will experience something closer to scenario 1, with high GNP and export growth and only modest decreases in solvency until 1995 and then increases in solvency thereafter.

If reforms are implemented more slowly or not as extensively, it is more likely that Israel will experience higher unemployment, greater emigration of its resident population, and slower export and GNP growth. These are the key characteristics of scenario 2, which also assumes that the Israeli government does not implement make-work programs.

If reforms are not fully implemented or are implemented at a slower pace, another possible outcome is scenario 3, with slower immigration and export and GNP growth than what occurs in scenario 2. This third scenario reflects potential immigrants' concerns that if they immigrate to Israel, they will be unemployed for a substantial period of time. Which of these two scenarios occurs depends on economic and social conditions in the former Soviet Union; the better the conditions, the more likely that scenario 3 will be realized. Although slower immigration could involve lower external borrowing and a lower external debt burden than does scenario 2, in scenario 3 external borrowing does not decline.

In scenarios 4 and 5, the Israeli government discards its plans for private sector employment and, instead, undertakes major public works employment programs to combat high unemployment. Production in these make-work jobs would be rather inefficient and would lack the increases in productivity over time that have occurred within the private sector during Israel's recent past. These public employment programs would be financed by higher taxes. For this and other reasons, significant reductions of private sector production and employment would occur. As a result, there is significantly lower growth in Israeli GNP and exports than what occurs in scenarios 2 and 3, respectively (see table IV.2). There would be a moderately large decrease in Israeli solvency until 1995, as indicated by the liabilities-to-exports ratio; then solvency would increase. This ratio is the more relevant measure of solvency because revenues from export growth can directly be used to pay external debt payments, assuming that imports do not grow too rapidly and transfer payments to Israel do not change too much.

According to our analysis, if Israel does not fully implement its absorption plans, Israeli liquidity declines a moderate amount for several years and then improves. The more Israel follows its absorption plans, particularly its employment strategy, the greater Israeli liquidity will be.

Other Ratings

There are a number of ratings available that measure Israel's political and economic risk. Israel has faced many crises related to its geopolitical situation, and this political risk is no doubt important in these ratings.

Standard and Poor's, an internationally recognized credit rating company, rates Israeli government senior debt a triple B minus (BBB-) implied, the lowest rating for investment grade securities, though it has recently revised its view of Israel to positive from negative due to a significant lessening of Israel's external threat. An Israeli government official informed us that recently a Standard and Poor's credit analyst had stated that were it not for Israel's geopolitical risk, its rating would be much higher.

Salomon Brothers recently evaluated Israel and concluded that Israel's risk made the Israeli government's medium- and long-term debt equivalent in risk to the highest medium grade sovereign debt, a mid-to-low single A, in contrast to Israel's Standard and Poor's rating of BBB-implied.[2] Salomon Brothers based its decision on (1) the large number of reforms Israel has implemented over the last 6 years and is expected to undertake in the near future, (2) the results of its projection of debt burden measures similar to those we present in the previous section, (3) its comparison of certain other Israeli economic indicators for 1989 with those of countries with similar or higher ratings, and (4) the lessening of Israel's internal and external security threat.

In October 1991, Institutional Investor, a leading magazine for financial institutions, presented its semiannual country risk survey. The ratings, calculated by averaging May 1991 survey responses from many major international banks, ranked Israel 51st of 113 countries rated. In September 1991, Euromoney, another leading magazine for financial institutions, ranked Israel 38th of 130 countries; Israel's rating was up dramatically from 60th 1 year earlier. This rise was partly attributed to Israel's improved rating but mostly to the decline of other countries' previous ratings.

Market Measures

Unlike many other countries, Israel has no variable interest rate financial instruments that are traded by professional portfolio managers on the secondary market and that would indicate professionals' market evaluation of Israeli political and economic risk. Israeli debt is generally not freely traded on the secondary market because of Israeli government prohibitions. The Israeli government does owe $400 million of mostly variable interest rate external debt to selected commercial banks, but trading restrictions and the small size of these relatively low interest rate loans make them inappropriate for this purpose. An Israeli government official told us that Israel was very concerned about who held these loans and preferred to educate its lenders and engage in long-term relationships. According to the same official, these are also reasons that the Israeli

[2]Debts rated A indicate a strong capacity to pay interest and repay principal, although the debt is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debts in higher-rated categories.

Debts rated BBB indicate an adequate capacity to pay interest and repay principal. Adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to service the debt.

A plus or minus signifies relative standing within the major rating categories.

government has not sought a formal rating from a second internationally recognized credit rating firm, such as Moody's, which would be necessary for it to offer its debt publicly on international credit markets.

An Overview of Israel's Economy

Israel is a country of 8,219 square miles, about the size of New Jersey, with a population of about 4.99 million. The territories occupied by Israel since 1967 have an area of 2,986 square miles and a non-Jewish population of about 1.6 million. Israel's 1991 GNP is estimated at $56.4 billion, about 1 percent of the U.S. GNP. In 1991, Israeli per-capita GNP was $11,300, compared to about $22,175 for the United States.

Since 1986, on the average, Israel has had relatively high levels of consumption, moderate levels of investment, a large government sector, and a large trade sector, and it has received large net transfer payments from abroad. From 1986 to 1991, Israel spent more than it earned, but its external debt declined as a percentage of GNP because it received large net transfer payments from abroad (averaging about 13 percent of its GNP). A large part of these transfer payments came from the U.S. government.

Israel's Successful Stabilization Program

In July 1985, Israel implemented a major stabilization program, with some advice and financial assistance provided by the U.S. government, that was successful in ending a 12-year period of very high inflation, low growth, and repeated balance-of-payments crises. The most important component of the stabilization program was the lowering of the government deficit from about 10 percent of GNP to roughly 2 percent. About half of the reduction resulted from higher real taxes (adjusted for inflation), and half resulted from reductions in real government spending and subsidies. Real taxes increased partly because, with much lower inflation, taxpayers had less incentive to be late in their payments. The stabilization program also involved a sharp devaluation of the currency and some reform of the indexation of wages and assets.

The biggest success of the stabilization program was to bring inflation down from about 400 percent in 1984 to 15 to 20 percent annually between 1986 and the present. While inflation remains high by typical OECD standards, the Israelis' stabilization program was more successful than any of the many programs attempted by developing countries during the 1980s.

Israel's Recent Economic Trends

On the average, the economy grew more rapidly after the stabilization program than it had during the 5 years before, with the growth of real GNP averaging an estimated 4.8 percent per year from 1986 to 1991. During this period, on the average, private consumption comprised 65 percent of GNP, gross investment comprised 20 percent, and government consumption comprised 32 percent. Exports of goods and services comprised

38 percent, and imports of goods and services comprised 51 percent. Government transfer payments and subsidies comprised about 19 percent and net factor payments overseas were 3 percent.

In 1986, following the stabilization program, real government consumption declined almost 10 percent. By 1991 it was estimated to be only slightly more than it had been in 1985. Measured as a share of GNP, real government consumption declined substantially from 39 percent in 1985 to an expected 26 percent by 1991. Following the trend since 1980, direct defense expenditures' share of GNP continued to decline; by 1991 it was about 14 percent, still much higher than typical OECD country standards.

Real private consumption expenditures grew an average of 7.2 percent per year between 1986 and 1991. The greatest growth occurred in 1986, immediately after the stabilization program was completed, and in 1991; very slow growth occurred in 1989 during a downturn in the economy.

Real gross investment has grown an average of 10.3 percent per year, with high growth in the expansion years of 1986, 1990, and especially 1991, and low or negative growth in other years. As a percentage of GNP, investment is now moderate; between 1986 and 1991 it averaged 19.6 percent of GNP, somewhat lower that the OECD countries' average.

Since 1985, Israel's external debt as a percentage of GNP and as a percentage of exports has steadily declined. External debt servicing as a percentage of exports has also steadily declined. Israel has gone from current account deficits prior to 1985 to mostly current account surpluses partly due to its receipt of larger net transfers. Foreign reserves have increased from $3.9 billion in 1985 to $7 billion in 1990.

The trade deficit of goods and services has declined significantly, measured as a percentage of GNP. However, measured in real terms, this trade deficit has grown. Between 1986 and 1991, real exports of goods and services grew an average of 3.3 percent each year, and real imports of goods and services grew an average of 6.6 percent. Israeli exports of goods and services have declined from 41 percent of GNP to 33 percent, and imports have declined from 55 percent of GNP to 45 percent. Israel's largest trading partners are the United States and the European Community.[1]

[1]The European Community consists of 12 member states: Belgium, Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, the United Kingdom, and Germany.

Israel's Recent Economic Cycles

Following the stabilization program, Israel had a 2-year boom until mid-1987, followed by a slowdown of the economy until mid-1990 and then an expansion until the present. The 3-year slowdown was largely caused by the Central Bank's policy of holding the nominal exchange rate constant to promote price stability. At the end of 1988, the Central Bank discontinued this policy. Since industrial costs were increasing more rapidly than prices in foreign markets, the constant nominal exchange rate caused the industrial sector to lose international competitiveness, and industrial production declined. The monetary authorities also kept interest rates high to prevent Israel's international reserves from being depleted, thereby causing investment to decline. Unemployment rose to the highest level in two decades. Subsequently, real wages began to decline, and labor productivity increased.

The intifada,[2] which began in late 1987, caused an estimated 1-1/2 percent decline in the growth of real GNP. In subsequent years, the intifada did not further lessen growth.

In 1989, monetary policy dramatically changed, although this change was not officially announced. Monetary authorities allowed the nominal exchange rate to decline at roughly the rate Israeli inflation exceeded that of its trading partners; that is, the real exchange rate remained relatively stable. The higher and relatively stable real exchange rate, lower interest rates, reduced real wages, and improved productivity raised the business sector's profitability, and the economy began to expand in the second half of 1990. Also, increases in demand by the many new immigrants began to propel the expansion. In 1990, real GNP grew 5.3 percent; real gross investment grew 25.2 percent; real exports of goods and services grew 2.2 percent; and real imports of goods and services increased 9 percent.

Recent estimates for 1991 are that real GNP grew 8.5 percent; real gross investment grew 36.0 percent; real imports of goods and services grew 11.1 percent; and real exports of goods and services declined 1.4 percent. The decline in exports is attributed to a decline in tourism for half of the year due to the Gulf war, real appreciation of the shekel, and lessened foreign demand for Israeli exports due to the slow growth of Israel's major trading partners.

In the last few years, even before new immigrants entered the labor force in significant numbers, the labor force expanded rapidly due to the

[2] A Palestinian uprising that began in December 1987 in the West Bank, including East Jerusalem, and the Gaza Strip.

increased number of working women and Six-Day War baby boomers entering the labor market. Unemployment has continued to increase despite an increase in the total number of jobs. Unemployment reached about 11 percent in November 1991 and is expected to rise still further when the many additional immigrants seek jobs.

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