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Z. Hahn
PD-ABP-834

FY 94 ISRAEL CASH TRANSFER

October 29, 1993

- / -

USAID

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

ACTION MEMORANDUM FOR THE ASSISTANT ADMINISTRATOR, BUREAU FOR ANE

FROM: NE/DR, Satish Shah MCWright for

SUBJECT: Israel - FY 94 ESF Cash Transfer Grant, 271-K-633

PROBLEM: Your approval is required for the authorization of up to $1.2 billion for an FY 1994 ESF cash transfer grant to Israel. Obligation would be made subject to the availability of funds under the A.I.D. OYB process.

DISCUSSION: In recent years, Congress has provided for an annual cash transfer to Israel of $1.2 billion. Under the current Foreign Operations Appropriations Bill, $1.2 billion would be provided to the GOI immediately, pending the signing of the Grant Agreement and other appropriate documents.

As in past years, we need to take into consideration Congressional and Agency concerns as to the possible impact of the cash transfer on U.S. exporters. To address this and other concerns, the Embassy of Israel, as in previous years, has furnished two letters to A.I.D.: the Embassy of Israel letter of assurance (Tab C); and the Embassy of Israel 1993 report on the quantity and value of Israel's imports from the U.S. (Tab D). Based upon our review, we conclude that:

1. Israel's non-military FY 1993 imports from the U.S. exceeded the level of U.S. economic assistance;

2. U.S. exporters have not been disadvantaged by shifting ESF assistance to Israel from a commodity import program to a cash transfer; and

3. The assistance will not cause adverse impact on the level of non-military exports from the United States to Israel.

The GOI's letter of assurance for FY 94 (Tab C), states that "the GOI shall use its best efforts to induce Israeli importers whenever feasible, to purchase U.S. grain and other agricultural products and to employ U.S. flag vessels," as was done in FY 93.

320 TWENTY-FIRST STREET, N.W., WASHINGTON, D.C. 20523

As required by the legislation on cash transfers, the amount of the Grant will be disbursed to Israel's separate bank account in the U.S. after the signing of the Grant Agreement by the AA/NE and the Ambassador of the Government of Israel or his designated representative. The $1.2 billion cash transfer may be used at the discretion of the Government of Israel to: purchase goods and services from the United States; service GOI debt owed to or guaranteed by the United States Government; pay to the U.S. Government any subsidies or other costs associated with loans guaranteed by the U.S. Government; service Foreign Military Sales (FMS) debt, both current and refinanced and; fund other uses, as may be agreed by the U.S. Government and the Government of Israel pursuant to the Grant Agreement. The GOI will report quarterly to A.I.D. on how these funds have been used.

The State Department concurs that it is appropriate to proceed with this obligation.

The Congressional Notification (CN) was sent to Congress on October 4, 1993 and expired on October 29, 1993 without comment.

This Cash Transfer is certified to have met the criteria for "Categorical Exclusion" under A.I.D. Environmental Procedures, 22 CFR 216, (Tab H).

RECOMMENDATION: That you authorize $1.2 billion for the cash transfer grant to Israel, subject to the conditions contained in the attached PAAD, to be obligated subject to the availability of funds. Please indicate your approval by signing in the space provided below, and on the attached PAAD.

Approved: Margaret Carpenter

Disapproved: ______________________

Date: 10/28/93

Attachments:

Tab A - Program Assistance Approval Document (PAAD)
Tab B - Grant Agreement
Tab C - Embassy of Israel Letter of Assurance
Tab D - Embassy of Israel Letter on the Quantity & Value of Israel's Imports from the U.S.
Tab E - Program Implementation Letter No. 1
Tab F - Program Implementation Letter No. 2
Tab G - Program Implementation Letter No. 3
Tab H - Environmental Clearance

Clearances: (see attached PAAD)

Drafter:NE/DR/MENA, CBellamy:9/15/93:ICT.94

C Bellamy

CLASSIFICATION:

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number	271-K-633
2. Country	ISRAEL
3. Category	CASH TRANSFER
4. Date	October 29, 1993
6. OYB Change Number	NE-94-001
8. OYB Increase	To be taken from: Economic Support Fund
10. Appropriation Budget Plan Code	HES4-94-33271-IG-31(470-63-271-01-50-41)

To
Margaret Carpenter
Assistant Administrator

From
Satish Shah M L Went for
Director, NE/DR

Approval Requested for Commitment of
$ 1,200,000,000

Type Funding: ☐ Loan ☒ Grant

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

13. Estimated Delivery Period

14. Transaction Eligibility Date

Commodities Financed

DE24 008560

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	

3. Summary Description

This assistance is part of continuing assistance to Israel. Israel's political and economic stability continue to be deemed essential to achieving a comprehensive peace in the Middle East. U.S. programs, both military and economic, tangibly reflect 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) supports Israel's civilian economy and helps Israel to manage its balance of payments. 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 of up to one billion two hundred million dollars ($1,200,000,000) to be obligated subject to the availability of funds under the A.I.D. OYB process, and to be disbursed upon execution of the grant agreement and satisfaction of the conditions precedent.

9. Clearances	Date
DAA/ANE:GLaudato	10-28-93
NE/ME:RMachmer	10-22-93
GC/NE:KO'Donnell	10/25/93
NE/DP:VMolldrem	10-25-93
PDM/FM:MUsnick	10/28/93
FA/P/PB:JPainter	10/21/93
STATE/NE/IAI:TMiller	10/25/93

20. Action

☑ APPROVED ☐ DISAPPROVED

Authorized Signature: Margaret Carpenter

Date: 10/28/93

Title: Assistant Administrator

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FY 1994 PROGRAM ASSISTANCE APPROVAL DOCUMENT

(PAAD)

ESF Support to Israel

PROJECT No. 271 - K - 633

October 29, 1993

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I. Program Summary and Purpose of the Assistance

The purpose of this cash transfer of $1,200,000,000 from the Economic Support Fund (ESF) is to provide foreign exchange to the economy of Israel. Public Law 103-87 of September 30, 1993 specifies that, ". . . not less than $1,200,000,000 shall be available only for Israel, which sum shall be available on a grant basis as a cash transfer . . . "

Political and economic stability in Israel are important to achieving U.S. foreign policy objectives in the Middle East. As stipulated in the Grant, the funds may be used to: (a) finance the importation of goods and services from the United States; (b) service external debt owed to the U.S. Government or guaranteed by the U.S. Government; (c) pay to the United States Government any subsidies or other costs associated with loans guaranteed by the U.S. Government; (d) service Foreign Military Sales debt, both current and refinanced; and (e) fund other uses, as may be agreed by the U.S. Government and the Government of Israel.

II. Political Context and Program History

A. Political Context

Since Israel's inception, a major U.S. foreign policy objective has been to support the existence of Israel as a free, democratic and independent nation. U.S. military and economic assistance has been provided to support a broader objective of helping Israel maintain its own security and economic development.

In recent years, Israel's attempts simultaneously to meet the demands of civilian consumption, military and security expenditures and costs related to the absorption of immigrants from the Soviet Union and elsewhere, have strained its finances. U.S. foreign policy interests in the region include support for Israel in the maintenance of peace and the resolution of conflict. Since the 1979 signing of the Camp David accords, the U.S. government has provided substantial economic and military assistance to both Israel and Egypt. Israel is the largest single recipient of U.S. Government economic assistance.

B. Program History

Between 1948 and 1993, excluding a special supplemental related to the Gulf War, the U.S. Government has provided $58.5 billion of grant and loan assistance to Israel. Of this amount, approximately $23.7 billion has been for economic assistance. Initially, obligations were rather modest, cumulating to less than $600 million by 1961. By 1976, annual ESF support had increased to $700 million in response to Israel's growing economic problems. Support remained at the $700-800 million level annually until FY 1984, when it was 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 yearly tranches of $750 million each. In FY 1986, the program was reduced to $1.148 billion due to Gramm-Rudman-Hollings legislation. In FY 1987, the program was restored to the $1.2 billion level, at which it has remained. The FY 1991 Dire Supplemental provided an additional $650 million which was used to reimburse Israel for expenses incurred during the Gulf War. In FY 1993, $1.2 billion was obligated in one tranche. In addition, $1 billion of the $2 billion per year USG loan guarantee program was utilized in March 1993. The second $1 billion was borrowed in September 1993.

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 was converted fully to grant obligations in FY 1981. In FY 1979, the CIP financing element was eliminated to alleviate difficulties which the GOI had encountered in disbursing available funds. Most of those difficulties arose from lack of direct GOI control over private sector importation. Since 1979 the ESF has been provided exclusively in the form of cash transfers.

The present cash transfer provides foreign exchange that will help Israel to meet its import demands and other foreign exchange needs while servicing previously incurred debts to the U.S. (The Cranston Amendment, initiated under PL 98-473 of 1984 and repeated in subsequent years, specifies that the amount of ESF assistance to Israel be at least equal to the amount required to service payments on prior U.S. loans).

There are no economic reform conditions attached to the assistance. However, this support is provided against the background of economic reforms that the GOI has begun and which are essential if Israel is to succeed in achieving sustainable private sector-led growth and improved long-term economic security. In support of the economic reform process, the U.S.- Israel Joint Economic Development Group (JEDG) met in Jerusalem in September 1993. The high level policy discussions clearly demonstrated serious Israeli commitment to their reform program.

III. Economic Assessment:

A. Overview

Israel, with a population of 5.2 million and a GNP of $64.3 billion in 1992, has a per capita income of $12,300. The

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Government of Israel (GOI) has been relatively successful in stabilizing the economy in the face of a massive inflow of immigrants which have increased the population by around 10 percent since the end of 1989. Real GDP growth has averaged around 6 percent per year over the past three years, employment has risen at an annual rate of 4 percent, the recently adopted exchange system has improved export competitiveness, and inflation has been reduced to 10 percent from around 20 percent in recent years (see Table 1). However, unemployment has increased from 8.9 percent in 1989 to 11.2 in 1992 and remains around 10 percent at present. While GDP growth is projected to slow to around 4 percent in 1993, expanding business investment and governmental infrastructure investment coupled with sustained export growth provide the basis for a resumption of 6 percent average annual GDP growth in 1994 and 1995.

TABLE 1: ISRAEL: ECONOMIC INDICATORS

	1989	1990	1991	1992	1993
Real GDP Growth (% change)	1.7	5.8	6.2	6.6	4.0
Immigration (thousands)	12	188	176	77	80
Civilian Labor Force (% change)	3.2	2.9	7.3	5.3	n.a.
Total Employment (% change)	0.5	2.1	6.1	4.5	4.0
Unemployment Rate (%)	8.9	9.6	10.6	11.2	10.0
Exports ($ Billion)	11.2	12.3	12.2	13.4	15.0
Imports (C.I.F., $ Billion)	12.9	15.1	16.9	18.7	20.1
Current Account Balance ($ Billion)	1.2	0.6	-0.8	-1.2	-0.9
Capital Account Balance ($ Billion)	-1.1	-0.8	-0.8	-1.9	1.4
Overall Balance ($ Billion)	1.4	0.5	--	-1.2	0.5
General Government (% of GNP)					
Expenditure	59.8	58.8	58.0	56.5	n.a.
Revenue	53.6	54.7	53.8	53.7	n.a.
Overall Deficit (after Grants)	-6.2	-4.1	-4.3	-2.8	n.a.
Domestic Component of Deficit	-8.1	-6.7	-7.1	-5.6	n.a.
Foreign Component of Deficit	1.9	2.6	2.8	2.9	n.a.
Money Supply (M-2) Growth (%)	30.9	36.8	19.9	24.9	n.a.
Consumer Price Index (end-year)	20.7	17.6	18.0	9.4	10.0
Exchange Rate (Shekel Per $)	1.92	2.02	2.28	2.46	2.73
Gross External Liabilities					
$ Billion	31.5	32.8	33.0	33.9	n.a.
As % of GNP	72.1	64.7	56.9	53.3	55.5
Debt Service as % of Exports of Goods and Services	42.0	36.8	36.2	29.2	n.a.

The GOI has appropriately adopted a strategy of abstaining from direct intervention in the labor market and has instead focused on providing the immigrants with housing and subsistence grants and training while encouraging a more favorable environment for the private sector investment and expansion. While government expenditures for immigrant absorption increased, fiscal discipline in other areas, including defense, provided for an overall reduction of government spending as a percentage of GNP. The domestic component of the fiscal deficit surged to 8.1 percent of GNP in 1989, but it has since declined to 5.6 percent in 1992 and 3.2 percent in 1993.

Beyond maintaining a stable macroeconomic environment, the sustainable reduction of unemployment will require significant intensification in efforts to structurally reform the economy. In particular, there is a need to accelerate the privatization program, to continue with financial sector reforms, to reduce labor market rigidities, and to proceed with further trade liberalization.

Privatization has been slow and needs to be significantly accelerated to improve domestic economic efficiency and to attract direct foreign investment. The State has been intensively involved in the banking, communications, electricity, transportation, and defense sectors and owns around 170 enterprises. Eighty-five of these enterprises which are considered eligible for privatization have an estimated net worth of $17 billion, equivalent to over 25 percent of GNP. In 1991 and 1992, the GOI had intended to sell around 20 companies, but only sold 7, generating an average of less than $250 million per year. The planned sales of government companies for a projected $681 million in 1993, if realized, will represent a significant increase over earlier privatization efforts.

While extensive financial system reforms have been made, more reforms are needed to make the system more competitive. The financial system is highly concentrated and directly involved in the real sector of the economy. At present, the three major commercial banks in Israel capture over 90 percent of deposits. Moreover, they control over 25 percent of a number of key industries and they own the major domestic insurance companies, mutual funds, pension funds, and provident societies.

An improved functioning of the labor market is essential for a sustainable reduction in unemployment. While unemployment has increased and real private sector wages have declined 7 percent over the past 3 years, real public sector wages have increased almost 2 percent. The GOI needs to take a firmer stance with regard to union wage settlements, especially in the public sector, adopt a wage structure that better reflects productivity differentials, and delink government wages from those in the public enterprises. At the same time, efforts should be made to build on earlier reforms, including a review of minimum wage legislation.

Further steps to liberalize external trade are essential to increase domestic competition. While considerable progress has been made with recent free trade agreements with the United States, the European Community and the European Free Trade Area (EFTA), much remains to be done. In particular, it is essential to resist pressure from domestic producers to slow down the scheduled reduction in import duties to maximum rates of between 8-12 percent over the next 5-7 years. Also, while quantitative restrictions have been largely removed on non-agricultural imports, they remain on most agricultural products.

B. Recent Immigration, Output and Employment Trends

Since late 1989, Israel has been subjected to a significant supply side shock in the form of the immigration of over 460,000 persons, mainly from the Soviet Union. Immigration, which was 12,000 in 1989, shot up to 188,000 in 1990 and 176,000 in 1991. While 200,000 immigrants annually were initially projected through 1995, actual immigration has been significantly less than expected, with only 77,000 immigrants in 1992. The revised projection for 1993 calls for 80,000 immigrants, but there were only 36,000 immigrants during the first six months of the year. The immigration slowdown reflects both the employment difficulties encountered by the immigrants in Israel and the lessened felt need to emigrate by those in the former Soviet Union.

The basic GOI strategy toward absorbing the immigrants has been one of avoiding direct labor market interventions, while catering to their housing needs and providing them with subsistence grants and training during their first year in Israel. In addition, the GOI has attempted to provide adequate infrastructure and a more favorable and less uncertain environment in which the private sector would be able to gradually absorb the extra supply of labor.

The large influx of immigrants significantly increased aggregate domestic demand, which is largely responsible for the average annual GDP growth of 6 percent over the past three years. Housing related spending was especially strong over this period, but non-residential investment also displayed considerable growth. During 1992, as the rate of immigration subsided and the GOI withdrew from construction activity, there was a slowdown in domestic demand growth.

However, this slowdown was offset by a rapid recovery of the export and tourism sectors from the Gulf War related slump. Given continued lower levels of immigration and the closure of the occupied territories earlier this year, real GDP growth may slow significantly in 1993 and could be limited to around 4 percent. An anticipated expansion of business and infrastructure investment coupled with rapid growth of exports provide the basis for a projected resumption of 6 percent average annual GDP growth in 1994 and 1995.

The viability of these projections depends significantly on Israel's ability to expand exports. Israel's exports have served as a major engine of growth in the past. Real exports grew at 12.3 percent between the early 1960s and 1980. However, export growth fell to only 2.5 percent between 1980 and 1991 in part due to high real wages. Recent rapid expansion of the labor force and conservative macroeconomic policies have produced real wage declines and a 12.7 percent expansion of real exports of goods and services in 1992. Realization of a continued export expansion at the projected rate of 9 percent will require continued policy efforts to contain real wages and improve the competitiveness of exports.

The rapid increase in the Israeli labor force brought on by immigration outstripped employment growth that averaged 4 percent per year over the past three years, causing the overall rate of unemployment to rise from 8.9 percent in 1989 to 11.2 percent by the end of 1992 before decreasing to 10.0 percent at present. Among immigrants, the unemployment rate declined from 38 percent in 1991 to 28 percent by the end of 1992. This relatively high immigrant unemployment rate reflects the short period of residence in Israel to date, their relatively old age structure, and very high concentration in technical professions, including engineering, medicine, and academia. Immigrants mainly found employment in industry (35 percent) and construction-related activities (10 percent). The composition of their occupations has changed as they have had to adapt to domestic labor market conditions. Hence, the percent of immigrants in scientific and academic occupations dropped from 39 percent in 1990 to 33 percent in 1992, while the percent in blue collar occupations increased from 16 percent to 23 percent over the same period.

Unemployment has declined in 1993 as immigration has slowed further to an estimated 36,000 in January-June and as Israelis have taken jobs left vacant by Palestinians barred by the closure of the occupied territories. The GOI's projected annual average employment growth of over 4 percent for 1993 through 1995 is consistent with a gradual reduction of unemployment from 10 percent in late 1993 to around 9

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percent in 1995.

C. Public Finance Policies

Since 1989, Israeli general government activity has been significantly affected by the objective of absorbing the new immigrants. In spite of this, the general government expenditures as a percentage of GNP have steadily declined, from 59.8 percent in 1989 to 56.5 percent in 1992. With overall receipts remaining relatively stable at around 54 percent of GNP, the overall deficit (after foreign grants) has been reduced from 6.2 percent in 1989 to an estimated 2.8 percent in 1992.

1. Expenditures: Public consumption of social services, including for education, health, and welfare have been a large and growing component of government expenditures, increasing from 30.1 percent of GNP in 1989 to 32.4 percent in 1992. In particular, transfer payments, which are provided as cash payments, have risen from 13 percent of GNP in 1989 to 15 percent in 1992.

Immigrant absorption expenditures of around 5 percent of GNP have been the main source of this expansion. The total annual direct aid per immigrant family is somewhat over $10,000. This includes an initial absorption cash grant plus health insurance and unemployment benefits during the second half of the first year in Israel. In addition, employers who employ immigrants are eligible for subsidies of up to one-third the immigrants' salary for the first year and one-fourth for a second year.

The GOI's strategy through mid-1992 placed emphasis on meeting the immigrants' housing needs in full. Accordingly, the GOI increased substantially public spending on housing through direct construction (20,000 units) and through guaranteeing the sales of houses built by private builders. Moreover, through the mortgage bank, the GOI offered the immigrants subsidized mortgages and grants depending on the duration of residence in Israel. While approximately 39,000 mortgages were provided for immigrant residential purchases up through 1992, an estimated 20,000 immigrant families remain in temporary housing units.

In the second half of 1992, the newly elected government announced a substantial cutback in GOI involvement in the housing sector, due in part to the lower-than-anticipated immigrant flows and the rising stock of unsold government-owned housing (20,000 units). The housing sector is to be primarily encouraged through shortening and streamlining the planning process, through easing

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restrictions on the import of construction materials, and through placing land zoned for residential construction more rapidly on the market.

In contrast to rising social service expenditures, defense expenditures have been steadily declining as a proportion of GNP. The domestic component of defense spending has decreased from 10.2 percent of GNP in 1989 to 8.8 percent in 1992, while defense imports declined from 3.1 to 2.1 percent over the same period. Continued reduction of defense expenditures may be an expected peace dividend if the peace process succeeds in reducing regional tensions.

Public investment expenditures have decreased from 2.5 percent of GNP in 1989 to 2 percent in 1992. This very low level of infrastructure investment is reflected in inadequate roads and heavy congestion which serve to restrain economic development.

While subsidies have declined from 4.5 percent of GNP in 1987 to 3 percent in 1992, they continue to significantly distort relative prices of food products, public transportation and water, and agriculture. Direct credit subsidies have largely been phased out.

Interest expenditures have also steadily declined from 9.8 percent of GNP in 1989 to 7.8 percent in 1992, reflecting the steady decline of the ratio of debt to GNP. However, the ratio of overall public debt remains high, at around 100 percent of GNP in 1992. Approximately 80 percent of the debt is owed domestically. Hence, the international component of public debt is a low 20 percent of GNP.

2. Revenue Trends: While tax revenue declined from nearly 45.3 percent of GNP in 1987 to 38.9 percent in 1989, it has since stabilized at around 39 percent GNP. There has been a substantial change in the composition of taxes as direct tax rates have been reduced to encourage the private sector. Thus, between 1986 and 1992, the top marginal income rate was reduced from 60 percent to 48 percent, the corporate tax rate was cut from 61 percent to 41 percent and the rate of National Insurance premium (equivalent to Social Security taxes) was lowered from 21 percent to 13 percent of wages. These direct tax reductions were partially offset by an increase in the value-added tax from 16 percent to 18 percent and the introduction of a temporary income tax surcharge of 5 percent. In an effort to further encourage the private sector, the employment tax on firms was eliminated in 1992.

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At present, Israel's overall tax burden (39 percent of GNP) is higher than that in the United States and Japan, but similar to a number of European countries. In spite of this relatively high tax burden, the government remains heavily dependent on foreign grants, which have been declining in recent years but remain at over 6 percent of GNP. Economic and military grants from the United States totaling $3 billion annually represent the bulk of intergovernmental transfers.

3. <u>The 1993 Budget</u>: The 1993 budget was presented in a three year format, with 1993 set out in full detail while the medium term plans for 1994 and 1995 were detailed only to the level of functional allocations or "envelopes". A basic goal of the 1993 budget was to reduce the domestic component of the deficit (excluding the granting of credits) from an estimated 5 percent of GNP in 1992 to 3.2 percent of GNP in 1993, which is consistent with the trajectory set out in the 1991 Budget Reduction Law. Although actual budget deficits have fallen below levels forecasted in recent budgets (in large part because actual immigration levels have not been as high as originally projected), the GOI remains concerned about factors that could increase the 1993 deficit above the budgeted level, including the serious financial difficulties within the health insurance program, defense industries, collective farms, and public and private pension plans.

The 1993 budget called for central government expenditures of approximately $35 billion, which represented a decline from 49.8 percent of GDP in 1992 to 46.4 percent in 1993. The budget provided for a substantial reordering of budget priorities. While housing construction expenditures have been curtailed since mid-1992, the 1993 budget envisaged that the cost of honoring past guarantees for unsold housing units would fall to one-third of the 1992 level. Except for completing the houses currently under construction, the GOI's housing policy in 1993 has been to focus on the sale of state-owned apartments and the creation of conditions favorable for private sector construction. While the budget called for immigrant absorption expenditures of 5.8 percent of GNP, expenditures probably will fall to below this level as actual immigration falls short of earlier projections. Expenditures on infrastructure were budgeted to increase by 30 percent, but this still represents only 2.5 percent of GNP in 1993. Most of this was directed at the Israeli road system, which is considered to be a major bottleneck to economic development. In addition, public investment in education, electrical power, and telecommunications was

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expanded.

The budget called for tax cuts of around 0.9 percent of GNP. The VAT was reduced from 18 to 17 percent, the overseas travel tax and the 4 percent exchange rate tax on service imports were eliminated, and the corporate tax was reduced from 40 percent to 39 percent.

The 1993 budget's indicative plan for 1994 and 1995 held government expenditure constant, which meant that government spending would continue to decline relative to GNP. The plan called for stabilizing real defense spending and public administration at their 1993 levels, while maintaining the increase in infrastructure investments obtained in 1993. Transfer payments and housing expenditures were projected to decline as immigration stabilizes.

4. The 1994 Budget: In July 1993, the GOI cabinet voted to raise the 1994 deficit ceiling to 3 percent of GDP from the 2.2 percent ceiling originally set out in the Deficit Reduction Law. The Law's target for eliminating the deficit by 1995 was also replaced by a less demanding goal of a continued trend in deficit reductions. The Ministry of Finance argued that greater spending was necessary to reduce unemployment and increase immigration levels. In August the cabinet approved the framework for the 1994 budget, which reduces budgeted expenditures to $34 billion and maintains the increased emphasis on infrastructure and education. A tax reform package was also submitted which reduces taxes by $280 million over two years, eliminates the 5 percent absorption surcharge on income taxes, lowers marginal tax rates on the middle class but increases the top marginal rate from 48 percent to 50 percent.

D. Monetary, Exchange Rate and Debt Policies:

1. Money, Exchange System and Inflation: Since the 1985 Economic Stabilization Program, monetary policy has focused on achieving financial stability. In late 1991, to reduce inflationary expectations and anticipations of sporadic exchange rate devaluations, the Bank of Israel moved to a gradually adjusting exchange rate system with a preannounced 9 percent annual rate of crawl. Under the new system, the daily exchange rate was to be maintained within a 5 percent margin of the midpoint or target rate. In November 1992, the midpoint was devalued by 3 percent, while an 8 percent target rate of change was announced for 1993.

In support of this new exchange policy and facilitated by

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a gradually declining government requirement for domestic financing, monetary policy has become significantly more conservative since 1990. The rate of monetary creation slowed from over 30 percent annually in 1989 and 1990 to around 20 percent in 1991 and the first half of 1992 before accelerating in the later half of 1992 in an attempt to spur economic activity. Recognizing that this had created excessive pressure on the exchange rate, the monetary authorities have since returned to a more moderate rate of credit and monetary expansion.

The monetary and exchange rate policies over the past several years have reduced inflation from recurrent annual rates of around 20 percent up through 1991 to 9.4 percent in 1992. While inflation in early 1993 accelerated to around 12 percent, the return to monetary restraint is geared to a 10 percent inflation target for 1993.

Monetary and fiscal policies have also been successful in improving the international competitiveness of Israeli exports. The real effective exchange rate (adjusted for consumer prices of Israel relative to international trading partners) depreciated by around 10 percent between 1989 and the end of 1992, thereby restoring the level of competitiveness that had prevailed in 1985. However, increased wage restraint will be needed to ensure export competitiveness in the future.

2. <u>Debt Management</u>: Since 1989, there has been only a modest increase in Israel's gross external liabilities to $33.9 billion at the end of 1992, while relative to GNP these liabilities have declined from 72 percent in 1989 to 53 percent in 1992. Likewise, Israel's net external liabilities, which are net of the commercial banks' and the Bank of Israel's international reserves, declined modestly to $15.6 billion by the end of 1992, while relative to GNP these liabilities declined from 37 percent in 1989 to less than 25 percent in 1992. All indicators of debt service further reflect the improving ability of Israel to manage its external debt, e.g., the ratio of gross debt service to exports of goods and services declined from 42 percent in 1989 to 29 percent in 1992, and the ratio of net debt service to exports of goods and services declined from 35 percent in 1989 to 22 percent in 1992.

Reflecting Israel's decreasing debt burden and the improving geopolitical and economic situation, Standard and Poor upgraded its implied rating of Israel from BBB- to BBB in February 1993. A June 1993 Salomon Brothers Inc. report argued that Israel's fundamental credit

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quality is higher than its current rating suggests. "Comparisons among Israel and other countries point to what we believe is a serious misrating of Israel. The Israeli economy is fundamentally more developed than those of other triple B-rated countries and many single A-rated countries. Indeed, the United Nations Development Program (UNDP) Human Development Index ranks Israel eighteenth among 60 industrialized countries based on a combination of national income, life expectancy and educational attainment. Israel ranked just below New Zealand (17) and Iceland (11), but above Italy (21), Ireland (22) and Portugal (39). In addition, purely economic indicators demonstrate that Israel compares favorably with many nations with higher sovereign credit ratings."[1]

Furthermore, external financing constraints have been dramatically reduced by the USG $10 billion loan guarantee program approved October 1992. The terms of this arrangement allow Israel to borrow $2 billion a year under the program for the next five years. Israel borrowed the first $1 billion in March 1993 and the second $1 billion was utilized in September 1993. In addition to the U.S. guarantees, private creditors are expected to continue to provide around $1 billion annually, mainly via State of Israel bonds. Hence, total net borrowing from abroad is likely to increase to over $3 billion annually.

E. Structural Reform Policies:

Beyond maintaining a stable macroeconomic environment, the sustainable reduction of unemployment will require significant intensification in efforts to structurally reform the economy. In particular, there is a need for an accelerated privatization program, additional financial sector reform, reduced labor market rigidities, and continued trade liberalization.

1. Privatization Program: The GOI privatization program, initiated in 1986, was designed to reduce the government's extensive involvement in the business sector, to open the economy to increased competition, to improve the efficiency of state-owned monopolies and to attract direct foreign investment. The State has been intensively involved in Israel's highly centralized economy, especially in the banking, communications, electricity, transportation, and defense sectors, owning

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[1] Salomon Brothers, Inc., "Israel: Continuous Improvement in Credit Fundamentals", June 1993, p. 9.

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a controlling interest in around 170 companies. The GOI considers about 85 of these enterprises to be eligible for privatization. They have an estimated net worth of $17 billion, or over 25 percent of 1992 GNP.

Progress to date in implementing the privatization program has been slow, as reflected in average proceeds from privatization sales of less than $250 million per year in 1991 and 1992, or less than 0.5 percent of GNP per year. The GOI had intended to sell around 20 companies in 1992, but only sold 7. The relative lack of progress is ascribed to the need for structural reforms to precede privatization, to legal complications, and to strong vested interests of management and unions within the state enterprises. There are also differences of opinion within the GOI on how to deal with the larger monopolistic state enterprises.

To help accelerate the privatization process, the GOI decided during the second half of 1992 to provide to the state privatization agency appreciably higher resources in terms of funding and manpower. Also, the Knesset recently passed an amendment to significantly enhance the ability of the privatization agency to enforce privatization actions within uncooperative companies, including authority to dismiss directors of public enterprises.

Even if these changes significantly overcome earlier difficulties and allow realization of the government's plans to privatize 7 non-bank enterprises in 1993, sales proceeds are only projected to be $681 million. Relative to the $17 billion in estimated net worth of the 85 enterprises considered eligible for privatization, a much more aggressive effort is called for if the economy is to be substantively reformed.

2. <u>Financial Sector Reforms</u>: Until the late 1980s, the GOI intervened in almost every aspect of the financial markets because of its interest in financing large budget deficits and directing the flow of financing within the economy. The principal mechanisms by which the government met these goals included barriers to investment abroad, mandatory purchase of government securities by institutional investors and high reserve ratios. The GOI's role in the banking sector increased dramatically in 1983 when it was forced to buy the plunging shares of Israel's three largest banks following a bank scandal. Under the 1983 Bank Share Arrangement, both ownership and full control of the banks will officially pass to the GOI in October 1993, unless the banks are sold or transferred to the private sector

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before then. These three banks together capture over 90 percent of deposits. Moreover, they control over 25 percent of a number of key industries and they own the major domestic insurance companies, mutual funds, pension funds and provident societies.

Israeli financial markets have been significantly liberalized over the past several years. Bank reserve ratios and requirements to hold government paper have been reduced, while the cancellation of many directed credit schemes has increased credit to the private sector. In addition, most restrictions on borrowing from abroad by Israeli residents have been removed, domestic enterprises are permitted to invest up to 40 percent of their capital abroad, mutual funds are permitted to hold up to 50 percent of their portfolio in foreign assets, and individuals are allowed to invest directly in foreign-traded securities. This liberalization has increased competition within the domestic capital market and in particular has reduced the spread between deposit and loan rates from over 30 percent in the late 1980s to less than 9 percent by the end of 1992.

Privatization of Israel's banking sector has met with relatively greater success than industrial privatization. Since 1992, the government has successfully sold its minority share holdings in four banking institutions, with several more sales anticipated by the end of 1993. The government projects total proceeds of over $1 billion from bank share sales for 1993. The government anticipates that 40 percent of government bank holdings will be privatized by the end of 1994.

In May 1993, a complementary banking reform package was unveiled. The draft legislation is designed to prevent conflicts of interest and increase competition in financial services. In addition, the legislation provides for Israel's three largest banks to be put into trusteeship until sold, preventing their automatic nationalization in October when the Bank Shares Agreement expires.

Despite significant reforms, much needs to be done to increase the role of market forces in the allocation of capital. With the exception of mutual funds, institutional investors are still barred from investing in foreign securities. Pension plans and provident and insurance funds are required to invest 93 and 50 percent of their assets in government bonds, respectively. Excessive management and ownership ties exist between financial and non-financial sectors and banking remains highly concentrated.

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3. Labor Market Reform: Israel's basic immigrant absorption strategy has been to generally abstain from direct intervention in the labor market and instead to focus on creating an economic environment conducive to the creation of private sector jobs. Among the measures adopted to reduce unemployment has been a wage subsidization scheme that provides subsidies for approximately 30,000 new employees for up to one third of wages for the first year and one fourth in the second year. (This scheme is to be discontinued after 1993.) In addition, the national employment insurance premium was reduced by 2 percentage points in 1991, and the employers' tax in the business sector was eliminated in 1992. In an effort to increase labor market flexibility, private sector employment agencies were authorized, while various restrictions on shift work were reduced.

In spite of this generally sound strategy, structural rigidities in the heavily unionized and regulated labor market significantly impede an expeditious and sustainable reduction in unemployment. Public sector wage setting policies, linked wage agreements and the high minimum wage remain areas of concern.

Since 1989, in response to the high unemployment, real private sector wages declined 7 percent. The decline in real wages was been more pronounced in the non-traded goods sector of the economy, such as construction and services, where there is less unionization. In contrast to the private sector wage decline, public sector real wages increased 1 3/4 percent. Given the adverse impacts of high real wages on export competitiveness and employment expansion, it is clear that the GOI needs to take a firmer stance with respect to union wage settlements, especially in the pace-setting public sector. The wage structure needs to better reflect productivity differentials, and government wages should be delinked from those in the public enterprises.

The minimum wage law, enacted in 1987, further reduces flexibility in the labor market. The law establishes a minimum wage equivalent to 45 percent of the average wage, and is adjustable every six months as the average wage increases. The minimum wage is currently about $6000 per year. Efforts to adjust the law, for example by allowing temporarily lower wages for new employees, have been blocked by opposition from the powerful Histadrut union. While wage subsidies (discussed above) are a way around this, the GOI should further consider revising the minimum wage law.

4. Trade Liberalization: With the objectives of

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increasing domestic competition and expanding exports, the Israeli economy has increasingly been opened up to international trade. Free trade agreements with the European Community since 1977 and with the United States since 1985 have significantly reduced mutual tariff levels. Tariffs on approximately 40 percent of Israel's imports from the EC and 90 percent of imports from the United States were either eliminated or are gradually being reduced to zero. In 1992, Israel also signed an agreement with the EFTA under similar conditions as the EC agreement.

Israel began to gradually liberalize trade with other countries not included in free Trade agreements in 1991. Nearly all quantitative restrictions on non-agricultural imports were initially replaced with tariffs ranging between 20 and 75 percent, with higher tariffs added for such products as wood and textiles. In 1992 maximum tariffs were reduced to 60 percent for most products and 110 percent for wood and textiles. All these tariffs were scheduled to be reduced to maximum rates of 8-12 percent over a period of 5-7 years. However, succumbing to pressures from domestic producers, this Spring the GOI extended the textile tariff reduction schedule by two years.

In spite of the progress, significant non-tariff barriers remain. Purchase taxes on luxury goods ranging between 25-100 percent serve effectively as tariffs where there is no domestic production of the good. The Israeli customs' service also artificially raises the value of imports for determining tariff duties and purchase taxes. While the GOI has agreed to eliminate this practice, they have not acted on the decision. Also, widespread quantitative restrictions on agricultural imports remain.

E. Future Challenges

The prospects for continued Israeli economic growth are good with the policy progress that has been made since 1989. The GOI has managed the supply-side shock of massive immigration with a sound strategy that has emphasized improving the investment environment rather than directly intervening in the labor market. Macroeconomic policy, including fiscal and monetary restraint, have reduced inflation and improved exchange rate stability and competitiveness, facilitating rapid economic expansion. Complementary structural changes, including significant capital market reforms, increasingly liberalized trade with the United States, Europe and other countries, and declining defense spending have improved the investment environment and increased export opportunities. And improved prospects for regional peace increase the

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likelihood of further defense cuts and increased interregional trade, significantly improving the prospects for continued rapid economic growth.

However, to take full advantage of these opportunities, the GOI needs to adopt a much more aggressive program of structural reform than it has to date. With government spending over 50 percent of GNP and indications that deficit elimination by 1995 is in jeopardy, a much more ambitious program of expenditure reduction should be adopted. The slow moving privatization program must be massively accelerated to facilitate private investment and enhance productive efficiency. Financial sector privatization and policies supporting greater competition within the sector need to be finalized. The GOI also needs to adopt a much more aggressive wage negotiating stance with unions within government and the public enterprises, and to reduce the distorting effects of the minimum wage. Wage restraint along with continued exchange rate depreciation are essential for export competitiveness. If the domestic economy is to fully gain the benefits of increased external competition, further backsliding on tariff reform must be resisted, the widespread agricultural quantitative import restrictions must be phased out, and the extensive cartels and monopolies that control the distribution of imports and domestic trade must be broken . With determined macroeconomic policies and more purposeful implementation of needed structural adjusted policies, Israel can continue to have both low inflation and rapid growth.

IV. Use of Economic Support Funds:

The grant of Economic Support Funds to the Government of Israel is a cash transfer for balance of payment support.

A. Use of the FY 1993 Cash Transfer

In compliance with the terms of last year's Grant Agreement, the Israeli Government has submitted a report to A.I.D. which details the uses to which the FY 1993 $1.2 billion grant proceeds were put. A.I.D. has reviewed this report and is satisfied that Israel has used the grant for eligible purposes as described in Implementation Letter No. 1. All of the grant was used either to repay or refinance outstanding debt. Approximately $7 million in interest generated was used to purchase agricultural surplus commodities from the United States.

B. Use of the FY 1994 Cash Transfer

The Cash Transfer may be used to: (a) purchase goods and services from the United States; (b) service debt owed to, or guaranteed by, the U.S. Government; (c) pay to the United States Government any Subsidies or other costs associated with loans guaranteed by the U.S. Government; (d) service Foreign Military Sales (FMS) debt, both current and refinanced; and (e) finance other uses as agreed in writing by both Parties on or after the effective date of the Grant Agreement. Program uses of the Grant will be restricted to the geographic areas which were subject to the Government of Israel's administration prior to June 5, 1967.

V. Grant Administration Procedures

Provisions of assistance to Israel in the form of cash transfers is 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. Such written assurances have been received. The Government of Israel has also provided written assurances that U.S. exporters will continue to enjoy equal access to Israeli markets. In the mid-80s, the Israeli Government also provided assurances regarding its purchase of U.S. grain and other agricultural products and its use of U.S. flag vessels in their shipment. However, since privatization of grain imports in 1989, the Israeli Government has provided only its assurances of best efforts to influence Israeli importers to continue to procure U.S. grain and other agricultural products and to employ U.S. flag vessels.

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 should, at a minimum, include sufficient information to document the withdrawal and disposition of dollar funds from the separate account and permit A.I.D. to track the dollars to their final uses, if necessary. 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 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 principal under the Cash Transfer Agreement.

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A.I.D. Grant No: 271-K-633

AGREEMENT

BETWEEN

THE GOVERNMENT OF ISRAEL

AND

THE GOVERNMENT OF THE UNITED STATES OF AMERICA

ACTING THROUGH

THE AGENCY FOR INTERNATIONAL DEVELOPMENT

Dated: October 29, 1994

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Agreement, dated October 29, 1993 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 $1.2 billion United States dollars (the "Grant").

ARTICLE II

Conditions Precedent to Disbursement

SECTION 2.1. Conditions 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) a 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.

(b) a designation of the bank account to which the Grant proceeds are to be deposited, together with the Grantee's statement that such bank account is established and will be maintained in the manner required by Section 4.3 of this Agreement.

SECTION 2.2. Notification

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

SECTION 2.3. Terminal Date for Conditions Precedent

If the conditions specified in Section 2.1 have 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 above Conditions Precedent, A.I.D. will deposit in the bank designated by Israel pursuant to Section 2.1 (b) above the sum of $1.2 billion United States Dollars ($1,200,000,000).

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 Purposes

Israel will not be permitted to use proceeds from the Grant to finance military requirements of any kind, including the procurement of commodities or services for military purposes.

SECTION 4.2. Uses of Grant Proceeds

The proceeds of the Grant may only be expended for such purposes as may be agreed upon by the two governments. 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.

SECTION 4.3. Accounting For Grant Proceeds

The parties agree on the following applicable procedures:

(a) Grant proceeds will be deposited to a bank account established by the Grantee solely for the receipt of Cash Transfer assistance from A.I.D. Such proceeds may not be commingled with other funds from whatever source. Should any interest be earned on such account, such interest will be treated as though it were principal (i.e., Grant proceeds) received under the terms of this Agreement.

(b) The Grantee will maintain financial documentation, books, and records, in accordance with generally accepted accounting principles and practices, concerning use of Grant proceeds for a period of three years from the date of this Agreement. Within four months of the disbursement by A.I.D. of Grant proceeds and quarterly thereafter, the Grantee will advise A.I.D. in writing, with appropriate detail on the uses to which such Grant proceeds have been put. The documentation, books and records required hereunder will be available for examination by A.I.D. or any of its authorized representatives at all times as A.I.D. may reasonably request for a period of three (3) years after the date of final disbursement by A.I.D. under this Agreement.

(c) Should grant proceeds be used in a way which will result in a generation of Israeli currency to the Government of Israel, then such generations will be deposited into a separate account to be established by that Government and will be available only for such purposes as A.I.D. shall agree. Prior to any contemplated uses of Grant proceeds for purposes which will result in such a generation, Israel and A.I.D. will negotiate and sign an agreement which sets forth: (1) the amount of Israeli currency to be generated or the formula for computation; (2) the terms and conditions for utilization; and (3) the responsibilities of Israel and A.I.D. with respect to monitoring and accounting for deposits into and disbursements from the separate account.

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 Development Resources - Near East
Bureau for Asia and Near East
Agency for International Development
Washington, D.C. 20523

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

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 Development Resources, 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, shall 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

By: A. Neubach

Title: Minister
Economic Affairs
Embassy of Israel

UNITED STATES OF AMERICA

By: Margaret Carpenter

Title: Assistant Administrator
Bureau for Asia and Near East
Agency for International Development

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EMBASSY OF ISRAEL
WASHINGTON, D.C.
MINISTER (ECONOMIC AFFAIRS)

שגרירות ישראל
ושינגטון
ציר כלכלי

September 23, 1993

Mr. Dennis M. Chandler
Acting Assistant Administrator
Bureau for Near East
Agency for International Development
Room 4533
320 21st Street, N.W.
Washington, D.C. 20523

Dear Mr. Chandler:

In conjunction with the shift in 1979 of the U.S. economic assistance program to Israel from the Commodity Import Program (CIP) to the cash transfers, the Government of Israel (GOI) provided certain assurances regarding the impact of the shift on U.S. exporters to Israel, and access of U.S. suppliers to the Israeli markets. These assurances were based upon the conditions then existing.

In the context of the economic assistance program, I would like to take this opportunity to convey to you, on behalf of my Government, our assurances for FY 94, as follows:

1) The GOI shall take all steps to ensure that the dollar level of Israel's non-defense imports from the U.S. will be at least equal to the level of U.S. economic assistance program obligations during the year, so that U.S. suppliers will 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 U.S. to Israel.

2) With regard to the GOI procurement of large capital equipment items which U.S. suppliers might furnish, special measures will be taken as necessary to ensure that they may compete on terms at least as favorable as those offered by prospective third country suppliers.

3) Although the GOI will no longer be responsible for purchasing grain or shipping it to Israel, the GOI shall use its best efforts to induce private Israeli importers whenever feasible, to purchase U.S. grain and other agricultural products and to employ U.S. flagged vessels.

The GOI believes that Israeli importers are likely to continue to purchase a large share of their grain in the U.S. and to continue

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to use a fair share of U.S. flagged vessels, whenever U.S. prices are competitive with world prices.

In the Summer of 1994, the GOI will review again the experience under the cash transfer procedures, and a report of the findings will be provided by September 1994.

Over the past few years, the level of Israel's non-defense imports from the U.S. has grown as indicated in the report submitted to AID in September 1993.

My government is prepared to discuss with the USG what reasonable steps it could take to make American sources of supply more attractive to Israeli importers.

Sincerely,

A. Neubach

Amnon Neubach
Minister
Economic Affairs

EMBASSY OF ISRAEL
WASHINGTON, D.C.
MINISTER (ECONOMIC AFFAIRS)

שגרירות ישראל
ושינגטון
ציר כלכלי

September 23, 1993

Mr. Dennis M. Chandler
Acting Assistant Administrator
Bureau for Near East
Agency for International Development
Room 4533
320 21st Street, N.W.
Washington, D.C. 20523

Dear Mr. Chandler:

According to the understanding between the Agency for International Development (AID) and the Government of Israel (GOI), we reviewed Israel's experience under the Cash Transfer Program (CTP) in the 1992 calendar year and in the first half of 1993.

The data on the development of total imports from the U.S. to Israel in recent years clearly shows that the shift in the economic assistance program to cash transfers has not adversely affected Israeli imports from the U.S.

Pursuant to the assurances given to AID, the dollar value of Israel's non-defense imports from the U.S. during the fiscal year 1992 exceeded the level of U.S. economic assistance provided during the same year.

The enclosed table shows that total exports of U.S. civilian goods to Israel amounted to $3,234 million in the 1992 calendar year, a decrease of 0.8% over 1991. This is attributable to two factors: first, the large decrease in miscellaneous manufactured articles (of 73%), largely as a result of the halt in the import of prefabricated buildings which are included in this category; second, U.S. exports grew 19.7% in 1991, whereas exports generally grew by 10.5%. Nevertheless, exports of mineral products grew by 204.5%, chemical products by 12.5%, textiles by 17.4%, machinery by 5.1%, and optical equipment by 4.1%. In 1992, total U.S. civilian exports to Israel exceeded economic aid by 169.5%. During the first half of 1993, such exports amounted to $1,919 million.

The table shows that grain and other agricultural product imports amounted to $377 million in 1992. During the first half of 1993, such imports amounted to $241 million (excluding wood and wood products). The GOI has made its best efforts to induce private Israeli importers, whenever feasible, to purchase U.S. grain and agricultural products.

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As in previous years, the competitiveness of the U.S. capital supplies was assured. In the first half of 1993, total imports to Israel grew by only 11.5% over the equivalent period the previous year. U.S. exports to Israel as a percentage of total Israeli imports grew from 17.2% to 18.8%. Growth was registered in virtually all categories with significant growth in: vegetable products (15.7%); rubber and plastics (16.4%); machinery and electrical equipment (23.1%); vehicles, aircraft and vessels (69.3%); and optical equipment (17.8%).

Our experience has demonstrated the effectiveness of the CTP vis-a-vis the Commodity Import Program in providing opportunities to U.S. suppliers. We are pleased that these results bear out the confidence that AID and other U.S. Government agencies placed in us when shifting the Commodity Import Program to the CTP. In the coming year the GOI will take the necessary measures to assure that the U.S. suppliers will not be disadvantaged by the termination of the Commodity Import Program.

Sincerely,

A. Neubach

Amnon Neubach
Minister
Economic Affairs

IMPORTS OF GOODS FROM THE U.S. (C.I.F.)
(In Millions USD)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993*
Animals & Animal Products	10	8	9	7	6	9	11	6	6	6	8	7	4
Plants & Products thereof(including grain)	455	382	375	383	324	301	276	333	364	333	286	324	185
Oils & Animal Fats	6	3	2	4	4	3	5	8	5	10	9	12	5
Processed Food, Beverage, Tobacco	31	28	32	33	22	26	31	64	77	82	71	34	47
Mineral Products	3	10	3	6	4	10	6	14	11	14	22	67	6
Chemical Products	84	88	79	81	66	92	107	143	169	215	215	242	134
Rubber & Plastics	39	39	38	36	34	41	54	54	59	80	106	110	61
Processed Leather & Furs	4	3	5	2	6	4	6	5	5	5	4	5	3
Wood & Products thereof	5	5	4	4	5	8	15	18	24	29	31	38	15
Paper & Cardboard	52	49	49	57	47	67	99	103	126	121	112	117	58
Textiles & Products thereof	65	45	34	37	45	44	56	49	50	72	86	101	55
Footwear & Headgear	1	1	2	1	1	2	3	4	5	6	7	8	5
Articles of Stone, Cement & Ceramic	10	11	11	14	16	15	17	17	18	23	36	38	20
Precious Stones	43	42	41	50	71	106	106	136	171	145	112	104	68
Base Metals	124	105	82	105	132	104	98	96	117	148	200	156	75
Machinery & Electrical Equipment	486	522	583	615	608	671	665	734	790	955	1160	1219	741
Vehicles, Aircraft and Vessels	120	102	248	164	106	111	196	183	151	243	354	332	274
Optical, Photography, Medical Equipment	75	79	94	115	144	136	141	148	157	170	194	202	114
Miscellaneous	6	7	5	4	5	6	8	15	17	30	203	55	23
Works of Art	4	0	3	3	6	8	6	2	4	5	11	4	2
Unclassified Commodities	7	13	24	35	27	25	26	21	30	34	36	31	24
TOTAL IMPORTS	1630	1542	1723	1756	1679	1789	1932	2153	2356	2723	3261	3234	1919

*First Half of the Year.

USAID

U.S. Agency for International Development

OCT 29 1993

His Excellency
Mr. Amnon Neubach
Minister (Economic Affairs)
Embassy of Israel
3514 International Drive, N.W.
Washington, D.C. 20008

Subject: Program Implementation Letter No. 1
Cash Transfer Agreement
A.I.D. Project No 271-K-633

Dear Mr. Neubach:

This letter will confirm detailed arrangements and undertakings relative to the above Agreement, signed on October 29, 1993.

Use of Grant Proceeds

It is understood that the dollar Grant proceeds may be used by your Government ("the Grantee") for purposes determined by the Grantee to be necessary for balance of payment support. The Grant may be used at the discretion of the Government of Israel to: (a) purchase goods and services from the United States; (b) service debt owed to, or guaranteed by the United States Government; (c) pay to the United States Government any subsidies or other costs associated with loans guaranteed by the United States Government; (d) service Foreign Military Sales (FMS) debt, both current and refinanced; and e) finance other uses as agreed in writing by both Parties on or after the effective date of the Grant Agreement.

If it should be determined that the Government of Israel may not be able to use the dollar proceeds made available under this Grant in a reasonable period of time and keep within the above categories of uses, A.I.D. is prepared to consider favorably a written request to expand eligible categories of uses of the dollar proceeds to include, in order of preference, servicing of commercial debt owed in the United States, servicing of debt owed to A.I.D. Geographic Code 899 countries, and financing of imports from Code 899 countries.

Accounting for Proceeds

Section 4.3 of the Grant Agreement addresses the legislative requirement for a separate bank account for Cash Transfer proceeds. We expect that your Government will, on reasonable request, during the next three years, make available appropriate records to our representatives. Financial records should, at a minimum, include sufficient information to document the withdrawal and disposition of dollar funds from the separate account and permit A.I.D. to track the dollars to their final uses, if necessary. 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. As you are reaching your decisions on actual allocations of this Cash Transfer assistance, we will be happy to discuss with your officials details of these documentary requirements.

Neither party expects that Grant proceeds would be used for other than the eligible purposes set forth above. Should this turn out not to be the case, however, we would expect your Government to deposit promptly, from its own foreign exchange, a commensurate amount of dollars in the separate bank account and to treat such deposit as principal (i.e., Grant proceeds) under the Cash Transfer Agreement. That is to say, such deposits would be spent for eligible purposes as noted above and accounting would take place in accordance with the procedures set forth in the Grant Agreement and elaborated above.

Interest on Separate Account

As noted in Section 4.3 (a) of the Grant Agreement, interest earned on the dollar proceeds placed into the separate account or accounts shall be treated as if it were principal (i.e., Grant proceeds). Should there be a period of time between the disbursement of the cash transfer and ultimate disposition of the proceeds in the separate account for mutually agreed purposes, it is agreed that in the interest of good cash management principles, the Grantee may place the Grant proceeds in various low-risk, non-speculative financial instruments in the United States pending ultimate use of those proceeds. Such interest-bearing financial instruments might include United States Treasury securities, certificates of deposit, and high quality money market accounts. However, prior to the time of ultimate disposition of the separate account proceeds for import financing, debt servicing, or other agreed uses, Grant proceeds should not be converted to or exchanged for the currencies of countries other than the United States or otherwise placed in international financial markets. The temporary placement of Grant proceeds in financial instruments, other than those stipulated above, shall be a matter of consultation and agreement between the two parties.

Possible Israeli Currency Accounts

A.I.D. is operating under a legislative requirement with respect to Cash Transfer assistance worldwide. This is contained in Section 575 (a) of our appropriations legislation and is to the effect that governments receiving "generations" of their own currency as a result of A.I.D. financing must deposit those in a separate bank account and, with A.I.D.'s approval, spend them for mutually agreeable developmental purposes, such as project financing, sector support or debt reduction. "Generations" for this purpose occurs when there is an actual receipt of local currency by a government, for example, where private sector importers pay the government in local currency for access to A.I.D. dollars or where the government itself did the importing and sale of A.I.D. - financed commodities and received local currency payment from such sale. On the other hand, payment of debt would not result in "generations" for this purpose nor would other transactions, such as import of equipment for use of a ministry, which do not result in actual receipt of local currency by the Government of Israel. Given the above legislative requirement, before Grant proceeds are used for transactions resulting in "generations" there would have to be a written agreement in place between A.I.D. and the GOI setting forth implementing details - such as the formula for computing amounts of local currency to be deposited, auditing and monitoring procedures, eligible expenditures and other matters. Therefore, when and if the GOI decides to use Grant proceeds for any transaction which will result in "generations", please let A.I.D. know in advance so that an appropriate agreement, as outlined above, can be negotiated and signed in advance. Otherwise, the transaction would be unauthorized and, as discussed above under "Accounting for Proceeds", A.I.D. would have to request that the GOI replenish the dollar account by the amount of that transaction.

Undertaking Concerning Imports

As in past years, the U.S. law appropriating funds for this Grant reflects Congressional concern about the possible impact of Cash Transfer assistance on the level of U.S. exports to Israel. Therefore, it is understood that the Government of Israel will

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take all steps to ensure that, during U.S. fiscal year 1994, the dollar level of Israel's non-defense imports from the United States will not be less than the dollar value of our level of economic assistance obligations.

I would appreciate it if your Excellency would confirm the above understandings and undertakings as acceptable to your Government, by signing below.

Sincerely yours,

Marc Winter

Marcus Winter
Acting Director
Office of Development
Resources - Near East
Bureau for Asia and Near East

Confirmed: A. Neubach

Date: 10/29/93

USAID

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

His Excellency
Mr. Amnon Neubach
Minister (Economic Affairs)
Embassy of Israel
3514 International Drive, N.W.
Washington, D.C. 20008

Subject: Program Implementation Letter No. 2
Cash Transfer Agreement
A.I.D Project No 271-K-633

Dear Mr. Neubach:

The purpose of this letter is to provide additional information to assist the Government of Israel in implementing the Grant Agreement signed with the United States on October 29, 1992. This information further defines non-allowable uses of Grant dollars, in addition to the provision contained in Article IV, Section 4.1 which prohibits their use for military purposes.

If the Government of Israel intends to use any or all of the Grant dollars to finance imports from the United States as provided by the Grant, these funds may not be used to finance any of the following: surveillance equipment; abortion equipment and services; luxury goods and gambling equipment; commodities and services for support of police or other law enforcement activities; or weather modification equipment. This same provision would also apply if the United States were to agree in writing to other uses, including imports from other countries, as discussed in the countersigned Implementation Letter No. 1.

If the Grant is to be used to service debt, it may not be used to service debt where it is known, without specific review of the loan documentation, that this debt was incurred to finance non-allowable items, with the exception of FMS debt, or where it could have been reasonably anticipated that this debt might be serviced in whole or in part out of the Grant.

If your Government has any questions concerning the eligibility of any proposed import item or debt service payment, which would be made with the Grant dollars provided under this program, I invite you to consult with me or my staff so that we can provide further details or clarification.

Sincerely yours,

Marc Winter

Marcus Winter
Acting Director
Office of Development
Resources - Near East
Bureau for Asia and Near East

USAID

U.S. Agency for
International
Development

OCT 29 1993

MEMORANDUM

TO: M/FA/FM/CONT, Mike Usnick

FROM: ANE/NE/DR, Marcus Winter

SUBJECT: Israel - FY 94 Cash Transfer Grant (271-K-633)

This $1.2 billion Grant Agreement was executed on October 29, 1993. Attached for your files are copies of the signed Grant Agreement.

The Conditions Precedent to Disbursement, specified in Section 2.1 of the Agreement, designation of representatives, and bank account to which proceeds are to be deposited, have been satisfactorily fulfilled by the Government of Israel (GOI).

Please note also that the Grant Agreement in Section 2.1 contains a Condition Precedent to Disbursement which requires that the Grant proceeds be deposited in a bank account established by the GOI solely for receipt of the Cash Transfer assistance and that these funds not be commingled with funds from any other source.

This office has received a written request from the Government of Israel to disburse the full amount of the grant proceeds to its accounts as follows:

> Federal Reserve Bank of New York for the State of Israel Treasury Account No. 0210-8441-6

Jack Slattery, ANE/NE/ME/LI will be responsible for oversight of the special account.

Accordingly, we hereby request that you effect immediate disbursement of the full amount of this Grant, One Billion, Two Hundred Million dollars ($1,200,000,000) to Israel's bank account.

Attachments:

1. Copy of the Program Assistance Approval Document
2. Copy of the signed Grant Agreement
3. Copy of the GOI letter dated September 29, 1993
4. Copy of PIL NO. 3 dated October 29, 1993

Subject: Memorandum to Mike Usnick: Israel - FY 94 Cash Transfer Grant (271-K-633)

Clearance: NE/ME:Jack Slattery (Draft) date 10/27/93
NE/DP:Vikka Molldrem (Draft) date 10/28/93

Drafter:NE/DR/MENA:CBellamy:9/15/93:ICT.94

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U.S. AGENCY FOR
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His Excellency
Mr. Amnon Neubach
Minister (Economic Affairs)
Embassy of Israel
3514 International Drive, N.W.
Washington, D.C. 20008

Subject: Program Implementation Letter No. 3
Cash Transfer Agreement
A.I.D. Project No. 271-K-633

Dear Mr. Neubach:

The purpose of this letter is to notify you that the Government of Israel has met the Conditions Precedent to Disbursement contained in Section 2.1 of the Grant Agreement executed by Israel and the United States on October 29, 1993.

Sincerely yours,

Marc Winter

Marcus Winter
Acting Director
Office of Development
Resources - Near East
Bureau for Asia and Near East

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U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

OCT 18 1993

MEMORANDUM

TO: ANE/DR/MENA, Cherie Bellamy

FROM: ANE/DR/ENV, Gilbert Jackson Gilbert S. Jackson
Environmental Coordinator

SUBJECT: Israel - FY 1994 ESF Cash Transfer, 271-K-633
Environmental Clearance

The proposed cash transfer meets the criteria for "Categorical Exclusion" under A.I.D. Environmental Procedures at 22 CFR 216.3. The cash transfer is not subject to the procedures set forth in Section 216.3.

cc: DAA/ANE:DChandler
GC/ANE:KO'Donnell
A.I.D. Affairs Officer, U.S. Embassy Tel Aviv