

Central Intelligence Agency

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DIRECTORATE OF INTELLIGENCE

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ISRAEL: Peres's Visit to Washington

Summary

Prime Minister Peres will focus on his government's plans to resolve Israel's economic crisis and prospects for gaining emergency US economic aid during his 8 to 9 October visit to Washington. The most immediate economic problem facing his national unity government is to stem a rapid decline in foreign exchange reserves. To tackle this and other economic problems, Peres's government is seeking budget cuts and a wage-price freeze. []

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Implementing this program will not be easy. Several ministers have already publicly opposed cuts in their budgets. Even if the Cabinet agrees on where to pare the budget, the cuts are unlikely to materialize in the absence of an enforcement mechanism. Negotiations on a wage-price freeze with the Histadrut, the powerful trade union organization representing about 90 percent of the work force, will also be difficult because Histadrut Secretary General Kessar opposes tampering with Israel's extensive system of indexing wages to the inflation rate. []

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Another major problem for the new government is the predictable lack of public support for a rigorous, sustained austerity program, which to be effective will entail increased unemployment and lower real wages. Faced with these obstacles, the easiest course for the new government will be to ask the United States for additional aid. []

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This memorandum was prepared by [] the Israel/Palestinian Branch, Arab-Israeli Division, Office of Near Eastern and South Asian Analysis. Information as of 25 September 1984 was used in its preparation. Questions and comments should be directed to Chief, Arab-Israeli Division, []

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During his 8 to 9 October visit to Washington, Prime Minister Peres will focus on explaining his economic program and sounding out Washington on its willingness to provide additional aid. He will be accompanied by Alternate Prime Minister and Foreign Minister Shamir. []

Current Economic Climate

The most immediate problem facing Peres's national unity government is to stem a rapid decline in foreign exchange reserves. The Bank of Israel recently announced that foreign exchange reserves fell by nearly \$700 million during July. The Bank subsequently announced that reserves fell by another \$192 million in August. Although the current reserve level of \$2.9 billion is sufficient to cover more than four months of civilian imports, the precipitous drop has added to the uncertain economic climate. []

In our view, the drop in reserves is largely the result of Israelis trying to hedge against anticipated economic policies of the new government by converting their assets into US dollars. They remember that the government denied plans to devalue the shekel during the weeks prior to a major devaluation last October and suspected that another devaluation was imminent. The foreign exchange controls adopted and gradually tightened since the October devaluation have encouraged an increasing number of Israelis to trade shekels for dollars on the black market. []

The pressure on reserves comes at a time when Israel's trade deficit is improving. During the first eight months of this year, the deficit was \$1.9 billion, \$600 million less than during the same period in 1983, according to Israeli statistics. The improvement is due to the more rapid depreciation of the shekel since last October, which made Israeli goods more competitive abroad and boosted the cost of imports in shekel terms. []

Real wages plummeted during the fourth quarter of 1983 because the devaluation of the shekel and the large increase in government-controlled prices in October caused inflation to soar to its current 400 percent annualized rate. Several wage increases to compensate for the higher inflation, however, have since boosted real wages. In March, the latest month for which data are available, real wages were 10 percent higher than the low recorded last fall, and wage agreements negotiated this summer will provide an additional boost to real wages. []

According to Israeli statistics, the unemployment rate reached a seasonally adjusted 5.9 percent in the second quarter of this year, the highest in more than a decade. For the past year industrial production has been holding fairly steady. []

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The Government's Economic Program

[redacted] Yitzhak Modai, leader of Likud's Liberal Party, was named Finance Minister to mollify the Liberals, who almost bolted from the Likud bloc before the election on 23 July.

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[redacted] His major accomplishment was the successful negotiation of an oil supply agreement with the United States in 1979 following the signing of the Israeli-Egyptian peace treaty.

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The rough outlines of Modai's economic strategy are already clear. These include budget cuts and a wage-price freeze. The Cabinet has approved in principle a \$1 billion budget cut. According to press reports, an 8-10 percent surtax will be imposed on October income taxes and "compulsory" loans of 5-7 percent of wages will be made to the government in each of the following three months. Prices of basic commodities have been substantially increased in order to reduce outlays on subsidies.

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The budget cuts would improve the balance of payments; lower growth and higher unemployment would probably follow. [redacted] we estimate that the civilian goods and services deficit would be \$500 million lower than it would have been if the budget cuts were not implemented. Real growth, however, would drop from 3.5 percent to 1.6 percent, and the unemployment rate would rise slightly.

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According to Israeli press reports, the government hopes to save another \$350 million by cutting subsidies. The resulting price hikes will boost inflation from its current 400-percent rate to a higher level that will be sustained unless the current cost-of-living adjustment formula is reduced. Subsidy cuts alone will have only marginal impact on the balance of payments.

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Obstacles

Implementing Modai's program will not be easy, in part because of cabinet opposition.

- Education Minister Navon has rejected the proposed \$100 million cut in his budget.
- Labor and Social Welfare Minister Katzav opposes welfare allowance cuts.
- Tourism Minister Sharir claims his ministry cannot cut its budget at all because this would undermine efforts to attract tourists who bring in badly needed foreign currency.

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Even if the Cabinet agrees on where to pare the budget, the cuts are unlikely to materialize in the absence of an enforcement mechanism. Israeli cabinets have been "cutting" the budget without effect for the past two years. Ministers have become adept at using "unanticipated" price hikes to justify their actual outlays. We believe it will be extremely difficult to discipline any minister for exceeding his spending ceiling because the Cabinet is so delicately balanced between Labor Party and Likud ministers. [REDACTED]

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Negotiations on a wage-price freeze with the Histadrut, the powerful trade union organization representing about 90 percent of the work force, will also be difficult. Histadrut Secretary General Kessar is particularly opposed to tampering with Israel's extensive system of indexing wages to the spiralling inflation rate. The US Embassy reports that he has three priorities:

- Maintain a high level of employment.
- Share the burdens of austerity equitably among all segments of society.
- Insure that the government carries through on all parts of the agreement. [REDACTED]

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Histadrut officials are not willing to renegotiate the public-sector or the private-sector agreements that were signed during the past few months, according to the US Embassy. They also have rejected proposed changes in the cost-of-living adjustment formula. The Israeli press reported that Modai aimed to reduce the September cost-of-living adjustment by 10 percent, but he subsequently announced that he had been misunderstood. [REDACTED]

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Militant second- and third-echelon Histadrut leaders favor a much more aggressive protection of worker interests. These younger leaders, particularly in government-sector unions that would be most directly affected by an austerity program, will resist Histadrut acquiescence to government proposals leading to loss of jobs or purchasing power. We believe these militants are prepared to take strike action in the expectation that the government will cave in rather than face widespread labor unrest. Kessar, who faces a Histadrut re-election campaign early next year, probably will be reluctant to back government initiatives on austerity that could provoke major divisions within the Histadrut. [REDACTED]

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Modai is unlikely to tackle the structural problems of the economy, such as the need for an independent monetary policy and to end wage linkage between various groups of workers. The Finance Ministry staff is likely to press for establishment of an independent monetary policy, but we are skeptical that Modai will agree because this would give the Governor of the Bank of Israel an enhanced policymaking role at the expense of the Finance Minister. Kessar's cooperation and support would be required to

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deal with the wage linkage issue, but he so far has been unwilling to negotiate with the government on this matter.

Outlook

Israeli officials are well aware that foreign exchange reserves cannot be allowed to fall much more and that the United States is watching their actions closely. They apparently believe that if the brakes are put on the economy for a short period the problem will be solved. Such an approach, however, will only buy some time.

We foresee a lack of public support for an austerity program, and this will be a key problem for Peres's national unity government. Israelis have prospered in recent years, even with triple-digit inflation, and most take a short-term attitude toward the economy. As long as the pervasive system of indexing wages to the inflation rate protects their income and savings, most Israeli will resist accepting higher unemployment and lower living standards in order to curb inflation.

Higher unemployment and lower purchasing power likely to result from the austerity program probably will lead quickly to growing public and political pressure on the government to desist from implementation of its economic reform plans. Many influential members of the Cabinet have ambitions to succeed Peres and Shamir as leaders of their respective parties and will be acutely sensitive to the impact of economic policies on their own political prospects. Each party will try to shift the onus of responsibility for unpopular economic measures.

As a result, Peres and his colleagues probably will find it politically easier to ask the United States for additional aid than to stick with a rigorous austerity program. Outgoing Finance Minister Cohen-Orgad publicly stated that Israel would ask the United States for an additional \$750 million to \$1 billion in economic assistance. The government also is likely to ask for disbursement next month of all US economic aid for FY 1985, at least \$1.1 billion. In addition, Israeli officials eventually may ask for rescheduling or forgiveness of Israel's Foreign Military Sales debt--\$8 billion--owed to the United States.

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