R. Ashton

INTERNATIONAL DEVELOPMENT COOPERATION AGENCY

AGENCY FOR INTERNATIONAL DEVELOPMENT

WASHINGTON, D.C. 20523

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

ISRAEL: Cash Transfer (271-K-625)

November 14, 1986

CLASSIFICATION: UNCLASSIFIED

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 271-K-625
2. Country: Israel
3. Category: Cash Transfer
4. Date: November 13, 1986
5. To: Charles W. Greenleaf, Jr., Assistant Administrator, ANE Bureau
6. OYB Change Number: N/A
7. From: Peter Bloom, Director, ANE/PD
8. OYB Increase: None
   To be taken from: Economic Support Fund
9. Approval Requested for Commitment of: $ 1,200,000,000
10. Appropriation Budget Plan Code: QES7-87-37271-KG-31 (770-63-271-00-50-71)
11. Type Funding: ☐ Loan ☒ Grant
12. Local Currency Arrangement: ☐ Informal ☐ Formal ☐ None
13. Estimated Delivery Period: N/A
14. Transaction Eligibility Date: 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	$1,200,000,000	Other	N/A

18. Summary Description

This assistance is part of a continuing assistance program to Israel. Israel's political and economic stability continue to be 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 and helps Israel to manage its large balance of payment deficit. It is intended to give Israel greater economic flexibility for easing some of the pressure on its economy.

It is recommended that you approve a cash transfer grant in the amount of one billion two hundred million dollars ($1,200,000,000) to be disbursed upon execution of the grant agreement and satisfaction of the condition precedent.

19. (cont'd.) ANE/PD/ME:JSilver (draft) Date 10/22/86
ANE/PD:RVenezia (draft) Date 10/23/86
DAA/ANE:RHBell Date 11/14/86

19. Clearances	Date
DAA/PPC:MDagata	(draft) 11/12/86
NEA/IAI:JHolzman	
F/FM:CChristensen	KCR 11/14/86
ANE/GC:AMattice (draft)	10/23/86
ANE/MENA:RMisheloff (draft)	10/24/86
ANE/PD/ME:JStanley (draft)	10/22/86
ANE/DP:NNicholson (draft)	10/27/86

20. Action: ☒ APPROVED ☐ DISAPPROVED

Authorized Signature: James A. Kolt
Date: 11/14/86
Title: Acting Assistant Administrator

AID 1120-1 (5-82)

CLASSIFICATION:

I. SUMMARY OF POLITICAL AND ECONOMIC CONSIDERATIONS

Political and economic stability in Israel is essential to achieving a comprehensive peace in the Middle East, a major U.S. foreign policy objective. 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. Assistance from the U.S. Economic Support Fund (ESF) helps maintain economic stability in Israel by financing some of the foreign exchange costs of economic growth and development.

Historically, large government expenditures and associated budget deficits triggered excessive expansion in the domestic money supply and fueled triple digit increases in consumer prices each year. The deficits were a result of the government's efforts at maintaining a high level of social welfare and rising civilian consumption, while at the same time expending large sums for defense. In addition to strong inflationary pressures, Israel experienced persistent balance of payments deficits. Both problems were considerably exacerbated after the 1973 Arab-Israeli War by world inflation, the rise in oil prices, and increased military expenditures. However, within the past 15 months or so, a program of economic austerity, supported by supplemental U.S. assistance, has markedly improved Israel's external financial position and sharply reduced the inflation rate. The steep decline in prices of oil imports and the depreciation of the dollar--to which the Israeli shekel was tied de facto until quite recently--are also important factors in explaining the turnaround.

Israel's efforts at meeting the demands of both its civilian and military sectors continue to require substantial balance of payments support despite its unique access to concessional capital flows from abroad. Israel's need for assistance in the future will depend importantly on its efforts to make necessary economic adjustments, i.e., eliminate internal disincentives to productive investment and increases in labor productivity, and continue reductions in the percentage of resources consumed by the public sector, particularly for non-investment purposes.

II. RATIONALE FOR ECONOMIC ASSISTANCE

A. Background

Israel's economic achievements in the first 25 years of its existence were remarkable, particularly in view of its limited natural resources. Fueled by very high levels of investment (frequently reaching 30 percent of gross domestic product), real gross domestic product (GDP) rose at an average annual rate of 9 percent between 1950 and 1972. At the same time, prices were relatively stable; until 1970 consumer prices increased at an average annual rate of 7 percent.

Beginning in the mid-1970's, Israeli economic performance deteriorated. By the early 1980's, GDP growth rates were much reduced, averaging only about 1.4 percent per annum, and annual inflation had reached triple digit levels. Increasingly, private savings were used to finance current government expenditures, while productive investment dropped because of the uncertainty of real returns under conditions of high inflation as against the certainty of positive real returns of securities issued by the government to help finance its own current expenditures. Gross domestic investment declined from 31 percent of GDP in 1972 to 21 percent 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 rising consumer prices or related exchange rate movements. Relatively high levels of consumption were stimulated by budget deficits and marked increases in real wages. Over the 1971-1984 period, labor market conditions were tight, as reflected in an unemployment rate of 2.5-5 percent, and real wages increased faster than labor productivity. The high levels of private and government civilian consumption, coupled with growing defense requirements and a lessened ability of the Israeli economy to supply 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 $600 million in 1972 (8.6 percent of GDP) to $4 billion in 1983 (16.7 percent of GDP) before falling to $3.3 billion (15 percent of GDP) in 1984. External foreign debt (net of foreign assets of Israeli commercial banks) rose from $4 billion in 1972 to $23.7 billion at the end of 1984.

In summary, the economy was characterized by:

- persistent civilian balance of trade deficits in excess of 10 percent of GNP;

- an increase in external liabilities and gross debt service of over 40 percent since 1980; at the end of 1984 the level of foreign liabilities was 4 percent higher than total GNP;

- a level of gross domestic investment which has been declining as a percentage of GNP for over a decade;

- budget deficits on the order of magnitude of 15 percent of GNP; and

- triple digit inflation.

B. Recent Economic Developments

1) Gross National Product (GNP) and its components

Real GNP increased by 3.6 percent in 1985 to approximately $21 billion. On a per capita basis, it was about $4,950.

Domestic demand declined by 1.8 percent in 1985. However, this was more than offset by a 7.5 percent real increase in exports of goods and services. This shift in resources from domestic uses to exports continued a trend which began in 1984.

As in 1984, domestic demand fell across a broad front. Private consumption declined marginally (0.4 percent), following a 6.8 percent drop the previous year; investment was down by over 13 percent (-7.6 percent in 1984); and domestic public consumption declined by approximately 4 percent. Explanatory factors include a sharp (9 percent) drop in real wages, cuts in the domestic budget (including transfer payments and subsidies) and high real rates of interest, particularly during the second half of the year.

Buoyant exports probably reflect slack domestic demand plus maintenance of favorable exchange rates.

Modest rates of economic expansion characterized the first half of 1985. Seasonally adjusted real GNP increased by 3.7 percent vis-a-vis the previous 6 month period, reflecting rapid expansion in government consumption outlays and more modest,

but still significant, growth of exports (4.2 percent). However, economic expansion abruptly ceased during the second half. Private and public consumption both fell--the latter by almost 15 percent--as did investment. GNP for the semester was down 3.6 percent. At the same time, the rate of unemployment increased considerably, particularly during the third quarter.

While economic activity remained slack throughout the last half of the year, the first signs of a recovery were already apparent by the last quarter. Consumption, particularly private consumption, rebounded sharply, and unemployment fell. Nevertheless, growth continued to be negative, with increased domestic consumption reflected in sharply rising imports and reduced stocks.

National accounts data for the first part of 1986 are incomplete. No clear picture emerges. On the one hand, both GNP and private consumption increased. For the first quarter, the former was 4.6 percent higher than the quarterly average for 1985 and 10 percent higher than it was for the last quarter of that year. Real private consumption during the first quarter was 8.7 percent above the 1985 quarterly average and 4.5 percent higher than it was during the preceding 3 months. This probably reflects sharply increasing real wages, particularly in the private sector. Similarly, the index of organized retail trade rose sharply (by almost 10 percent) during the first quarter, and then more slowly during the second, reinforcing the impression one gets of rising consumer demand. On the other hand, the index of industrial production increased at a much more modest rate during the first quarter, and unemployment began to creep up again. While the data are not yet available to fully explain these trends, it may be noteworthy that imports have grown sharply in 1986, and that the rate of growth of consumer imports was especially high. Thus, one is left with the impression of strong domestic private consumption demand, but a productive sector not yet confident enough to respond fully.

For 1986 as a whole, the Government of Israel projects growth in real gross domestic product (GDP) in the 2.5-4 percent range. Private consumption is expected to lead the way with growth reaching 9-12 percent. Other elements of domestic demand--public consumption and investment--are expected to contract, continuing recent trends, although the expected rate of decline in investment--0-2.5 percent--would be much less precipitous than it was in 1984 (7.6 percent) or 1985 (13.4 percent). Exports are expected to continue growing (by 2.5-5 percent), but at a slower rate than they did in the recent past.

2) Inflation

The consumer price index (CPI) rose by 185 percent in 1985, compared to 445 percent in 1984. During the first half of the year, the inflation rate averaged 12 percent a month, or 285 percent on an annual basis, reflecting rising nominal wages, a large budget deficit, and continued shekel depreciation. A three-month freeze on prices, profits, and tax rates dating from November 1984 proved totally inadequate in the face of these strong underlying pressures. The same holds true for the system of administratively regulated prices introduced in January 1985 to replace the earlier freeze.

Following introduction of a more comprehensive economic stabilization program in July 1985 (see section IIC2 below), the inflation rate declined suddenly and dramatically. For the year beginning August 1985, monthly increases in the CPI averaged 1.8 percent. 1/

For the first 8 months of 1986, the inflation rate was even lower--averaging 1.2 percent a month, or 15 percent a year.

3) Balance of Payments and Trade Developments

The goods and services deficit fell from $4.8 billion in 1984 to $4 billion in 1985, despite an increase in defense imports of some $350 million. For the first time in at least 25 years, the current account was in surplus (by $1.1 billion). This represented a $2.5 billion swing from the 1984 outcome--which in turn was a substantial improvement over 1983 performance. Major factors were an $800 million drop in service imports--chiefly overseas travel by Israelis and interest payments--and a large increase in U.S. Government grant financing (economic and military). Were it not for the latter factor, the current account would have remained in deficit, although the size of that deficit would have been smaller than it was in 1984.

1/ In July 1985 the CPI rose 27.5 percent as a result of a currency devaluation and sharp, but one time, increases in the prices of subsidized goods and services, as well as other goods and services whose prices had been controlled since November 1984. These measures were integral elements of the aforementioned stabilization plan introduced that month.

The capital account was slightly in deficit in 1985. This was due almost entirely to the shift of all U.S. Government assistance to a grant basis. Thus, one of the major factors explaining improved current account performance also accounts for the decline in capital inflows. The result was not a wash, however, as Israel's basic balance 2/ showed a $1 billion surplus in 1985, as against a $250 million deficit the year before.

Approximately $200 million of the basic surplus was used to reduce net short term indebtedness. Foreign exchange reserves were rebuilt to a year-end level of $4.7 billion--an increase of $620 million--reversing the downward trend of 1983 and 1984. The year-end reserve level is equivalent to approximately 3 1/2 of non-FMS financed imports at the 1985 level.

For the first quarter of 1986, the current account was in approximate balance. The goods and services deficit remained roughly unchanged from the previous quarter at a level of approximately $900 million, despite a fall in defense imports and much lower prices for imported oil. The major change was a fall in public sector transfers to a more normal level, following close to $2 billion in ESF disbursements during the last half of 1985.

Long and medium term capital movements were approximately in balance during the first quarter, as was the basic balance. Nevertheless, the Israeli Government and, to a lesser extent, the private sector continued to reduce their net short term debt, drawing down reserves by some $200 million in order to do so. Reserve holdings, however, certainly did not decline enough to create a problem, and indeed in subsequent months have almost recovered to their comfortable year-end 1985 level.

As indicated previously, exports grew impressively in 1985 in real terms. However, they contributed little to the improvement in the balance of payments as measured in dollars, presumably because of the appreciation of the dollar relative to the currencies to many of Israel's major trading partners. Industrial exports did especially well, with metals, electronics, chemicals and diamonds leading the way. On the other hand, service exports declined as a result of falling interest income.

2/ Current account plus medium and long term capital movements

Trade performance during the early part of 1986 has not lived up to Israeli Government expectations. While merchandise exports increased almost 14 percent in terms of current dollars during the January-July period (vis-a-vis the same period the previous year), over half of the increase reflected a surge in diamond exports which are volatile, affected by factors beyond Israeli control, and have very low domestic value added.

Import demand has strengthened. During the first seven months of the year total merchandise imports excluding diamonds (which surged as a result of the strong demand for exports of cut stones) and fuel (which fell sharply because of the rapid decline in oil prices) rose 19 percent in terms of current dollars vis-a-vis the corresponding period the previous year. All catagories of goods were affected, but imports of finished consumer products rose most sharply (by 48 percent).

Total outstanding external debt increased by $100 million (less than 1/2 percent) in 1985 to a year-end level of $23.8 billion, 3/ the smallest such increase in many years. All of the increase is accounted for by medium and long term borrowing by the private, non-financial sector. Nevertheless, government liabilities account for approximately two-thirds of total outstanding debt.

While total debt continues to be heavy (approximately 113 percent of GNP), its structure is favorable; only 15 percent is short-term, while well over one-half represents very long term and/or concessional loans provided by the U.S. Government and holders of Israeli bonds.

Debt service payments remained approximately constant in 1985 at a level of $3.9 billion. A $200 million increase in amortization of medium and long-term loans (to $1.25 billion) was offset by an equal decline in interest payments (to $2.65 billion). The debt service ratio 4/ remained unchanged at 37 percent. Net debt service, i.e., total principal and interest payments less interest receipts, totaled $3 billion, up $320 million from 1984, which in turn was $600 million higher than 1983. On a net basis, debt service obligations required expenditure of approximately 20 percent of the foreign exchange

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3/ Includes the gross debt of the government and the non-bank private sector, plus the net obligations of the banking system.

4/ Gross debt service as a percentage of export earnings (including services).

Israel received from exports of goods and services (except capital services) plus unilateral transfers 5/ (vs. 21 percent in 1984 and 17 percent in 1982 and 1983). As a percentage of GNP, net debt service payments rose--from 12 percent in 1984 to 14 percent in 1985.

C. Economic Stabilization Efforts Of The National Unity Government

1) The "Package Deals"

To stem foreign exchange outflows and reduce inflation, the coalition government formed in September 1984 decided to cut government expenditures, devalue the shekel, raise prices of subsidized goods and services, and impose administrative restrictions on foreign exchange purchases and imports. In November, it reached agreement with the Histadrut (the labor confederation) and the Manufacturers' Association (representing private employers) on the first of what was to be a series of agreements (so-called "package deals") freezing--or in later phases--administratively determining--prices, profits, and tax rates for specified periods.

At first, these initiatives appeared to be having a salutary impact. Inflation slowed dramatically at the end of 1984 and the beginning of 1985. Moreover, the non-defense trade deficit declined. However, it soon became clear that the underlying pressures which had caused the crisis had not abated, and could not be expected to respond well to a program which relied very heavily on controls and administratively determined pricing of goods, services, and labor.

2) The July 1985 Economic Stabilization Program

In July 1985, faced with growing dissatisfaction, resurgent inflation, an unsustainable budget deficit, and continuing decline in foreign exchange reserves, the government put into effect a new, more comprehensive economic stabilization program. The basic elements were:

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

5/ Including U.S. grant assistance disbursements of $3.9 billion.

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

3) a price freeze (subsequent to the above mentioned increases);

4) a complex series of wage adjustments designed to erode real wage rates during the last half of 1985, and then permit them to rise again during the first quarter of 1986;

5) reductions in the public service workforce;

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

7) reductions in expenditures of government ministries totaling approximately $530 million on an annual basis;

8) an 18.8 percent devaluation of the shekel, after which the dollar/shekel exchange rate was to be stabilized for a time at IS 1500 = $1;

9) abolition of foreign currency linked deposits (PATAM) which mature in less than one year; and

10) a restrictive monetary policy featuring high real interest rates.

The government hoped that the program would be instrumental in effecting a sizable reduction in private consumption and the budget deficit, thereby releasing resources for use in export-oriented industries and containing inflationary pressures. At the same time, it was expected that export profitability would be maintained at reduced cost to the treasury. The reduction in private consumption was to be accomplished by keeping interest rates high--thereby

encouraging savings--and reducing real private disposable income by means of upward adjustments in various taxes and fees and, most importantly, reductions in real wages.

Reductions in subsidies and other government expenditures, in combination with increases in taxes and fees, were also designed to reduce public deficit financing requirements, which according to original budget projections were, for the most part, to have been met by inflationary advances from the Bank of Israel.

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

To date the most dramatic effects of the program have been the very sharp decline in the inflation rate and the increase in foreign exchange reserves.

Measures taken by the Government of Israel in the areas of budgetary, monetary, and wage policy in the months following the introduction of the program proved sufficient to restrain both public and private demand enough to reduce inflationary pressures. For the Israeli fiscal year ending March 31, 1986, the budget deficit, after factoring in U.S. economic assistance, dropped below 5 percent of GNP for the first time in many years, thanks both to an increase in tax and other revenue yields and a decline in current expenditures, particularly transfers, subsidies and interest payments. Real wage rates declined sharply during the third quarter of 1985. This, in combination with very high real rates of interest, probably accounts for the 6 percent drop in private consumption which occurred during that 3 month period. Thus, it is fair to say that while a price freeze was an element of the July stabilization program, the dramatic decline in inflation reflects a lessening of underlying demand pressures, and probably could have been achieved even if the freeze had not been imposed.

On the other hand, the stabilization program does not appear to have made any substantial impact on balance of payments performance. While the current account was in substantial surplus during the second half of 1985, the major cause was unusually high U.S. grant assistance disbursements. Seasonally adjusted exports and non-defense imports (excluding diamonds)

were both approximately equal in dollar terms during the first and second halves of the year. Moreover, while data for 1986 is still fragmentary, it does not appear that performance has improved. As indicated above, merchandise exports (diamonds excepted) have grown more slowly than was anticipated, while imports have increased in dollar terms, despite the sharp decline in oil prices.

There are also other warning signs on the horizon.

1) Real wages which, as noted, had declined in the months immediately following introduction of the stabilization program, began to rise again late in 1985, and have probably regained their pre-stabilization program level. This may help explain the resurgence in private consumption demand (including demand for imports) which began in the fourth quarter of 1985 and is continuing.

2) Government expenditures, while lower than they have been in past years, continue to require for their financing very high levels of U.S. grant assistance, and, in some combination, expansion of the domestic debt or money creation. For the Israeli fiscal year April 1, 1986 through March 31, 1987, for example, the government projects foreign grants, domestic non-bank financing, and net borrowing from the Bank of Israel at respectively 13 percent, 2 percent and 5 percent of GNP. 6/ Each of these financing modes intensifies already existing problems. Money creation is inflationary. Large infusions of U.S. aid tend to perpetrate a sense of economic dependence which is of concern to many thoughtful Israelis. Lastly, with internal debt already at almost 200 percent of GNP, debt service is over 20 percent of projected budget expenditures. This, in combination with still higher expenditures for defense, makes it very difficult to cut the budget. Equally important, heavy government borrowing requirements tend to raise domestic interest notes and crowd out private investment (which, as previously noted, has been falling).

6/ The projected deficit before taking into account U.S. assistance is 18.5 percent of GNP. However, financing requirements are slightly higher because the government expects to reduce its external indebtedness.

In an environment in which cutting budget expenditures is very difficult, it is tempting to think in terms of reducing deficits by raising taxes. In Israel this would be a mistake. Domestic revenues--of which taxes are the major component--are already over 40 percent of GNP. The top income tax bracket is 66 percent. These rates probably have an adverse impact on work effort and investment. They may also be a factor explaining why many skilled Israeli workers emigrate.

Given continued high levels of U.S. assistance flows, the above does not indicate a near-term balance of payments financing problem. However, it does suggest that, while the stabilization program successfully averted a crisis, more needs to be done before Israel can achieve a growth rate which it considers acceptable, and which is sustainable without reigniting inflationary pressures or again subjecting itself to intense balance of payments difficulties.

D. Structural Adjustment

Initially, the stabilization program focused on resolution of short-term problems. In the near crisis atmosphere which prevailed during most of 1985, this was entirely appropriate. More recently, the Government of Israel has been turning its attention to the more fundamental measures necessary for self-sustaining growth. Some steps have already been taken, e.g., delinking of some liquid financial assets from the consumer price index and partial delinking of wages. What follows is a listing of other areas in which reform would be useful in facilitating non-inflationary economic growth. While it covers areas which we believe to be of importance, it is not meant to be all inclusive.

1) Investment Policy. While plant and equipment already in being is sufficient to permit growth in the short-run, longer-term development will require new investments. However, non-residential investment has been falling as a proportion of GNP for many years, and foreign equity investment has never been significant. The reasons are complex and not completely understood. Doubtless, inflation has had serious disincentive effects, since it is very difficult to gauge profitability when input and output prices are escalating rapidly.

Thus, stabilizing the economy might be the most important thing Israel is doing to encourage a resurgence of investment. The fact that that resurgence is not yet in evidence does not refute the point, since potential investors understandably wish to assure themselves that the stabilization program is not a passing phenomenon before putting resources into long-term ventures.

Nevertheless, there are other measures Israel might take to encourage the investment it needs for growth. These include:

a) Capital Market Reform. There is a clear need to better channel traditionally high levels of private savings into productive investments. In this context, two problems are worth mentioning. First, financing a large budget deficit inter alia by means of domestic borrowing means that the government is using private savings for its own current expenditures, in the process crowding out private investment. Second, the government tends to intervene in the capital market using a variety of incentives and administrative devices to channel private capital into favored uses, disregarding market forces.

b) Investment Incentives. It might be useful to review incentives currently in place to determine their effectiveness and cost. The system is complex, and given the adverse trends in investment aggregates, their cost-effectiveness is open to debate.

c) Deregulation and Divestiture. Entrepreneurs in Israel confront a complex tax system, as well as regulations governing imports, pricing, profit repatriation (in the case of foreign investors), access to the capital market, etc. A priori logic suggests that the tax and regulatory systems discourage investment and distort resource allocation. Many Americans who do business in Israel indicate that this is the case. The case for divestiture in the Israeli context warrants study. The Israeli Government maintains an equity position in many productive ventures. To what extent, if at all, this impedes efficient plant operations is not known.

2) Tax Policy. There are at least two major difficulties--high rates and the sheer complexity of the system. Gross tax receipts have been running between 43 and 50 percent of GNP for several years, which is high. Moreover, in 1984 a 66 percent tax bracket was introduced on incomes in excess of $52,000 a year. Thus, it seems likely that tax policy is a disincentive to work effort.

While reducing high marginal taxes has obvious attractions, it needs to be considered in the context of the budget deficit. If public expenditures can be reduced, tax reduction becomes very attractive.

It may be possible to devise a revenue neutral tax reform in advance of further expenditure cuts. The scope for reducing high direct tax rates by broadening the tax base is unclear and seems an appropriate subject for study. Similarly, a serious review of indirect taxes would be well worth the effort. The system is exceedingly complex. Domestically produced goods and services, for instance, may be subject to up to six separate taxes (the value added tax, purchase tax, fuel taxes, excises, various fees and licenses, and a stamp duty). Levies on imports are no less complicated, raising serious questions about their impacts both on resource allocation and equity.

3) Linked Financial Assets. Under current arrangements, the value of some near money liquid assets adjusts automatically to changes in the inflation rate, thereby depriving the Bank of Israel of effective control over the monetary aggregates. Thus, once generated, inflationary pressures are very difficult to reduce. Steps taken by the Israeli government in 1985 to abolish liquid assets tied to the dollar were helpful. More needs to be done, particularly measures to do away with, or diminish the attractiveness of, liquid shekel assets linked to the consumer price index.

4) Labor Market Reform. Wages remain partially linked to the consumer price index. This too complicates the process of bringing inflation under control, although the problem is not as serious as is linkage of financial assets. More importantly, wage rates for different sectors of the economy are linked to each other. This tends to suppress wage differentials which might otherwise be useful in facilitating shifts of labor out of services and sectors which produce for the domestic market and into export oriented industries.

It might also be useful to take a good look at other labor market rigidities to see if they significantly reduce mobility. To the extent that legal and/or institutional impediments to the hiring/firing and shifting of workers between sectors can be eliminated, the process of economic adjustment will be less painful.

III. U.S. ECONOMIC ASSISTANCE PROGRAM

A. Recent Economic Assistance Program

Since fiscal year 1972, A.I.D. has provided 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. By 1976, they had increased to $700 million in response to Israel's growing economic problems. They remained at the $700-800 million level until FY 1984, when they were increased to $910 million. In FY 1985, obligations were increased again to $1.2 billion (exclusive of the $750 million disbursed from the $1.5 billion in supplemental assistance appropriated that year). In FY 1986, the program was reduced slightly to $1.148 billion due to budgetary ceilings imposed by the Gramm-Rudman-Hollings legislation. However, the final $750 million of the aforementioned supplemental assistance package was also disbursed that year. For FY 1987, we again propose a $1.2 billion program.

From FY 1976 through FY 1980, approximately two-thirds of the ESF program was provided on a grant basis; the remainder was on highly concessional loan terms. The terms of the package were changed to all grant in FY 1981, and have remained all grant since then.

In FY 1979, 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 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 (and continues to be) 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.

This FY 1987 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, rapid disbursement of these funds is required. A cash transfer is suitable for this purpose.

IV. GRANT ADMINISTRATION

A. Procedures

Since FY 1979, all economic assistance to Israel (PL 480 and ASHA excepted) has been provided as cash transfers, linked at the aggregate level to Israeli non-defense imports from the United States.

In August 1985, the Congress, at the request of the Administration, appropriated $1.5 billion in supplemental economic assistance for Israel to be disbursed during FY 1985 and FY 1986 as cash grants. The first $750 million tranche was disbursed in September 1984. The remaining $750 million was disbursed in two equal tranches during FY 1986.

Provision of assistance to Israel in the form of cash transfers 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 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. Written assurances covering these subjects have been received by A.I.D. for this cash transfer.

B. Utilization of Economic Support Fund (ESF) Assistance

From July 1, 1974 through September 30, 1986, A.I.D. provided a total of $11,303.4 million of Economic Support Funds (formerly Security Supporting Assistance) to the Government of Israel. As of September 30, 1986, all of these funds had been disbursed.

TABLE I

July 1, 1974 - September 30, 1986 ESF Funding for Israel
(in billions of dollars)

Program	Grant	Loan	Total
Commodity Import	1.100	.755	1.855
Cash Transfer	8.928	.520	9.448
Total	10.028	1.275	11.303

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

MEMORANDUM

TO: ANE/PD/ME, Thomas E. Johnson

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

SUBJECT: Israel - FY 1987 ESF Cash Transfer, (271-K-625), 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, Alice Mattice
ANE/MENA, Russell Misheloff
AID Affairs Officer, U.S. Embassy Tel Aviv

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EMBASSY OF ISRAEL
WASHINGTON, D.C.

שגרירות ישראל
וושינגטון

October 2, 1986

Mr. Charles Greenleaf
Assistant Administrator
Bureau for Asia & Near East
Agency for International Development
Washington, DC 20523

Dear Charlie,

You will recall that in conjunction with the shift of the U.S. economic assistance program to Israel from commodity import financing to cash transfer, the Government of Israel provided certain assurances regarding the impact of the shift on U.S. exports to Israel and access of U.S. suppliers to Israeli markets.

In particular, the Government if Israel undertood to:

a) take all steps to insure that, during th U.S. fiscal year 1979, the dollar level of Israel's non-defense imports frome the United States would be at least equal to the level of U.S. economic assistance obligations during that year, that U.S. suppliers would not be disadvantaged by the termination of the CIP, and the level of cash transfers made to Israel does not cause an adverse impact on the total amount of non-military exports from the United States to Israel.

b) regarding the carriage of goods imported from the U.S., continued to follow procedures which had been followed up to that time for bulk shipments of grain on dry bulk carrier

In conveying these assurances, we also indicated, in an illustrative way, steps which we had decided to take to fulfill our commitments. In this regard, we indecated that:

a) regarding Israeli Government procurement of large capital equipment items which U.S. suppliers might furnish, special measures would be taken as necessary to assure that they can compete on terms at least as favorable as those offered by prospective third country suppliers, and

b) the Government of Israel would continue importing from the United States grains and other agricultural products purchased on government account at levels approximating those of the past few years, with due allowances for Israel's requirements for such goods and capacity to store them.

On behalf of my government, I would like to take this opportunity to renew the aforementioned commitments for U.S. fisical year 1987, and to indicate that we will continue to implement the illustrative measures for carrying out these commitments as numerated above.

In the summer of 1987 the Government of Israel will undertake another review of experience under the cash transfer procedures. A report of our finding will be provided to the United States by September 1, 1987.

Over the past few years, the level of Israel's non-defense imports from the United States has grown as indicated in the report we submitted to AID on October 2, 1986.
My Government anticipates additional increases in the coming year, and, as before, is prepared to discuss with appropriate U.S. Government officials what reasonable steps it could take to make American sources of supply more attractive to Israel importers.

Sincerely,

Pinhas A. Dror
Minister (Economic Affairs)

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Mr. Charles Greenleaf
Assistant Administrator
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Dear Charlie,

Further to the understanding between the Agency for International Development and the Government of Israel, a review of Israel's experience under the Cash Transfer Program was undertaken during the summer of 1986. I am pleased to provide you with a report of this experience in this letter.

Pursuant to the assurances that were given to AID, the dollar level of Israel's non-defense imports from the United States during fiscal year 1986, exceeded the level of U.S. economic assistance during that year. The current policy of the Government of Israel calls for leveling imports and increasing exports as a measure to reduce the current deficit in the balance of payments. U.S. suppliers were clearly not disadvantaged by this policy nor by the termination of the Commodity Import Program. This can readily be seen from the tables attached hereto as tables I and II. Table I shows the comparative imports of 21 separate items (including grains). Table II shows comparative imports of 4 grains. Both tables cover the years 1980 through the first three quarters of 1986.

As in previous years, the Government of Israel continued take measures to assure the competitiveness of U.S. captical equipment suppliers. Imports of U.S. manufactured metals to Israel during 1985 totaled $132 million, an increase of $27 million over the previous year. Imports of U.S. Optical Photography, Medical Equipment to Israel during 1985 totaled $144 million, an increase of $29 million over the previous yea

In 1985 the value of the import of goods from the U.S. decreased by 5%. This decrease came after an increase of 15% in the dollar value of the imports in the years 1983 and 1984, while total imports in those years increased by 1% only.

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The volume of imports from the U.S. increased in that period in even a faster rate (by approximately 20%).

The decrease in imports in 1985 resulted from the continuing revaluation of the dollar that caused imports from the U.S. to be more expensice. Although the development of the dollar in 1985 was not fully reflected in the flow of trade, it caused an increase of about 1% in the value of imports from the U.S. in the first half of 1986.

From data on the development of imports from the U.S. to Israel in recent years, it is obvious that the shift in the economic assistance program to cash transfers will not cause a reduction in the Israeli imports from the U.S. In 1980 the share of the U.S. in Israel's total imports was about 18%, in 1985 the share of the U.S. in Israel's total imports reached 20%. According to partial data available, this U.S. share will be sustained in 1986, as well, and it is likely to expect that this share will increase in 1987 (if there will be no unexpected fluctuations in the relative exchange rates.)

U.S. bulk carriers have benefited as well. Procedures were worked out for the Agency for International Development and the Maritime Administraion transportation experts for employing U.S. bulk carriers of grain to Israel. Suitable American-flag vessels were used to the extent possible. The market share of U.S. bulk carriers have reached the desired mark of 50%.

Our experience under the Cash Transfer Program has demonstrated the effectiveness of the Program vis-a-vis the commodity Import Program, in terms of providing opportunities to U.S. suppliers of exports to Israel. We are pleased that these results bear out the confidence that AID and other U.S. Government agencies placed in us in shifting from the Commodity Import Program to the Cash Transfer Program.

In the future, as well as in the past, the Government of Israel will take necessary measures ensuring that no U.S. suppliers will be desadvantaged by the termination of the Commodity Import Program.

Sincerely,

Pinhas A.Dror
Minister (economic Affairs)

IMPORTS OF GOODS FROM THE U.S. (C.I.F.)
MILLIONS OF U.S. DOLLARS
1981–1985, January – June 1986

	1981	1982	1983	1984	1985	I–VI 1985	I–VI 1986
Animals and Products of Animals	10	8	9	7	6	3	5
Plants and Products thereof	455	382	375	383	324	177	142
Oils and Fats of Animals	6	3	2	4	4	2	2
Processed Foods, Beverages, Tobacco	31	28	32	33	22	11	11
Minerals	3	4	3	6	4	1	1
Chemical Products	84	88	79	81	66	36	46
Rubber and Plastics	39	39	38	36	34	17	20
Processed Leather & Furs	4	5	5	2	6	4	1
Wood and Products thereof	5	3	4	4	5	2	3
Paper and Cardboard	52	49	49	57	47	22	31
Textiles and Products thereof	65	45	34	37	45	26	21
Footwear	1	1	2	1	1	0	1
Articles of Stone, Cement, Ceramic	10	11	11	14	16	8	7
Precious Stones	43	42	41	50	71	36	53
Metals	124	105	82	105	132	70	58
Machinery & Electric Equipment	486	522	583	619	608	316	335
Vehicles, Aircraft and Vessels	120	102	248	176	106	40	53
Optical Photography, Medical Equipment	75	79	94	115	144	75	67
Miscellaneous	6	7	5	4	5	3	2
Works of Art	4	0	3	3	6	3	5
Unclassified Commodities	7	13	24	35	27	16	40
TOTAL IMPORTS	1,650	1,542	1,723	1,772	1,679	868	874

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IMPORTS OF GRAINS FROM THE U.S.

(Thousands of Long Tons)
1978-1985
1986 (Jan-Sept.; Forecast)

	1980	1981	1982	1983	1984	1985	Jan - Sept. 1985	Jan - Sept. 1986	Forecast 1986
WHEAT	388	392	556	379	563	437	314	384	606
CORN	658	456	477	389	216	264	289	217	312
SORGHUM	304	463	335	434	585	479	270	84	192
SOYBEANS	426	445	488	469	382	420	332	274	434
	1776	1756	1856	1671	1746	1600	1205	959	1544

Remark: In the last three years small quantities of soybeans and feedgrains were privately imported for re-export purposes, therefore were exempted from the 50% U.S. flag requirement.

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