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INTERNATIONAL DEVELOPMENT

COOPERATION AGENCY

AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D.C. 20523

PROJECT PAPER

ISRAEL: FY 1985 ESF Supplemental Cash Transfer Grant - 271-K-621

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P.

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

ASSISTANT
ADMINISTRATOR

513398

28 AUG 1985

ACTION MEMORANDUM FOR THE ADMINISTRATOR

THRU: AA/PPC, Richard Derham

FROM: AA/ANE, Charles W. Greenleaf, Jr. CG

SUBJECT: Israel - FY 1985 ESF Supplemental Cash Transfer Grant 271-K-621

PROBLEM: Your approval is required for the authorization of the $1.5 billion ESF supplemental cash transfer grant to Israel.

DISCUSSION: On August 15, 1985, the President signed the Supplemental Appropriation Act for Fiscal Year 1985. The legislation provides that the cash transfer grant to Israel will be available for obligation until September 30, 1986. The House and Senate conferees meeting to iron out differences between the supplemental appropriations bills passed by the two houses of the Congress indicated ". . . that the Administration is to move quickly to disburse funds that Israel needs to meet its most urgent economic needs and to provide assistance on a reasonable and timely basis". The legislation does not request or provide for conditionality of any kind.

We have been asked by Assistant Secretary of State Richard W. Murphy to disburse an initial tranche of $750 million immediately upon execution of the grant agreement. The levels and schedule for future disbursements will be discussed with appropriate agencies within the administration and with the Government of Israel.

OMB has apportioned, and Treasury has allotted the initial $750 million disbursement from the 1985 ESF Supplemental account.

Since the time the U.S. has been providing Israel with cash transfers in lieu of commodity program assistance, the Government of Israel (GOI) provided written assurances each year that non-military imports from the U.S. would exceed the level of U.S. economic assistance for that year, that Israel would continue to purchase U.S. corn, wheat, soybeans and other agricultural products at approximately the levels established during the past few years, that acceptable procedures would continue to be followed for selection of dry bulk carriers of grain shipments from the United States and that U.S. exporters would not be disadvantaged by shifting ESF transfers to Israel from a commodity import program to a cash transfer program. Israel provided such an assurance in October 1984 applicable to FY 1985. The supplemental legislation does not require that the GOI provide additional assurances regarding the aggregate level of Israeli purchases of non-defense goods from the U.S. The other assurances provided in October 1984 are unaffected by the provision of supplemental assistance and remain in effect.

RECOMMENDATION: That you approve the $1.5 billion cash transfer grant to Israel by signing the attached PAAD. The PAAD approves for obligation one half of the grant, or $750 million, which will be disbursed to Israel's bank account shortly after signature of the grant agreement by the AA/ANE and an appropriate official from the Embassy of Israel. The PAAD also delegates authority to the AA/ANE to amend the PAAD facesheet to allow obligation of the remaining $750 million, subject to the availability of funds.

Attachments:
Tab A - Program Assistance Approval Document (PAAD)
Tab B - Draft grant agreement

Clearance:
GC:HFry ________________ Date 8/27/85

ANE/PD/ME:CJPatalive:08/05/85:632-9734:Doc 0924B

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AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 271-K-621
2. Country: Israel
3. Category: Cash Transfer
4. Date: SEP 10 1985

5. To: M. Peter McPherson, Administrator, A.I.D.
6. OYB Change Number: N/A
7. From: Charles W. Greenleaf, Assistant Administrator, ANE
8. OYB Increase: None
To be taken from: Economic Support Funds
9. Approval Requested for Commitment of: $750,000,000.00
10. Appropriation Budget Plan Code: 72-115/61037 BPC NES 5-85-33271-KG-31

11. Type Funding	12. Local Currency Arrangement	13. Estimated Delivery Period	14. Transaction Eligibility Date
☐ Loan ☒ Grant	☐ Informal ☐ Formal ☒ None	N/A	N/A

15. Commodities Financed
N/A

16. Permitted Source		17. Estimated Source	
U.S. only	N/A	U.S.	N/A
Limited F.W.	N/A	Industrialized Countries	N/A
Free World	N/A	Local	N/A
Cash	$750,000,000.00	Other	N/A

18. Summary Description

This supplemental assistance is part of a continuing program to Israel. Israel's political and economic stability have been deemed essential to achieving a comprehensive peace in the Middle East. The assistance is also in recognition of the progress which Prime Minister Peres' Government has made on economic reform and his stated intention to further develop the GOI economic program and strengthen implementation within the context of a mutually acceptable policy framework.

I hereby approve a cash transfer grant in the amount of one billion five hundred million dollars ($1,500,000,000.00) to be obligated and disbursed in tranches at the discretion of the Executive Branch. One half of the grant, or $750,000,000.00, will be obligated and disbursed immediately upon execution of the grant agreement. The remaining proceeds will be obligated and disbursed on a schedule mutually agreeable between the two Governments and in accordance with the AID OYB/allotment process and amendment of the PAAD facesheet. Authority is hereby delegated to AA/ANE, with M/FM clearance, to amend the PAAD facesheet adding the remaining $750,000,000.00 subject to the availability of funds.

19. (Cont.)
ANE/PD:PBloom ______ Date 8/26/85 DAA/ANE:RHBell ______ Date 8/28/85
ANE/PD/ME:TRTiffet ______ Date 8/26/85 SER/COM:MMcDaniel ______ Date 8/27/85
ANE/PD/ME:CPatalive:amf:08/14/85:Revised08/26/85:x29734

19. Clearances	Date
AA/PPC:RADerham	
GC:HFry	
M/FM:CChristensen	9/10/85
NEA/IAI:PWilcox	
ANE/DP:BSidman	8/27
GC/ANE:RJohnson	8/27/85
ANE/MENA:RMishelofF	27 Aug 1985

20. Action
☒ APPROVED ☐ DISAPPROVED

Authorized Signature: M. Peter McPherson — Date: SEP 10 1985

Title: Administrator, A.I.D.

AID 1120-1 (5-82)

CLASSIFICATION:

I. SUMMARY OF POLITICAL AND ECONOMIC CONSIDERATIONS

Israel's political and economic stability have been deemed essential to achieving a comprehensive peace in the Middle East. U.S. assistance programs, both military and economic, tangibly reflect U.S. support and help give Israel the confidence it needs to take the risks necessary to reach a peace settlement with its Arab neighbors. The U.S. Economic Support Fund (ESF) directly supports Israel's civilian economy, thereby facilitating maintenance of a modest rate of economic growth and management of Israel's large balance of payments problem. The balance of payments problem has grown more severe during the past year as a result of deterioration in the capital account. It is for this reason that Israel has sought supplemental assistance.

For many years, Israel has been attempting to maintain a high level of social welfare services, a modest economic growth rate, and full employment, while at the same time expending large sums for defense and debt service (internal and external). Despite unique access to concessional resources from abroad, this has contributed to inflationary pressures and persistent balance of payments deficits. Both problems were considerably exacerbated after the 1973 Arab-Israeli War by world inflation, particularly oil prices, recurring periods of recession in the economies of Israel's traditional trading partners and the need to rearm and maintain adequate military forces.

Despite periodic attempts to dampen aggregate demand (particularly for consumption) and stimulate exports, it is clear that Israel's security and prosperity cannot yet be assured without substantial financing from abroad. Economic assistance is still needed to assure Israel of access to the resources it needs to maintain economic activity at a level high enough to assure reasonably full employment and a stable or slowly improving standard of living. The period of time during which Israel will continue to require assistance will depend on Israeli efforts to make necessary economic adjustments, on future international developments which affect the prices of traded goods and services, on the demand for Israeli exports and on the level of Israeli defense expenditures.

II. RATIONALE FOR ECONOMIC ASSISTANCE

A. Background

Israel's economic achievements in the first 25 years of its existence were remarkable in view of its very limited natural resources. Fueled by very high levels of investment (frequently reaching 30% of GDP), Israel's real GDP rose at an average annual rate of 9% between 1952 and 1972. At the same time price levels were relatively stable; until 1970 consumer prices increased at an average annual rate of 7%.

Since the early 1970s, Israeli economic performance has deteriorated. By the early 1980s, economic growth rates were much reduced, and the rate of inflation had reached triple digit levels. An increasing proportion of national savings was channelled toward the financing of current government expenditures, while productive investment declined because of the uncertainty of the magnitude of real returns under conditions of high inflation as against the certainty of positive real returns on securities issued by the Government to help finance its own consumption expenditures and transfers. The level of gross domestic investment declined from 32% of GDP in 1972 to 21% in 1984. The incomes of Israeli consumers, on the other hand, were largely protected against the erosive forces of inflation by an increasingly widespread system of indexing wages, welfare payments, interest income, and income tax brackets to rises in consumer prices or related exchange rate movements. Relatively high levels of consumption were stimulated by deficit spending and marked increases in real wages. Over the 1971-1983 period, labor market conditions were tight as reflected in an unemployment rate of 2.5-5% and Israeli real wages increased at an average annual rate of 3%, far in excess of growth in labor productivity. The high levels of consumption coupled with growing defense requirements and a lessened ability of the Israeli economy to supply demanded goods and services because of inadequate investment led to growing current account deficits, which were financed both by increased U.S. assistance flows and rising foreign borrowing. The deficit on civilian goods and services account increased from $700 million in 1972 to $4.2 billion in 1983. External foreign debt (including short-term and private debt) rose from $4 billion in 1972 to $22.7 billion at the end of 1983.

B. Developments in 1984 and the first part of 1985

The decision in March 1984 to hold elections was followed by a slackening in the pace of increases in prices of government controlled commodities. The cost of subsidies thus increased beyond what was projected in the budget. This, in combination with adjustments designed to offset the sharp (15%) drop in real wages which had occurred late in 1983, bolstered private consumption, contributed to a further deterioration in the budget picture and intensified already strong inflationary pressures. Private consumption increased at a 4 percent per annum rate in the second quarter, reversing declines of the preceding year. In the third quarter the rate of increase accelerated sharply to 17 percent as Israelis purchased large volumes of durable goods anticipating a devaluation of the shekel after the formation of a new government following the July elections. The consumer price index rose at an annual rate of almost 500 percent during the second quarter and over 600 percent during the third. The latter figure was more than twice that of the first quarter.

The balance of payments picture during this period was mixed. The goods and services deficit declined during the second and third quarters by 8 percent in current dollar terms vis-a-vis the corresponding period a year earlier. However, during the summer months, the public's uncertainty about the outcome of the election and the future course of economic policy led to capital flight. Foreign currency reserves fell by $1.2 billion during the third quarter--$700 million in July alone--to a level of $2.6 billion on September 30. The latter figure represented a six year low, and corresponded to approximately two months of non-FMS financed imports at the 1984 level.

To stem foreign exchange outflows and reduce inflation, the coalition government formed in September decided to cut government expenditures by $1 billion, devalued the shekel by 8 percent, raised prices of subsidized goods and services by 18-55 percent, imposed a six month ban on imports of consumer appliances and luxuries, and restricted foreign exchange purchases for foreign travel and other personal purposes. In November, the Government decided on a further $550 million budget cut and reached agreement (the first so-called "Package Deal") with the Histadrut (the labor confederation) and the Manufacturers' Association (representing private employers) on a three-month freeze in prices, profits, and tax rates. The agreement also stipulated that for November and December wage earners would receive only two-thirds of the cost of living adjustment that would otherwise have been due.

Initially, these initiatives appeared to be having a salutary impact. The rate of increase in the consumer price index, which had accelerated to over 1,000 percent on an annualized basis in the September - November period, slowed in December and January to a rate which, had it been sustained, would have resulted in annual inflation of about 70 percent, the lowest Israel has experienced since 1978. The foreign trade (goods and services) deficit dropped by one-third during the fourth quarter as compared with the last three months of 1983. Reserves increased by $500 million owing to disbursement of the full $1.2 billion FY 1985 ESF cash transfer in October. This was partially offset by continuing outflows of foreign exchange, but at a rate which was slower than that of the previous quarter.

On the other hand, the Government was not able to cut the budget as intended. The major difficulty was that the price freeze, which was a major feature of Package Deal I, was applied to subsidized goods and services. As domestic costs continued to rise, owing particularly to increasing nominal labor costs and shekel depreciation, the budget for subsidies rose correspondingly, more than offsetting whatever savings were achieved in other budgetary expenditures.

By January 1985, it was clear that the Government's economic program would need to be strengthened. While the price freeze was generally observed, domestic costs were rising squeezing profits. Hard hit businesses were threatening to cut production if they were not granted some relief, and spot shortages were beginning to develop. Additionally, government expenditures at the end of 1984 were running at a pace which, had they been sustained over the full Israeli fiscal year (April 1-March 31), would have exceeded the amount originally budgeted by $1.8 billion or 12 percent. Moreover, tax receipts were falling short of the expected level. The upshot was a deficit in excess of 25 percent of GNP. Although foreign grants--largely U.S. economic and military assistance--totalled over $2.2 billion, a very sizeable proportion of the financing requirement was met by government borrowing from the Bank of Israel (the central bank). Thus, despite relatively low recorded inflation rates in December and January--due to the price freeze--it was clearly understood that underlying inflationary pressures had not abated.

The Government responded at the end of January by raising the price of subsidized goods and services and then negotiating "Package Deal II" with the Histadrut and the Manufacturers' Association. Under its terms

a) prices of unsubsidized goods and services were permitted to rise by specified amounts (on average about 5 percent) immediately; thereafter, subsequent increases, generally 3-5 percent a month, were to be determined by the Government following consultations with a "professional committee" on which it, together with the Histadrut and the Manufacturers' Association, was represented;

b) additional cuts in subsidies were to be made in February and March;

c) increases in the consumer price index attributable to the cut in subsidies were not to be taken into account in calculating cost of living adjustments to wages so long as the increases did not exceed six percent. Instead, wage earners were to receive small, one time cash payments and income tax credits as compensation. The effect was expected to be a drop in real wages.

The agreement was to remain in effect for eight months, but could be renegotiated at the request of any of the involved parties at the end of the fifth month (early July). In fact it quickly ran into trouble. Determining prices for the myriad of goods and services produced by the economy in a way which would not give rise to distortions and inequities and at the same time contribute to achieving the objective of reducing inflation proved to be a very difficult task. As a result, at the end of March, the agreement was further amended to provide for a general price increase at the beginning of April, followed by a two-month freeze and anther increase at the beginning of June.

C. Recent Economic Performance

1) GNP and its components

Real Gross National Product in 1984 was virtually unchanged from the previous year at a level of approximately $22.5 billion. Per capita GNP was just under $5,500.

While the economy as a whole neither grew nor contracted, there were significant changes in its component parts. In particular, domestic uses of resources (GDP plus the import surplus) declined by 4.7 percent. This was roughly offset by a 14.5 percent real increase in exports of goods and services. The relative importance of exports in the economy thus increased, accounting for 30 percent of total resource use in 1984 as opposed to 26 percent in 1983.

Domestic demand fell across a broad front. Private consumption declined 6.3 percent; domestic public consumption dropped 3.9 percent; and investment was down 9.2 percent. Major explanatory factors were a small drop in real wages, a substantial decline in the value of the public's liquid asset holdings as a consequence of the stock market crash (particularly bank shares) which took place at the end of 1983, high real interest rates, and a reduction in local public consumption (chiefly domestic defense purchases) and public sector investment.

2) Inflation

The consumer price index rose by 445 percent in 1984, compared to 191 percent in 1983. The Bank of Israel comments cogently on inflation in Israel as follows:

> This year's [1984] rise in the rate of price increase continues the trend of recent years. This inflationary process is characterized by the lack of a nominal anchor for the price level, full indexation of most financial assets, almost full indexation of wages, and adjustment of the exchange rate to the expected rate of inflation. Together with persistent inflationary expectations, these add up to an inflationary process with strong inertia, with price shocks translated into a rise in the rate of price increase.1/

Indexation of liquid financial assets to the domestic price level or to a hard currency is particularly important. For many purposes these assets serve as money. Thus, while indexation protects the real value of the public's liquid holdings, it also deprives the authorities of an effective means of controlling growth of the monetary aggregates.

The above quoted Bank of Israel summary description of the inflationary process might well have also mentioned the important role of the Government's fiscal operations. For the Israeli fiscal year 1984/85, the budget deficit was projected to be approximately $1.8 billion (8 percent of GNP) after taking account of U.S. Government military and economic grants. Over 60 percent of that amount ($1.1 billion) was to be financed by net credits from the Bank of Israel. However, as already noted, subsidy expenditures exceeded the amounts budgeted, particularly in the months immediately preceding the election and again during the Package Deal I period. Domestic and foreign interest payments also exceeded the amounts budgeted by significant amounts. These developments were not offset by increases in domestic revenues. The budget deficit thus grew to over $2.5 billion (11 percent of GNP). And since actual sales of government bonds (mostly linked) to the public were very close to the amounts originally budgeted, financing of the budgetary overruns was derived almostly exclusively from

1/ Bank of Israel, Economic Developments in 1984 inflationary borrowing from the Bank of Israel. For the full year, the latter totalled approximately $1.9 billion.

Given this experience, it is understandable and proper that the GOI has given considerable emphasis in recent months to reducing the budget deficit. Reductions in subsidies in January as part of Package Deal II have already been mentioned. Since that time prices of government controlled "basic" goods and services have been raised periodically in an effort both to keep the budget deficit down and to prevent unintended growth in real private disposable income.

The budget for the 85/86 fiscal year which began on April 1 called for a decline in outlays for subsidies of approximately 30 percent vis-a-vis estimated expenditures for the preceding year (the rate of decline vis-a-vis the original fiscal 1984/85 budget was much smaller however; the intent was to reverse the trend toward increased subsidy outlays which developed during the 1984/85 fiscal year). Total budget expenditures were projected to decline by about $750 million (5 percent). Domestic revenues and U.S. assistance outlays were both projected to increase, leaving a deficit of $1.1 billion (less than 5 percent of GNP). Regrettably however, it was also expected that net receipts from government borrowing operations would decline leaving financing via Bank of Israel advances at approximately the actual fiscal 1984/85 level.

Government of Israel efforts to deal with inflation via fiscal restraint have also taken the form of promulgating certain institutional changes. In particular, two significant pieces of legislation have been enacted. One strengthens the hand of the Finance Ministry in enforcing budgetary discipline. The other is designed to gradually increase the independence of the Bank of Israel, which heretofore has been required by law to advance to the Government whatever sums it might need to finance the budget deficit. The full effect of this latter piece of legislation will not be felt for a few years yet, but it is a potentially important tool in the fight against inflation.

Recently, the Government of Israel has taken a further step. In an effort to expand the pool of unlinked liquid assets, and thus increase the scope for monetary policy, it has decided that Israelis will no longer be permitted to open liquid dollar-linked accounts (so-called PATAM) or to deposit additional sums into existing accounts. This too is a potentially important step in that it may provide an additional tool which can be used to counter inflationary pressures.

3) Balance of Payments

The balance of payments deficit on current account declined from $2.3 billion in 1983 to $1.5 billion in 1984 despite an increase in defense imports of some $440 million. A $600 million increase in goods and services exports (6 percent in terms of current dollars; 14.5 percent in real terms), a large increase in U.S. Government grant financing (economic and military), and a $400 million decline in non-defense imports were the major factors. Export growth (and the drop in imports) was facilitated by the decline in local demand (which released resources for export production) and strengthening of demand for Israeli imports, particularly on the part of the United States. Industrial exports other than diamonds accounted for virtually the entirety of the export surge. Metals, electronics and chemicals were the fastest growing sectors.

The decline in consumer goods imports was especially sharp (31.3 percent). Investment goods imports also declined (10.8 percent), while, on the other hand, imports of production inputs rose by nearly 7 percent, presumably to accommodate the needs of export oriented industries.

No balance of payments data are available for 1985 yet. On the basis of partial year trade statistics, it can be tentatively concluded that the trend toward improvement in the current account, which emerged in 1984, probably continued, but at a slower rate. Seasonally adjusted merchandise exports for the first half of 1985 were up by 5.8 percent in dollar terms vis-a-vis the comparable period in 1984. Non-defense merchandise imports during the same period fell by 3.8 percent.

Net medium and long term capital inflows fell by over $1 billion in 1984, more than offsetting the decline in the current deficit, thus resulting in a substantial basic deficit.2/ The major factors were large declines in private investment3/ and medium and long term commercial borrowing. The deficit was financed by short term borrowing by the Government and a $600 million decline in international reserves. The latter stood at $3.06 billion as of December 31, 1984, approximately 2.6 months of non-FMS financed imports of goods and services at the 1984 level.

2/ The current account deficit less medium and long term capital movements.

3/ Historically, foreign investment has never been a major source of foreign exchange for Israel. However, in 1983 there was a surge of capital inflows to support bank shares which were recorded as foreign investment. The subsequent decline in 1984 represented a return to historical patterns.

Total outstanding external debt increased by $625 million during 1984 to a year end level of $23.4 billion. The structure of the debt is favorable; only 17 percent is short-term, while well over one-half represents concessional loans provided by the U.S. Government and holders of Israeli bonds. Nevertheless, it is a bit disconcerting that almost one half of the increase in the total debt recorded in 1984 was short-term, and that the entirety of this amount was government borrowing to cover balance of payments deficits.

Debt service payments rose by $400 billion in 1984 to a total of $4 billion--$3 billion in interest payments ($2.7 billion in 1983) and $1.1 billion in amortization of medium and long term loans ($1 billion in 1983). Debt service obligations required expenditure of approximately 29 percent of the foreign exchange Israel received from exports of goods and services plus unilateral transfers (vs. 28 percent in 1983, 31 percent in 1982, and 27 percent in 1981). It thus appears that Israel's debt service burden remains heavy, but is not increasing.

Despite continued improvement in the merchandise trade account, international reserve holdings fell by $500 million in the first four months of 1985, continuing the trend which emerged in 1983 and accelerated in the last half of 1984 (although the rate of decline appears to be slowing). This suggests continued difficulties in the capital account. Reserve holdings as of April 30, 1985 ($2.5 billion) were equal to approximately two months of non-FMS goods and services imports at the 1984 level.

D. Current Status and Outlook for the Israeli Economy

Despite the attention which the coalition government has paid to economic issues since coming to power a year ago, recent developments, particularly continued inflationary pressures and declining international reserve holdings, have made it plain that Israel needs to do more in order to reestablish its economic health and set the stage for a resumption of non-inflationary economic growth. With these objectives in mind, the cabinet approved a new program at the end of June the basic elements of which are

1) increases in prices of subsidized consumer goods and services ranging from 25 to 100 percent,

2) increases in the prices of most other goods and services of 17 percent,

3) a three month price freeze (subsequent to the above mentioned increases),

4) a 14 percent increase in wages payable on August 1 to partially compensate workers for May and June increases in the consumer price index,

5) additional increases in nominal wages of 12 percent payable on September 1 (which is a one time only payment and will not be added to wage rates for the purpose of calculating future cost of living adjustments), 4 percent each on December 1 and January 1, and 3.5 percent on February 1, the latter three increases to be in addition to regular cost of living adjustments to wages to be paid simultaneously,

6) reductions in the public service workforce (the levels and timing of which are to be agreed upon later),

7) increases in various taxes, the most important of which is an 8 1/3 percent supplemental tax on the incomes of companies and self-employed persons applicable to the 1985 tax year,

8) reductions in expenditures of government ministries and government supported insurance schemes totaling approximately $530 million on an annual basis,

9) an 18.8 percent devaluation of the shekel, after which the dollar/shekel exchange rate is to be stabilized for a time at approximately IS1500 = $1, and

10) abolition of foreign currency linked deposits (PATAM) which mature in less than one year.

The Government hopes that the program will be instrumental in effecting a sizeable reduction in private consumption and the Government deficit, thereby releasing resources for use in export oriented industry and containing inflationary pressures. At the same time, it is expected that export profitability will be maintained at reduced cost to the treasury. It is expected that real private disposable income will be reduced by the cut in subsidies on consumer goods and services, the upward adjustments in various taxes and fees and, most importantly, the adjustments in wages which will significantly reduce the purchasing power of paychecks. In this regard, it is important to note that the wage provisions in the program call for upward adjustments which are substantially less than those which would have been paid in the normal course under the wage indexing agreements previously in force. It is anticipated that these adjustments will only partially compensate for inflation, although the latter is expected to fall as the program takes effect.

Reductions in subsidies and other government expenditures in combination with increases in taxes and fees should also reduce public deficit financing requirements, which according to budget projections were, for the most part, to have been met by inflationary advances from the Bank of Israel. The provision in the program prohibiting new deposits to liquid foreign currency linked accounts may be an important first step in increasing the scope for use of monetary policy as an anti-inflationary tool.

Lastly, the devaluation was clearly indicated in view of the need to narrow the current account deficit and restore confidence.

The sustainability of the wage adjustment and foreign exchange provisions of the program, and the effect of the program on balance of payments developments over the coming months depends critically on whether the inflation rate drops rapidly and remains low, as the Israeli Government expects. Clearly, there is a limit to the willingness of Israelis to accept reductions in their living standards, and those limits could be exceeded if inflation does not abate sufficiently. Similarly, adverse developments in the balance of payments--both the current and capital accounts--can be expected if inflation persists while the nominal dollar/shekel exchange rate is maintained at IS1500 = $1. Were that to happen, pressures for another devaluation would quickly mount. At some point they would doubtless be accommodated, but not before Israel's external financial accounts were damaged.

The critical variables which will determine whether inflation will be reduced sharply and quickly enough to make the program sustainable involve fiscal and monetary policy. In short, the Government will have to reduce its deficit significantly and rapidly, and finance the residual in the least inflationary way possible. This in turn suggests two questions:

1) Are the deficit reduction measures in the program adequate?

2) What are the prospects that these measures will be fully implemented?

Neither question can be answered in a definitive way. With respect to adequacy, we do not yet have a good grasp of the extent of reductions in the budget deficit or their timing.

The Israeli Government estimates that cuts in the budgets of government ministries and various insurance schemes will total approximately $530 million on an annual basis. Tax provisions of the new program are estimated to yield approximately $220 million. What we do not yet know--and need to in order to discuss the question of adequacy in an informed way--are

-- when the cuts in the deficit will be realized,

-- the effect on the budget deficit of other important elements of the program, e.g. decline in the value added tax, impact of the devaluation and subsequent stabilization of the shekel on outlays under the exchange rate insurance program, and

-- Israeli Government intentions, particularly regarding subsidies, for the period after expiration of the three month price freeze.

Prospects for full implementation of deficit reduction provisions of the program are also unclear. Projections of expenditures for consumer subsidies are vulnerable; the deficit reduction targets established by the Government last fall were not realized principally because of overruns in outlays for subsidies during the three months Package Deal I was in effect. Past experience with implementation of cuts affecting operating ministries also raises questions. It is hoped that recently promulgated legislation which strengthens the hand of the Finance Ministry in enforcing budgetary discipline will be helpful. However, at this point the legislation remains untested.

In summary, it appears that the Government has recently introduced a program designed to deal with Israel's long standing problems of inflation and external disequilibrium in a serious way. The sustainability of the program depends chiefly upon whether it succeeds in bringing down the rate of inflation sharply and quickly, and then keeping it down. That in turn will be determined largely by the future course of fiscal and monetary policy; the temporary price freeze put into effect when the program was introduced will at best only suppress inflation for a time, but is no substitute for a well thought out, fully implemented program designed to significantly reduce the Government's deficit financing requirements and to minimize the inflationary impact of whatever residual requirements remain. The adequacy of the fiscal program from this perspective, and Israel's ability to fully implement it, remain open questions.

III. U.S. ECONOMIC ASSISTANCE PROGRAM

A. Recent Economic Assistance Program

Since fiscal year 1972, A.I.D. has been providing grant and loan assistance from the Economic Support Fund to finance non-defense commodity imports and to meet Israel's needs for foreign exchange. Initially, obligations were fairly modest ($50 million in FY 1972, FY 1973 and FY 1974). By 1976, they had increased to $700 million in response to Israel's growing economic problems (a $550 million CIP loan and grant program and a $150 million cash grant). The following year, the program reached $735 million, of which $300 million was in the form of a cash grant. In FY 1978, it was increased again to $785 million ($485 million in commodity import financing and a $300 million cash grant). It remained at approximately that level until FY 1984 when it was increased to $910 million. In FY 1985, it was increased again to $1.2 billion (exclusive of the supplemental assistance discussed in this document). From FY 1976 through FY 1980, approximately two-thirds of the ESF program was provided on a grant basis; the remainder was on concessional loan terms. The terms of the package were changed to all grant in FY 1981.

In FY 1979, the nature of the program changed in that, for the first time, the total amount was provided as a cash transfer. The CIP financing element was eliminated to alleviate difficulties which the Government of Israel had encountered in utilizing available funds. Despite the high volume of Israel's non-military imports from the U.S. ($900 million to $1.6 billion a year for the past several years), Israel had considerable difficulty in collecting the necessary documentation on a sufficient volume of transactions to ensure timely disbursement of all available CIP funds. The problem arose because of Israel's traditional lack of government control over private sector transactions. The result was that undisbursed CIP funds totaled approximately $300 million as of September 30, 1978.

In addition to ESF, the U.S. provided PL 480 Title I food for several years and authorized several Housing Guarantee Programs for Israel. Under other legislation, assistance has been provided to help Israel settle new immigrants from the Soviet Union and other countries. During FY 1975, a $20 million grant for a Joint U.S.-Israel Desalination Project was authorized. This project was completed in 1983.

The following amounts of military assistance have been provided to Israel since FY 1976: FY 76-$1.5 billion, TQ-$200 million, FY 77 through FY 80-$1 billion per year, FY 81 and FY 82-$1.4 billion per year, FY 83 and FY 84-$1.7 billion per year, and FY 85-$1.4 billion. Additionally, in FY 1979, the U.S. provided $3 billion to assist Israel to pay for the redeployment of military installations and personnel in the Sinai. Of this total, $800 million was a grant for the construction of two air bases in the Negev; the remainder was provided as FMS credits.4/

This FY 1985 supplemental assistance will be in the form of a cash transfer. Since its purpose is to help Israel finance current, non-defense balance of payments deficits, it is necessary that we choose a mode of assistance which will permit rapid disbursement. A cash transfer is such a procedure.

IV. GRANT ADMINISTRATION

A. Procedures:

Prior to FY 1979, A.I.D. provided annual funding to the Government of Israel under both a Commodity Import Program (CIP) and a cash transfer program. In FY 1979, a decision was taken to eliminate the Commodity Import Program element and to provide all economic assistance to Israel (PL 480 and ASHA excepted) as an annual cash transfer, linked at the aggregate level to U.S. non-defense exports to Israel. The cash transfer mode has been used since that time.

In August 1985, the Congress, at the request of the Administration, appropriated $1.5 billion in supplemental economic assistance for Israel. These funds are to be disbursed during FY 85 and 86 as cash grants. The House and Senate conferees meeting to iron out differences between the supplemental appropriations bills passed by the two houses of the Congress indicated ". . . that the Administration is to move quickly to disburse funds that Israel needs to meet its most urgent economic needs and to provide assistance on a reasonable and timely basis". In report language accompanying its version, the House indicated that the timing of disbursements was to be left to the discretion of the President or his designee and was to be ". . . based exclusively on achievement . . . of programmatic benchmarks mutually agreed upon by the United States and Israeli Governments, and not upon other considerations unrelated to economic performance".

4/ Of the $1.4 billion FMS package provided in FY 1982, $200 million was a supplement to the FY 1979 redeployment assistance package.

Provision of assistance to Israel in the form of cash grants is normally conditional upon receipt of satisfactory Israeli Government assurances that Israel will import from the United States non-defense goods at least equal in dollar value to our level of economic assistance obligations. The Israeli Government provided such an assurance to the U.S. in FY 1985. However, this assurance did not contemplate supplemental assistance. We do not plan to extend that assurance to include the supplemental assistance discussed in this document. The Government of Israel has also provided assurances that U.S. exporters will continue to enjoy equal access to Israeli markets and that Israel will follow procedures worked out in cooperation with the United States for bulk shipments of grain on dry bulk carriers. These assurances are unaffected by the current request for a supplemental appropriation and remain in effect.

B. Utilization of Economic Support Fund (ESF) Assistance:

From July 1, 1974, through June 30, 1985, A.I.D. provided a total of $8,655 billion of Economic Support Funds (formerly Security Supporting Assistance) to the Government of Israel. As of June 30, 1985, all of these funds had been disbursed.

TABLE II

July 1, 1974 - July 30, 1985 ESF Funding for Israel (in billions of dollars)

Program	Grant	Loan	Total
Commodity Import	1.100	.755	1.855
Cash Transfer	6.280	.520	6.800
Total	7.380	1.275	8.655

ANE/MENA:RMisheloff:sp:08/01/85:1126M

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

MEMORANDUM

AUG 13 1985

TO: ANE/PD/ME, Charles J. Patalive, Project Chairperson

FROM: ANE/PD/ENV, Stephen F. Lintner, SFL Environmental Coordinator

SUBJECT: Israel - FY 1985 Supplemental Cash Transfer, (271-K-621), Environmental Clearance

The proposed cash transfer is exempt from environmental review under the "Categorical Exclusion" provisions of 22 CFR 216, "A.I.D. Environmental Procedures".

cc:
GC/ANE/NE, R. Johnson
ANE/MENA, R. Misheloff
AID Affairs Officer, U.S. Embassy Tel Aviv, R. Reubensaal

Draft: ANE/PD/ENV:SFLintner, 7/26/85, Doc. 0931B

5C(1) - COUNTRY CHECKLIST

Listed below are statutory criteria applicable generally to FAA funds, and criteria applicable to individual fund sources: Development Assistance and Economic Support Fund.

A. GENERAL CRITERIA FOR COUNTRY ELIGIBILITY

1. FAA Sec. 481; FY 1985 Continuing Resolution Sec. 528. Has it been determined or certified to the Congress by the President that the government of the recipient country has failed to take adequate measures or steps to prevent narcotic and psychotropic drugs or other controlled substances (as listed in the schedules in section 202 of the Comprehensive Drug Abuse and Prevention Control Act of 1971) which are cultivated, produced or processed illicitly, in whole or in part, in such country or transported through such country, from being sold illegally within the jurisdiction of such country to United States Government personnel or their dependents or from entering the United States unlawfully?

   It has not been so determined.

2. FAA Sec. 620(c). If assistance is to a government, is the government liable as debtor or unconditional guarantor on any debt to a U.S. citizen for goods or services furnished or ordered where (a) such citizen has exhausted available legal remedies and (b) the debt is not denied or contested by such government?

   Israel is not known to be in violation of this section.

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3. FAA Sec. 620(e)(1). If assistance is to a government, has it (including government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities?

Israel is not known to be in violation of this section.

4. FAA Sec. 620(a), 620(f), 620(D); FY 1985 Continuing Resolution Sec. 512 and 513. Is recipient country a Communist country? Will assistance be provided to Angola, Cambodia, Cuba, Laos, Syria, Vietnam, Libya, or South Yemen? Will assistance be provided to Afghanistan or Mozambique without a waiver?

No. Assistance will not be so provided.

5. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, the damage or destruction by mob action of U.S. property?

Israel is not known to be in violation of this section.

6. FAA Sec. 620(l). Has the country failed to enter into an agreement with OPIC?

There is an Investment Guarantee Agreement between the U.S. and Israel.

7. FAA Sec. 620(o); Fishermen's Protective Act of 1967, as amended, Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing activities in international waters?

(a) Israel is not known to have taken such actions.

(b) If so, has any deduction required by the Fishermen's Protective Act been made?

8.	FAA Sec. 620(q); FY 1985 Continuing Resolution Sec. 518. (a) Has the government of the recipient country been in default for more than six months on interest or principal of any AID loan to the country? (b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the appropriation bill (or continuing resolution) appropriates funds?	No.
9.	FAA SEC. 620(s). If contemplated assistance is development loan or from Economic Support Fund, has the Administrator taken into account the amount of foreign exchange or other resources which the country has spent on military equipment? (Reference may be made to the annual "Taking Into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of Agency OYB." This approval by the Administrator of the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)	Yes, as reported in the Annex Report on implementation of FAA Section 620(s).
10.	FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have they been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?	No, Israel has not severed diplomatic relations.

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11. FAA Sec. 620(u) What is the payment status of the country's U.N. obligations? If the country is in arrears were such arrearages taken into account by the AID Administrator in determining the current AID Operational Year Budget? (Reference may be made to the Taking into Consideration memo.)

To the best of our knowledge, Israel is not in arrears on its U.N. obligations.

12. FAA Sec. 620A; FY 1985 Continuing Resolution Sec. 521. Has the country aided or abetted, by granting sanctuary from prosecution to, any individual group which has committed an act of international terrorism?

No.

Has the country aided or abetted, by granting sanctuary from prosecution to, any individual or group which has committed a war crime?

No.

13. FAA Sec. 666. Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA?

No.

14. FAA Sec. 669, 670. Has the country, after August 3, 1977, delivered or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards? Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device? (FAA Sec. 620E permits a special waiver of Sec. 669 for Pakistan.)

We have no knowledge that Israel has delivered or received such items or detonated such a devise.

15. ISDCA of 1981 Sec. 720. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Assembly of the U.N. of Sept. 25 and 28, 1981, and failed to disassociate itself from the communique issued? If so, has the President taken it into account? (Reference may be made to the Taking into Consideration memo.)

No.

15. FY 1985 Continuing Resolution. If assistance is from the population functional account, does the country (or organization) include as part of its population planning programs involuntary abortion?

Not Applicable.

16. FY 1985 Continuing Resolution Sec. 530. Has the recipient country been determined by the President to have engaged in a consistent pattern of opposition to the foreign policy of the United States?

No. It has not been determined that Israel has engaged in a consistent pattern of opposition to the foreign policy of the United States.

B. FUNDING SOURCE CRITERIA FOR COUNTRY ELIGIBILITY

1. Development Assistance Country Criteria

Not Applicable.

FAA Sec. 116. Has the Department of State determined that this government has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, can it be demonstrated that contemplated assistance will directly benefit the needy?

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2. Economic Support fund Country Criteria

FAA Sec. 502B. Has it been determined that the country has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, has the country made such significant improvements in its human rights record that furnishing such assistance is in the national interest?

No. It has not been determined that Israel is engaged in a consistent pattern of gross violations of internationally recognized human rights.

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3A(2) - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B, a distinction is made between the criteria applicable to Security Supporting Assistance and the criteria applicable to Development Assistance. Selection of the appropriate criteria will depend n the funding source for the progra

CROSS-REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? IDENTIFY. HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. App. Unnumbered; FAA Sec. 653(b)

   (a) Describe how Committees on Appropriations of Senate and House have been or will be notified concerning the nonproject assistance;

   (a) Committees have been notified in accordance with normal Agency procedures.

   (b) is assistance within (Operational Year Budget) country or international organization allocation reported to the Congress (or not more than $1 million over that figure plus 10%)?

   (b) Yes.

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   No further legislative action is required within Israel.

3. FAA Sec. 209, 619. Is assistance more efficiently and effectively given through regional or multilateral organizations? If so, why is assistance not so given? Information and conclusion whether assistance will encourage regional development programs. If assistance is for newly independent country, is it furnished through multilateral organizations or in accordance with multilateral plans to the maximum extent appropriate?

   No.

4. FAA Sec. 601(a); (and Sec. 201(f) for development loans). Information and conclusions whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.	Funds will help finance Israels imports and generally assist its economy.
5. FAA Sec. 601(b). Information and conclusion on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (includin use of private trade channels and the services of U.S. private enterprise).	U.S. private trade and investment will benefit to the extent U.S. goods are purchased with the funds.
6. FAA Sec. 612(b); Sec. 636(h). Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other servic and foreign currencies owned by the Unit States are utilized to meet the cost of contractual and other services.	Not Applicable.
7. FAA Sec. 612(d). Does the United States own excess foreign currency and, if so, what arrangements have been made for its release?	Not Applicable.

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Security Supporting Assistance

(a) FAA Sec. 531. How will this assistance support promote economic or political stability?	The purpose of this assistance is to support the economy and political stability of Israel.
2. Nonproject Criteria for Development Assistance	Not Applicable.

3. <u>Nonproject Criteria for Development Assistance (Loans only)</u> — Not Applicable.

4. <u>Additional Criteria for Alliance for</u> Progress — Not Applicable.

A.I.D. Grant No: 271-K-621

AGREEMENT

BETWEEN

THE GOVERNMENT OF ISRAEL

AND

THE GOVERNMENT OF THE UNITED STATES OF AMERICA

ACTING THROUGH

THE AGENCY FOR INTERNATIONAL DEVELOPMENT

Dated: September 11, 1985

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Agreement, dated September 11, 1985 between the Government of Israel ("Israel") and the Government of the United States of America acting through the Agency for International Development ("A.I.D."), together referred to as the "Parties."

ARTICLE I

The Grant

To support the economic and political stability of Israel, A.I.D., pursuant to the Foreign Assistance Act of 1961, as amended, agrees to grant to Israel under the terms of this Agreement not to exceed Seven Hundred Fifty Million United States Dollars ($750,000,000) (the "Grant").

ARTICLE II

Condition Precedent to Disbursement

SECTION 2.1. Condition Precedent to Disbursement

Prior to the disbursement of the Grant, or to the issuance by A.I.D. of documentation pursuant to which disbursement will be made, Israel will, except as the Parties may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D., a

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statement of the name of the person holding or acting in the office specified in Section 5.2, and of any additional representatives, together with a specimen signature of each person specified in such statement.

SECTION 2.2 Notification

When A.I.D. has determined that the condition precedent specified in Section 2.1 has been met, it will promptly notify Israel.

SECTION 2.3. Terminal Date for Condition Precedent

If the condition specified in Section 2.1 has not been met within ninety (90) days from the date of this Agreement, or such later date as A.I.D. may agree to in writing, A.I.D., at its option, may terminate this Agreement by written notice to Israel.

ARTICLE III

Disbursement

SECTION 3.1. Disbursement of the Grant

After satisfaction of the condition precedent, A.I.D. will deposit in a bank designated by Israel the sum of Seven Hundred Fifty Million United States Dollars ($750,000,000).

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SECTION 3.2. Date of Disbursement

Disbursement by A.I.D. will be deemed to occur on the date A.I.D. makes deposit to the bank designated by Israel in accordance with Section 3.1.

ARTICLE IV

Special Covenants

SECTION 4.1. No Use for Military Purpose

It is the understanding of the Parties that the Grant will not be used for financing military requirements of any kind, including the procurement of commodities or services for military purposes.

SECTION 4.2. Use Only Within Pre-1967 Boundaries

Program uses of the Grant shall be restricted to the geographic areas which were subject to the Government of Israel's administration prior to June 5, 1967.

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ARTICLE V

Miscellaneous

SECTION 5.1. Communications

Any notice, request, document, or other communication submitted by either Party to the other under this Agreement will be in writing or by telegram or cable, and will be deemed duly given or sent when delivered to such Party at the following address:

To Israel: Economic Minister
Embassy of Israel
3514 International Drive, N.W.
Washington, D. C. 20008

To A.I.D.: Director, Office of Project Development
Bureau for Asia and Near East
Agency for International Development
Washington, D. C. 20523

All such communications will be in English, unless the Parties otherwise agree in writing. Other addresses may be substituted for the above upon the giving of written notice.

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SECTION 5.2. Representatives

For all purposes relevant to this Agreement, Israel will be represented by the individual holding or acting in the office of Economic Minister, Embassy of Israel and A.I.D. will be represented by the individual holding or acting in the office of Director, Office of Project Development, Bureau for Asia and Near East, each of whom, by written notice, may designate additional representatives for all purposes.

The names of the representatives of Israel, with specimen signatures, will be provided to A.I.D., which may accept as duly authorized any instrument signed by such representatives in implementation of this Agreement, until receipt of written notice of revocation of their authority.

SECTION 5.3. Amendment

This Agreement may be amended by the execution of written amendments by the authorized representatives of both Parties.

IN WITNESS WHEREOF, Israel and the United States of America, each acting through its duly authorized representative, have caused this Agreement to be signed in their names and delivered as of the day and year first above written.

GOVERNMENT OF ISRAEL

Udi Polonsky

By: Udi Polonsky
Title: Assistant Economic Minister
Embassy of Israel

UNITED STATES OF AMERICA

Charles W. Greenleaf Jr.

By: Charles W. Greenleaf, Jr.
Title: Assistant Administrator
Bureau for Asia and
Near East

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