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July 15, 1977

DCI CABINET BRIEFING

Israel: Economic Prospects

- I. With Israeli Prime Minister Begin now in the US, I think it would be useful to review the Israeli economic situation and economic prospects for the future. Briefly, we believe that Begin will continue to give overriding priority to defense and that, as a result, the civilian economy will continue to be hamstrung despite large amounts of US aid. Labor shortages and austerity measures will hold growth to a mere two percent or so at best.
- A. Israel's defense burden has increased sharply since the 1973 war.
1. The military is taking roughly 40 percent of GNP, compared with about 20 percent before 1973.
 2. Identified military imports have ballooned to \$1.6 billion this year, compared with \$500 million in 1972; a considerable portion of so-called civilian imports represents material and components for military industries.
 3. The defense forces absorb an estimated 15 percent of available manpower.

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- B. The Begin government is likely to enlarge--not merely maintain--the role of the military.
1. The new Defense Minister, Ezer Weizman, was instrumental in developing Israel's aircraft industry and will push for expansion of domestic military output such as Kfir aircraft and Chariot tanks.
 2. The new government also favors co-production arrangements with US firms covering F-16s and hydrofoil boats. Such arrangements are not cost effective; co-production of F-16s would cost Israel 15-25 percent more than US procurement.
- C. Israel does not have the manpower to make immediate use of the military equipment it is seeking. For example, recent deliveries of A-4 aircraft went directly into storage because of shortages of pilots and mechanics.
- II. In the siege atmosphere existing since 1973, labor shortages have been the main constraint on the civilian economy. We estimate that the civilian labor force has increased by less than 5 percent since 1973, for these reasons:
1. Military manpower requirements have increased; the standing army has increased from 110,000 to 160,000, and reserve duty has been expanded.

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2. Net immigration, which had been adding 30,000 people a year to the population, is now roughly zero.
 3. The pool of Arabs from the West Bank has dried up because of more lucrative jobs in the oil-rich Gulf States.
 4. Moreover, the growth of defense industries probably has more than absorbed the small increase in the civilian labor force.
- A. These manpower constraints, coupled with government efforts to reduce the 40-percent inflation rate, have cut economic growth from a prewar rate of 10 percent to 1-2 percent in 1975-76.
1. The civilian construction industry is at a standstill.
 2. Higher taxes and lower subsidies have reduced consumption.
 3. Industry is operating considerably below capacity, reflecting both labor bottlenecks and soft demand.
 4. A potential worsening in labor strife, now that the Labor Party is in opposition, further dampens economic growth prospects in the months ahead.

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III. The worsening in Israel's current account deficit since 1973 is completely attributable to the growth in foreign military purchases.

A. Even though civilian imports have leveled off because of the economic slowdown and exports have grown rapidly in response to economic recovery abroad, Tel Aviv's overall current account nonetheless will remain in deficit for some years to come because of military purchases. This will remain true even if non-military exports consistently grow two or three times faster than non-military imports.

IV. Israel's foreign financial gap has been filled mainly by US aid; in 1976-77 this aid was large enough to cover current requirements and permit a rise in foreign reserve holdings.

A. Israel is now receiving more than \$2 billion a year in US aid--about two-thirds on a grant basis--mainly for military purposes.

1. Half of US aid still consists of direct military assistance to underwrite purchases of US arms even though this type of aid has declined in both absolute and relative terms since 1973.

2. Economic aid has increased in recent years from only \$50 million in FY74 to nearly \$800 million in FY77, but some of these funds are used to cover military purchases.

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- B. In an effort to channel aid into specific economic uses, the US has been shifting economic aid allocations from straight budget support to the Commodity Import Program (CIP). Under this program Israel is reimbursed for certain civilian goods purchased in the US.
- C. Tel Aviv has in fact made little use of the economic aid offered under CIP; in the first half of FY77, it drew down only \$16 million of the \$535 million CIP allocation.
1. Tel Aviv alleges that the paperwork involved is burdensome and that the permitted import list is too restrictive (the purchase of a 747 aircraft was recently turned down).
 2. In fact, the tight domestic labor situation does prohibit initiation of large-scale civilian projects, that could absorb substantial CIP aid.
 3. Furthermore, Tel Aviv is wary of importing finished civilian goods that would supplant domestic production or support a consumer boom.
- D. Israel clearly would prefer a return to untied budget support so that funds could be used either for military or economic purposes.

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Israel: Balance of Payments Position, 1977
 Million US \$

	Expenditures 8,940	Receipts 9,355	
	1,600 (Military)	2,295	US Aid
Import of Goods	4,300 (Civilian)	5,000	Export of Goods and Services
Import of Services	2,200	1,000	Private Transfers
Debt Maturities	840	1,060	Capital Inflows (Non-US)

Israel: Selected Economic Indexes
1970 = 100

