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AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D. C. 20523

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

ISRAEL: Cash Transfer - (Economic Support Fund) (271-K-626)

October 29, 1987

UNCLASSIFIED

CLASSIFICATION:

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 271-K-626
2. Country: ISRAEL
3. Category: CASH TRANSFER
4. Date:

5. To: Julia Chang Bloch, Assistant Administrator, ANE Bureau

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: 72-118/91037 QES8-88-37271-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. (cont) NEA/IAI: JHolzman (draft) Date: 10/15/87
ANE/DP: PBenedict (draft) Date: 10/13/87

19. Clearances	Date
DAA/ANE: WFuller	
ANE/PD: BJOdell (draft)	10/8/87
ANE/PD: TJohnson (draft)	10/8/87
ANE/MENA: PGary (draft)	10/15/87
DAA/PPC: MDagata (draft)	10/15/87
FM/CONT: CChristenson	ESU 10-29-87
GC/ANE: JSilverstone (draft)	10/15/87

20. Action: ☒ APPROVED ☐ DISAPPROVED

Authorized Signature: [signature] Date: Oct. 29, 1987

Title:

AID 1120-1 (5-82)

CLASSIFICATION:

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PROGRAM ASSISTANCE APPROVAL DOCUMENT

(PAAD)

ISRAEL

Project No. 271-K-626

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I. Program Summary and Summary of Political and Economic Considerations:

The cash transfer of $1.2 billion was appropriated by Congress to provide assistance from the Economic Support Fund (ESF) to Israel. This transfer will help maintain economic stability in Israel by supporting economic reforms taken by the Government of Israel (GOI) and by providing needed balance of payments support. Political and economic stability in Israel are essential to achieving a comprehensive peace in the Middle East, a prime U.S. foreign policy objective. The U.S. assistance programs, both economic and military, help give Israel the confidence it needs to maintain its own security and achieve peace with its neighbors in the region.

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, despite its unique access to concessional capital flows from abroad. U.S. foreign policy interests in the region dictate support for Israel in the maintenance of peace and the resolution of conflict. 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 closer to a more 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 relatively democratic and politically stable country in a region of great social, political and military instability. The region is vital to U.S. political and economic interests and accordingly the maintenance of stability in Israel is an important foreign policy objective.

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 Gramm-Rudman-Hollings legislation. In FY 1987 the program was restored to the $1.2 billion level. From FY 1976 through FY 1979, 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 basis in FY 1980 and has been ever since.

In FY 1979, the CIP financing element was eliminated to alleviate difficulties which the GOI had encountered in utilizing available funds. Despite the high volume of Israel's non-military imports from the U.S., Israel had considerable difficulty in managing the documentation processes required for CIPs. Most of the problem arose due to the lack of control that the GOI exercises over private sector importation. As a result, CIP funds were disbursed at an intolerably slow rate.

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. Under other legislation, assistance has been provided to help Israel settle new immigrants from the Soviet Union and other countries. In FY 1975, a $20 million grant for a Joint U.S.-Israel Desalinization project was authorized. This project was completed in 1983.

This FY 1988 assistance is in the form of a cash transfer. Its purpose is to help Israel maintain economic stability by providing needed balance of payments support. A cash transfer is suitable for this purpose.

III. Economic Setting:

A. Historical

Israel experienced rapid economic growth until the early 1970s. Fueled by very high levels of investment, at times exceeding 30% of GDP, real GDP grew at an average rate of 9% p.a. 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-1970s Israel's economy turned sluggish. By the early 1980s, the economy was only growing at an annual rate of 1.4%. 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 over to defense. The GOI in trying to maintain

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civilian expenditures in the face of slower economic growth and greater security needs financed growing budgetary deficits with private domestic savings. With the growth in budget deficits and concomitant money supply growth inflation roared. 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 personal and government civilian and military consumption were induced through large and growing budget deficits and other expansionary aggregate demand policies, which tended to stimulate growth in real wages. Over the 1971-1984 period, labor demand growth was high as reflected in the low rates of unemployment, 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 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 (8.6% of GDP) to $4 billion in 1983 (16.7% of GDP) in 1984. External foreign debt (net of foreign assets of Israeli commercial banks) rose from $4 billion in 1972 to $23.7 billion at the end of 1984.

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

- reduction in government expenditures;
- rise in prices of subsidized goods and services;
- imposition of foreign exchange and import restrictions; and
- freezing or controlling many prices, wages and interest rates.

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. The need for more comprehensive reform was recognized. In July of 1985, buoyed

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by the $1.5 billion ESF supplemental the NUG initiated a new Economic Stabilization Program (ESP), comprising:

- price control
- wage restraints
- reductions in public sector workforce
- tax increases
- reduction in other government expenditures
- devaluation
- limited monetary reform
- tight monetary policy

Many achievements have been attained by the ESP since its initiation, although significant problems remain to be confronted. Despite continuing difficulties, the Israeli economy has taken great steps forward. New reforms initiated in 1987 include the de-indexing of bonds, deregulation of the capital market, and preliminary research into the divestiture of public sector corporations.

B. Recent Developments

The success of the ESP is manifested in three main areas: the budget has been balanced on a current basis; inflation has declined from 15% per month to 1.5%; and the currency has been stabilized. On the other hand, unemployment increased during the first quarter of the program, up to 8%. 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 the prices of fuel and other imported commodities.

Israel's economy grew slowly in 1986 after only modest growth in 1985: GDP grew 2.2% in 1986, slightly faster than the 1.6% growth in population. Preliminary estimates for 1987 indicate GDP growth of 3.2%, with per capita income increasing from $6,416 to $7,095 (current dollars). In 1986 unemployment averaged 7.1% but is expected to be only 5.5% in 1987. Despite a slight worsening in the trade balance, due to increases in imports outpacing export growth, official foreign exchange reserves increased from $4.7 billion to $6.0 billion, almost enough for eight months of imports. The reasons for this increase have to do with capital inflows attracted by high real rates of interest and newly discovered confidence in the Sheqel.

The progress made in the past two years gives rise to the opportunity to turn toward economic growth and the necessary structural reforms that are prerequisite to growth. The contribution and role of economic policy is to create the

conditions and climate for this process, mainly by removing those factors that blocked growth over the past ten years, including: decreasing the role of government in the economy, both by administrative involvement in many spheres, licensing, regulation and high levels and rates of taxation and over involvement in the capital market.

C. Prospects

After the 1986 "rotation" in the National Unity Government (NUG) from the Labor party to the Likud, the GOI continued with the Economic Stabilization Program (ESP). To stimulate growth within the framework of stability, especially export growth, the government in 1987 took the following steps: a) reduced the budget by $240 million; b)reduced public subsidies; c) lowered the top marginal personal income tax rate from 60% to 48%, and to 45% on corporations; d) reduced interest rates (although they remain comparatively high) and narrowed the interest rate differential between government and private bonds; e) decreased liquidity ratios for savings schemes in commercial banks, (similar to reducing the U.S. reg. Q reserve requirement) thus loosening up private credit expansion; and f) relaxed many foreign currency controls.

Developments during the first half of 1987 point to some problems in the recovery. With the relative return to growth it is not clear that the momentum remains within the government to follow through on the rest of the reform package. Other problems remain: pay increase overcompensating for earlier declines in real wages; failure to reduce public consumption; renewed demand for consumer durables; non-implementation of other planned tax measures and spending cuts; growth of exports below targets and imports above targets; and mounting pressure to provide government support to concerns facing financial difficulties. These increase pressure on the budget and on the government's resolve to follow through with economic reform. The problem remains that while the government has, indeed, achieved very considerable success, the structural reforms necessary to maintain stability and sustain growth and progress still must be implemented. Other countries, such as Brazil and Argentina, have achieved similar degrees of success only to falter at the juncture of structural reform and have found themselves slipping back into economic morass. While the NUG has affirmed its commitment to economic reform the threat of a return to the former difficulties is real.

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IV. Use of Economic Support Funds:

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

From July 1, 1974 through September 30, 1987, A.I.D. provided a total of $12,503.4 million of Economic Support Funds (formerly Security Supporting Assistance) to the Government of Israel. As of September 30, 1987 all of these funds have been disbursed.

The breakdown of the use of ESF is provided below.

July 1, 1974 - September 30, 1987 ESF Support for Israel
(in billions of dollars)

Program	Grant	Loan	Total
Commodity Import	1.100	.755	1.855
Cash Transfer	10.128	.520	10.648
TOTAL	11.228	1.275	12.503

V. Grant Administration

A. Procedures

Provisions of assistance to Israel in the form of cash transfers 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. Prior to release of U.S. dollars from the separate account, the Government of Israel and A.I.D. will agree on uses, which may include financing of imports and servicing of debt. 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 deposit, from its own foreign exchange, a commensurate amount of dollars in the separate bank account and to treat such deposit as principle under the Cash Transfer Agreement.

MEMORANDUM

DATE: October 15, 1987

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

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

SUBJECT: Israel- FY 1988 ESF Cash Transfer, (271-K-626), Environmental Clearance

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

cc:

GC/ANE, JSilverstone
ANE/MENA, PGary
AID Affairs Officer, U.S. Embassy Tel Aviv