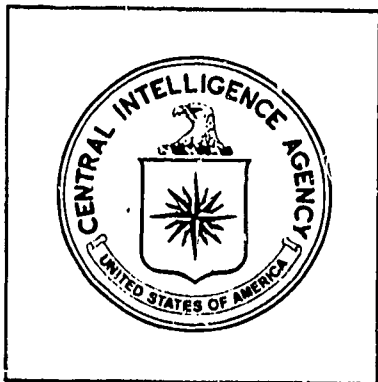


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Israel: Economic Impact of the War

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ISRAEL: ECONOMIC IMPACT OF THE WAR

CONCLUSIONS

1. Israel has emerged from a month of war and uneasy cease-fire in excellent financial and economic condition. The balance-of-payments surplus for 1973 will almost certainly increase because foreign remittances will rise more rapidly than the current account deficit. Authorized US military assistance, if fully used, would provide a military establishment considerably stronger than at the outset of the war. In the longer term, the economic situation will be critically dependent on the political and military settlement, the amount and terms of arms purchases, the duration of the mobilization, and finally the expectations and will of the Israeli people. Even in the event of a long period of mobilization and uneasy cease-fire, however, the Israelis would pay much of the current cost of military readiness by reducing domestic investment and consumption, and aid needs for the civilian economy would be negligible.

DISCUSSION

The Economy Before the War

2. Israel's economy was in a strong position before the war, with growth of real GNP projected at about 8% for 1973. Foreign exchange reserves had reached US \$1.5 billion in September 1973, about \$300 million above the level at the end of 1972 and equal to more than one-third of annual imports of goods and services. Inflation, which had reached an annual rate of 20%, was the principal economic problem and was caused by high domestic demand, nearly full utilization of productive capacity, and rising import prices.

3. The outlook for the balance of payments remained good in 1973, although it was unfavorably affected by inflation. After marked improvement in 1971-72, the current account deficit was increasing in 1973 as a result of booming imports, while capital account earnings were running below the previous year. Nevertheless Israel, thanks to large borrowing, continued to accumulate foreign exchange reserves.

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Note: Comments and queries regarding this publication are welcomed. They may be directed to [redacted] of the Office of Economic Research,

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4. The longer term trends in the Israeli balance of payments were healthy. Exports were increasing faster than imports, and the current account deficit was expected to decline after 1973. Although Israel's foreign debt had risen sharply during the years since 1969 and at the end of 1972 stood at \$4.2 billion, the largest per capita debt in the world, servicing of the debt was not creating any difficulties. The ratio of debt service to export earnings was declining, and debt service payments -- about \$600 million in 1972 -- were more than offset by the inflow of unilateral transfers. With bond sales also likely to remain at high levels, Israel's prospective balance-of-payments surplus in 1974 and 1975 seems likely to exceed the level of US aid.

	Million US \$			
	Projected			
	1972	1973	1974	1975
Goods and services	-1,103	-1,550	-1,350	-1,150
Unilateral transfers	1,054	865	1,000	1,050
Capital account	331	288	500	450
US assistance	440	547	450	350
Increase in reserves	722	150	600	700

Economic Impact of the War

5. The Israeli economy has been disrupted, but not severely, by the war. There has been virtually no war damage. The callup of reservists together with the loss of Arab labor from the occupied territories cut the civilian labor force by about 25%, and the sequestering of trucks by the military caused some economic disruption. Adjustments have since been made, however, including a return of critical workers to their jobs and a substantial increase of the number of women and teenagers in the labor force. Mobilization has been less than total, thanks to heavy reliance on armor and air arms and light use of infantry. Although services such as tourism, and the construction industry have been hit hard, other industries and agriculture appear to be producing near pre-war levels. There has been no rationing of consumer goods and services.

6. Israeli officials have estimated the value of lost production at \$14 million a day, or nearly \$100 million a week. This would mean more than \$5 billion at an annual rate, or two-thirds of the projected GNP of \$8.7 billion. Beyond the first few days of the war, this rate of loss is obviously greatly exaggerated. Although aggregate figures are not available, a more reasonable estimate would be a drop of about 20% in civilian production.

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As indicated below, the increase in domestic military expenditures, excluding military imports, is probably running at an annual rate of some \$1 billion, or some 12% of GNP. Currently, the civilian labor force probably is not down more than 15%, representing much less than full mobilization. A 20% drop in GNP appears to make ample allowance not only for diversion of resources to military use but also for some continued disruption of economic activity.

7. The supply of trucks probably is the most troublesome bottleneck in the Israeli economy. With many civilian trucks being used by the army, the civilian economy is short of convenient transportation and the Israeli government is trying to import trucks on a priority basis. The supply of petroleum constitutes a potential problem. Closure of the Bab al Mandab Strait has stopped petroleum deliveries to Elat from Iran. Israel's petroleum stocks, however, amounted to more than 16 weeks of supply at the beginning of the war, and if major fighting does not resume, Israel can import sufficient petroleum via the Mediterranean.

8. Dry cargo ships are entering and leaving Israeli ports, although there was a slowdown during the fighting. There appear to be no serious actual or potential shortages of imported goods.

9. The government's Ministerial Economic Committee has assigned priorities for keeping the economy as close to normal as possible during the war. Priorities include preserving export markets, completing housing for high priority groups (immigrants from the USSR who have continued arriving during the war), finding new sources of financing, and returning key workers from military service. To ease the transportation bottleneck, the government has allocated 1,400 heavy-duty trucks for civilian distribution and is seeking to import 2,500 trucks on a priority basis. The Bank of Israel has agreed to an extension of credit to ease short-term liquidity problems.

Cost of the War

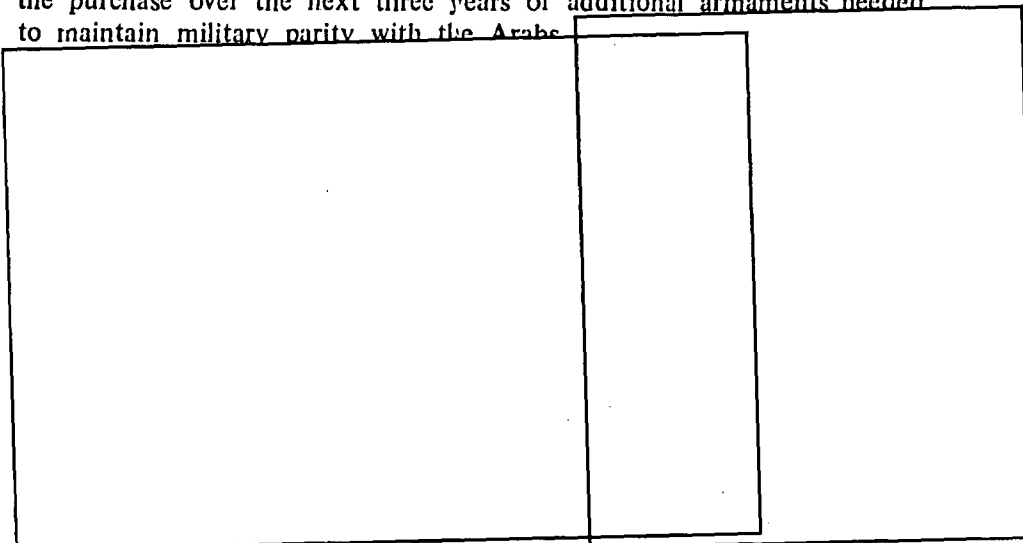
10. Israeli statements on the cost of the war have varied considerably; the most often quoted figures - \$250 million a day and \$2 billion in the first week of the war - seem exaggerated. Israeli officials apparently lumped together the direct and indirect military costs of the war and the economic costs, including the value of output lost and losses of foreign exchange earnings. The major costs will be for the replacement of military equipment and materiel, the impact of which will be spread over a number of years.

11. Our preliminary estimates place the value of Israel's losses of major military equipment at a minimum of about \$325 million. Expenditures of military supplies and supporting equipment would add

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considerably to these costs. Before the war, Israel had contracted to purchase from the United States about \$500 million worth of military equipment, including 48 F-4 and 42 A-4 jet aircraft valued at about \$300 million, to be delivered out of FY 1974 Foreign Military Sales funds. Since the war began, the United States has approved for sales to Israel \$825 million in military supplies of which \$500 million to \$600 million has been shipped.

12. Israeli officials have reportedly put a price tag of between \$2.5 billion and \$3.0 billion on the replacement of its 1973 losses and the purchase over the next three years of additional armaments needed to maintain military parity with the Arabs.



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Financing the War

14. Israel has moved rapidly to mobilize domestic and foreign resources to pay for the war. The government has issued bonds that all citizens and businesses must buy and is raising additional revenue through voluntary bond drives. These two sources are expected to bring in \$500 million. The government also has ordered cuts in the development budget that will save \$60 million.

15. If the cease-fire holds, the balance of payments should end the year in surplus because, with both imports and exports lower, the trade and services account should not change much, while there will be a large increase in contributions from abroad.

16. Exports of most goods and services have continued during the war, except those goods exported through the port of Elat which remains blockaded. Agricultural exports have not been hurt; the important citrus crop harvest is now beginning, and fresh produce has been exported by

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air. Exports of industrial products, except diamonds, slowed appreciably during the first week of the war, but have since recovered. Tourism, off an estimated 75%, is the only important source of earnings adversely affected to date. Demand for civilian imports has fallen off, but imports of military-related goods such as trucks and raw materials for defense industries are rising. The increased costs of war-risk insurance, which is being borne by the government, would add slightly to the import costs.

17. The pre-war Israeli projections of the balance of payments for 1973 anticipated receipt of \$350 million in personal remittances and another \$318 million in bond sales. Much of this probably was collected before the war. Since the war, the government has projected new goals of \$1,250 million for personal remittances and \$750 million for bond sales abroad through the end of 1974. If we assume that half of the new total will be collected by the end of 1973 and that other receipts remain as projected, the total of unilateral transfers and capital inflows for 1973 could be more than \$2.0 billion.

Prospects for the Economy

18. Although the Israeli economy is unlikely to experience serious difficulties in the next few months, a number of uncertainties make it difficult to estimate the longer term impact of the war. In any case, the economy is unlikely to expand as rapidly as it did after the 1967 war, when there was much unused capacity and a clear victory greatly stimulated consumer demand and business expectation.

19. If the war ends with a definitive settlement and a favorable security environment, economic growth will resume and the long-term outlook will be favorable. The need for aid would depend on the amount and terms of arms purchases; aid for the civilian economy would be negligible. The proposed \$2.2 billion US credit for Israeli military purchases would provide a military establishment considerably stronger than at the outset of the war, but perhaps not as strong as the Israelis now think they need. It could increase projected debt service payments of principal and interest by as much as \$514 million a year on hard terms or \$286 million on soft terms. The debt service to exports ratio at the estimated post-war export levels would be 50% with credit on hard terms, about the same as the average ratio during 1956-61.

20. If Israel is forced to maintain large forces in place for an uncertain cease-fire, military aid would be unchanged, domestic output would be reduced, new investment expenditure outside of armaments would be sharply curtailed, and personal consumption reduced somewhat. Foreign exchange needs would be little affected, however, because demand for

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civilian imports would be held down as well. Israel would minimize the size of the armed forces by relying heavily on imported mechanized equipment rather than infantry.

21. Between these two extremes, many scenarios are suggested that would involve varying levels of mobilization and of costs to the economy. Included among these would be an extension of the Arab oil boycott that could possibly exert pressures on all EC countries to reduce their trade with Israel. Arab boycotts have not been effective in the past, although they lacked the leverage now afforded by oil. The Israelis, however, have always been resourceful in making adjustments in their foreign markets.

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