R. Ashton

UNCLASSIFIED

AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D. C. 20523

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

ISRAEL: Cash Transfer (271-K-627)

October 28, 1988

UNCLASSIFIED

CLASSIFICATION:

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 271-K-627

2. Country: ISRAEL

3. Category: Cash Transfer

4. Date:

5. To:

6. OYB Change Number:

7. From: Ronald F. Venezia, Director, ANE/PD

8. OYB Increase:

To be taken from: Economic Support Fund

9. Approval Requested for Commitment of: $ 1,200,000,000

10. Appropriation Budget Plan Code: 72-119/01037 QES9-89-37271-KG-31

11. Type Funding: ☐ Loan ☒ Grant

12. Local Currency Arrangement: ☐ Informal ☐ Formal ☐ None

13. Estimated Delivery Period:

14. Transaction Eligibility Date:

15. Commodities Financed:

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. Clearances (cont'd.)
NEA/IAI:SNoble (draft) Date 10/14/88
ANE/DP:PBenedict Date 10/5/88

19. Clearances	Date
DAA/ANE:WFuller	[illegible]
ANE/PD:BOdell	[illegible]
ANE/PD/ME:JMSilver (draft)	10/4/88
ANE/MENA:PGary (draft)	10/5/88
DAA/PPC:GLaudato (draft)	10/14/88
FM/CONT:MUsnick	10/28/88
GC/ANE:JSilverstone (draft)	10/6/88

20. Action

☒ APPROVED ☐ DISAPPROVED

Authorized Signature: Carol C. Adelman

Date: 10/28/88

Title: Assistant Administrator, ANE

AID 1120-1 (5-82)

CLASSIFICATION:

PROGRAM ASSISTANCE APPROVAL DOCUMENT
(PAAD)
ISRAEL
[Project No. 271-K-627]

I. Program Summary

This cash transfer of $1.2 billion from the Economic Support Fund (ESF) was appropriated by Congress to help maintain economic stability and growth in Israel in order to preserve its independence and support Israel's continuing pursuit of the peace process in the Middle East. Political and economic stability in Israel are deemed essential to achieving a comprehensive peace in the Middle East, a prime U.S. foreign policy objective.

II. Political Context and Program History:

a. Political Context

Israel's efforts at meeting the demands of civilian consumption and security needs place great stress on the country's finances. U.S. foreign policy interests in the region dictate support for Israel in the maintenance of peace and the resolution of conflict. This support is deemed necessary to assure that Israel has the incentive and confidence to continue pursuing the peace process. Since 1979 and the signing of the Camp David accords, the U. S. has been providing substantial economic and military assistance to both Israel and Egypt, with the objective of supporting the accord between those two countries. This policy has had some success as these two once belligerent neighboring countries move toward a lasting peace.

U.S. interests in Israel, however, go beyond the maintenance of the Camp David accords. The existence of Israel as a free and independent nation is an important U.S. foreign policy objective, in and of itself. Israel is a democratic and politically stable country in a region of great social, political and military instability. The U.S. assistance programs, both economic and military, help Israel to maintain its internal political stability, and to preserve its independence.

b. Program History

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 support Israel's requirements 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 in addition to a $1.5 billion supplemental disbursed in two separate year tranches of $750 million each. In FY 1986, the program was reduced to $1.148 billion due to a sequestration mandated by Gramm-Rudman-Hollings legislation. In FY 1987 the program was restored to the $1.2 billion level. From FY 1976 through 1980, approximately two-thirds of the ESF program was provided on a grant basis; the remainder on highly concessional loan terms. The program became fully grant in FY 1980.

In FY 1979, the CIP financing element was eliminated to alleviate difficulties which the GOI had encountered in utilizing available funds. Most of the difficulties and slow disbursements arose due to the lack of control that the GOI exercises over private sector importation.

In addition to ESF, the U.S. provided PL 480 Title I food aid for several years and authorized several Housing Guarantee Programs for Israel. In FY 1975, a $20 million grant for a Joint U.S. - Israel Desalination project was authorized. This project was completed in 1983. More recently, a number of regional projects, involving Egypt, have also been implemented.

This FY 1989 assistance is in the form of a cash transfer. Its purpose is to help Israel maintain economic stability through balance of payments support. This support is needed to help Israel in its efforts to achieve sustained economic growth, and to assure its continued pursuit of the peace process.

III. Economic Setting:

a. Historical

Israel experienced rapid economic growth until the early 1970's. Fueled by very high levels of investment, at times exceeding 30% of GDP, real GDP grew at an average rate of 9% per year between 1950 and 1972. At the same time, prices were relatively stable, and private capital inflows easily covered balance of trade deficits. By the mid-1970's, Israel's economy turned sluggish: from then through 1986, the economy grew at an annual rate of less than 2%. Much of the slowdown was brought on by the rapid escalation in oil prices after 1973 and 1979. Also, the war of 1973 diverted a major share of national resources to defense. The GOI, in trying to maintain civilian expenditures in the face of slower economic growth and greater security spending, financed growing budgetary deficits with private domestic savings. With the growth in budget deficits and concomitant money supply growth, inflation roared to triple digit levels. Productive private sector investment declined in the face of uncertain real returns. Gross domestic investment declined from 31% of GDP in 1972 to only 21% in 1984.

During this period of slow growth and rapid inflation, personal consumption was maintained through indexation of welfare payments, wages, interest income and taxation. High levels of consumption were induced through large and growing budget deficits and other expansionary aggregate demand policies. Over the 1971-1984 period, unemployment was low at between 2.5% and 5.0%, and real wages rose more rapidly than did productivity.

The expansion in government spending and aggregate demand led to excessive money creation, domestic borrowing and current account deficits. The current account deficits were financed by increased U.S. assistance flows and by foreign borrowing. The trade deficit on civilian goods and services account rose from $600 million in 1972 (9% of GDP) to $3.8 billion in 1983 (17% of GDP). 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.

To stem foreign exchange outflows, reduce inflationary pressures, and, in general, stabilize the economy, the National Unity Government (NUG) in 1984 devised a stabilization program. The stabilization program was to include:

- Reduction in government expenditures;
- Rise in prices of some subsidized goods and services;
- Freezing or controlling many other prices, wages and interest rates;
- Imposition of foreign exchange and import restrictions

Initially the program had some positive impact. Inflation had slowed by the beginning of 1985 and the overall balance of payments moved into surplus. However, it soon became apparent that the underlying pressures which had created the earlier economic instability were still in place and were blocking restored economic growth. The need for more comprehensive reform was recognized. In July of 1985, bucyed by the $1.5 billion ESF supplemental the NUG initiated a new Economic Stabilization Program (ESP), comprising mainly:

- Reduction in price controls and some subsidies
- Wage restraints
- Reduction in public sector workforce
- Reduction in other government expenditures
- Devaluation
- Tight monetary policy

b. Recent Developments

The success of the ESP is manifested in three main areas: (1) the budget deficit, exclusive of foreign aid, has declined from 26% of GNP in 1984/85 to 14% in 1987/88; (2) inflation has declined from more than 15% per month to 1.5%; and (3) the currency has been shored up. Of course, a number of external factors contributed to the success of the program, namely: the U.S supplemental; decline of the U.S. dollar; and decreases in interest rates abroad and in the prices of fuel and other imported commodities.

The most impressive recent macro-economic development has been the sharp restraint on the inflation rate to below 20% during 1986. Disappointing has been the failure to reduce it below 16% this year or last. Other macro-economic developments have been less favorable. The GDP growth rate began to grow above 2% during the last part of 1986 and grew at 5.2% for 1987. We expect little or no growth in 1988 as the economy experiences a slowdown begun in 1987, compounded by the effects of the uprising. The uprising has depressed economic activity in tourism, construction and inter-regional trade. The Israeli trade deficit had gradually improved from $3.2 billion in 1983 to $1.9 billion in 1986; but then this deficit more than doubled during 1987: Exports increased by $1.5 billion during 1987, but civilian imports rose by $2.0 billion and military imports jumped by 150%. With favorable capital movements in recent years, foreign exchange reserves rose from $2.4 billion at the middle of 1985 to $5.9 billion at the end of 1987, or enough for 5 months of imports. Reserves fell below $5.0 billion by August 1988.

The major reform accomplished during 1987 was the lifting of controls on numerous prices. As a result, the fees on government services had risen by 72% and the percentage of consumer items still covered by price controls was reduced to 26% from 89% in January 1986. The major reform accomplished during 1988 was in the area of privatization. The sale of Paz Oil company has been completed and inter-ministerial approval given for the sale of 74% of Israel Chemicals. The First Boston Privatization report, submitted in April, has become the blueprint for further privatization. There has been a substantial reduction in government financial aid being provided to distressed companies, with Alliance Tire Factory, for example, being allowed to close. Finally, planning is underway which would allow private takeover of grain imports.

c. <u>Prospects</u>

Little movement in structural reform outside the privatization area has taken place recently because attention has been focused on the November elections and on the redemption of $3.6 billion of bank shares in October. Economic stagnation and the uprising have caused the budget deficit to grow again, but, unlike past election years, there has been effective restraint on calls for budget increases. This restraint was even tightened just six weeks before the Israeli election by subsidy cuts for transport, milk, poultry, and bread and by small across-the-board cuts for most Ministries. A gradual sale of the bank shares to the public over the years is anticipated so as to limit government involvement and permit reform in capital markets. Other important reform issues are eventual implementation of a realistic foreign exchange rate and dampening real wage rate increases beyond levels merited by increases in productivity. Tax reform, banking and credit market liberalization and further steps towards privatization and liberalization of governmental controls have also been cited as necessary areas for structural reform. The most important element of structural reform needed to promote more self-sufficient economic growth will be renewed vigor in budget deficit reduction. Hopefully, a post-election Israeli government will exert a new push on structural reforms in a number of key areas.

IV. Use of Economic Support Funds:

This year's allocation of $1.2 billion in Economic Support Funds to the Government of Israel is a cash transfer for needed balance of payment support.

From July 1, 1974 through September 30, 1988, A.I.D. provided a total of $13,703.4 million of Economic Support Funds to the Government of Israel.

The breakdown of the use of ESF is provided below.:

July 1, 1974 - September 30, 1988 ESF Support for Israel
(in billions of dollars)

Program	Grant	Loan	Total
Commodity Import	1.100	.755	1.855
Cash Transfer	11.328	.520	11.848
TOTAL	12.428	1.275	13.703

During 1988, Israeli debt payments to the United States totaled about $1.17 billion, including $974 million in FMS payments. With re-financing of the highest interest-bearing portion of FMS debt, Israel has achieved at least $90 million in annual savings in FMS interest payments; the result is that Israel's 1989 debt payments to the United States will be just about $1.2 billion.

V. Grant Administration Procedures

Provisions of assistance to Israel in the form of a cash transfer will be 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.

The Government of Israel will open a separate bank account solely for Cash Transfer proceeds. Financial documentation, books, and records will be maintained, in accordance with generally accepted accounting principles and practices, concerning the use of Grant proceeds for a period of three years. Over the three year period appropriate documentation will be made available to A.I.D. upon reasonable requests. Financial records will at least be suitable to document the withdrawal and disposition of dollar funds from the separate account and their tracking into final uses. This documentary evidence might, for example, take the form of letters of credit or bank statements in support of actual transactions for specific purposes and end uses. Should Grant proceeds be used for other than for the eligible purposes, the Government of Israel would redeposit, from its own foreign exchange, a commensurate amount of dollars in the separate bank account and to treat such redeposit as principle under the Cash Transfer Agreement.