U.S. Credit Analysts Fault Israel on Economic Reforms

Report Complicates Loan Guarantee Request

10/3/91 Note timing of appearance

By Jim McGee
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U.S. government credit analysts have warned that Israel's failure to carry out painful reforms to deal with its "looming financial and economic problems" casts doubt on its ability to pay for planned increases in its debt burden.

The credit assessment, given to the Bush administration in July by the Export-Import Bank and vigorously disputed in many respects by the Israeli government, highlights a new complication for Israel's request for $10 billion in U.S. government-guaranteed loans to finance the resettlement of an estimated one million Soviet Jews.

The bank report said it is "not beyond Israel's ability" to service a larger foreign debt, "provided new credits and generous grants are forthcoming" and there is a growth in exports. But while noting that debt "rescheduling is not yet viewed as a probable course," it warned that "rescheduling at some point . . . has a higher probability than before."

Noting the "socialist bent of its founders," reflected in substantial state ownership of production and state employment of 39 percent of the labor force, the report said "Israel has shown a pattern of large fiscal and external deficits to finance high defense expenditures, an extensive social welfare system, and a relatively high standard of living." economic crimes?

"The experience of the past two decades," the report said, "indicates the government has put off free-market reforms and has been willing to adopt emergency economic measures only when confronted with a crisis." Further, it said, the powerful Histadrut labor federation, which owns 25 percent of the country's enterprises, "continues to re-

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sist all major economic proposals adversely affecting labor."

According to Congressional Research Service (CRS) studies distributed last month, the Israeli economy is dependent on foreign aid and "philanthropic donations" to meet its current $3 billion a year balance of payments deficit, and consistently runs budget and trade deficits. The unemployment rate rose from 6 to 10 percent over the past two years, one study said, "and appears destined to climb further with the wave of immigrants in search of jobs."

The Ex-Im Bank's closely held "country review" of Israel, which has not been made public, cautioned that Israel's long-term economic prospects are troubling even if a relatively high growth rate is assumed. "The expected buildup of external debts gives rise to concerns about Israel's ability to meet its future debt service obligations on a timely basis," said the analysis.

Overall, the report said, "If new lending is sharply increased . . . it is likely that by the end of the decade the U.S. government will be in a position where the secheduled repayments exceed disbursements. Thus the U.S. government would become a net capital importer from Israel."

The bank's analysis contrasts starkly with Israeli assurances, backed by supporters in Congress and in the U.S. public, that Israel can easily cope with substantial new debt.

Amnon Neubach, economics minister at the Israeli Embassy, said the report did not give sufficient weight to the improvements in Israel's economy during the past five years, and its successful management of foreign debt.

"According to their assessment of our economy, we can still pay our debts," Neubach said, even though the Ex-Im projection of a 5.6 percent growth rate is less than Israel's projection of 7 to 8 percent. ". . . the growth will be there, we know that."

"What it predicts is that Israel might have in the near future a default potential," said Ruth Yaron, an embassy spokeswoman. But she and other Israeli officials argued that the report also did not take into account the one-time nature of the resettlement costs, and the economic growth the new immigrants would engender.

Israel also says that it has a perfect payback rate on foreign debt, and that its foreign debt burden as a percentage of gross domestic product has been reduced from 80 percent in 1985 to 36 percent last year.

But one U.S. official noted that, while foreign debt as a percentage of income has decreased, total government debt—including domestic debt—has increased rapidly over the past five years. Israel's current foreign debt is manageable, largely because the United States allowed Israel to refinance its military debt in 1988 with other U.S. guaranteed loans, according to the CRS.

"What [Israelis] don't say is that the [payback] record is perfect because we give them more aid the next year to service the debt," said an administration official.

The United States has provided a total of $53 billion in assistance to Israel since 1949—of which $21 billion has been military loans and grants and the rest economic assistance, according to the CRS. Aid has been $3 billion a year since 1985. The total owed by Israel to the United States for previous loans as of January was $4.36 billion.

Consideration of the $10 billion guarantee request by Congress was delayed until January after the administration argued—over strong protests from Israel and its congressional supporters—that approval at this time would send the wrong signal about U.S. evenhandedness to participants in the ongoing Middle East peace process.

But beneath the political battle over the timing and foreign policy wisdom of the guarantees has been an undercurrent of concern about Israel's increasing financial dependence on the United States in the absence of meaningful reform in its centrally-run economy. The delay in considering the loan package—which requires a substantial amount of U.S. government funds to be set aside to cover possible losses to private creditors—has opened the door to more careful scrutiny of Israel's economic condition.

Rep. David R. Obey (D-Wis.), chairman of the Appropriations subcommittee on foreign operations, said he plans to hold hearings on the guarantees. "It's my job as a committee chairman to serve as a skeptical loan officer on behalf of the U.S. taxpayer," Obey said in an interview. " . . . Will they in fact be able to pay that back without getting additional aid?"

The administration privately has welcomed scrutiny of Israel's economy, according to officials. Irritated by what it sees as Israel's lack of cooperation on some elements of the peace process—in particular Prime Minister Yitzhak Shamir's refusal to stop building settlements in the occupied territories—the administration in several high-level conversations with Shamir and his government has mentioned the economy as an example of problems that could interfere with future U.S.-Israeli relations, officials said.

"What Israel is used to is not having to face the tough questions," said a senior official. "They were just never raised by the administration or the Congress to any extent.

"This is not going to happen this time around. There are friends of Israel who are even questioning whether we do her a favor by letting Israel incur another $10 billion in debt with no economic reforms," the official said. "Are we really doing favors by propping up an economic system that is collapsing and would collapse without state control?"

While the Export-Import Bank is not directly involved in the $10 billion request, its semiannual country reviews are considered credible assessments of credit risk and are distributed to various government agencies.

"All politicians, not just the OMB [Office of Management and Budget] are looking at [the report], and it is presenting them with a tough, tough proposition," said an administration official.

It is the OMB that will have to decide how much money the U.S. government will have to set aside for the guarantees in each of the five years during which Israel has proposed borrowing $2 billion under the plan. The amount of that set-aside subsidy already has been a subject of some debate here.

The guarantee proposal calls for administration by the U.S. Agency for International Development. Similar, although much smaller, AID-administered loan guarantees have required set-asides of 2.5 percent each year. In Israel's case, Sen. Robert W. Kasten Jr. (R-Wis.), who introduced legislation last month on the proposal, estimated the subsidy cost at only 1 percent. In its own briefing paper, the American Israel Public Affairs Committee lobbying group estimated the Israel subsidy "should only be .55 percent."

"This is not grant aid to Israel,"

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Israel Strongly Disputes Report by Ex-Im Bank

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said Sen. Daniel K. Inouye (D-Hawaii), a cosponsor of the legislation with Kasten, on the Senate floor last month. "There is no free lunch. Israel is not asking for a handout, but for an outstretched hand. . . ."

But the CRS, noting new U.S. budgetary restrictions that require the set-aside to be taken out of authorized foreign aid funds, said that the standard 2.5 percent "may not be a good indication of what an estimate for the Israeli request might be."

"The subsidy calculation will be based on Israel's economic performance, its previous debt repayment record, the projected impact of the new immigration on the Israeli economy, on Israel's capacity to acquire and manage the new debt, and on other factors," the CRS said.

While noting that Israeli officials and supporters argue that Israel's credit is good, the briefing paper said, "others are not so optimistic about Israel." The risk analysis, an administration official said, "implies a [U.S.] subsidy significantly higher than what people have been talking about."

The Ex-Im report also noted other factors it said should be taken into account in assessing risk in loans to Israel, including domestic instability caused by high unemployment among immigrants and the "continued building of settlements in the occupied territories," which could exacerbate tensions with the Palestinians, and the external threat from Syria.

The report included among the potential risk factors the "cooling of relations" with the United States that could result from "Israeli insistence on building settlements."

Rep. Lee H. Hamilton (D-Ind.), chairman of the House Foreign Affairs subcommittee on the Middle East, said, "I think the loan guarantees are going to be much less effective than they could be if the Israeli government does not step up the pace of reform. Israel faces exceedingly serious economic problems, and they have to change."

Israeli officials said repeatedly that the report gave too little weight to positive indicators. "The [Ex-Im] report didn't take into consideration all the improvement of the economy in the last five years," Neubach said. The officials cited a report by the investment firm of Salomon Brothers titled "Israel: A Misunderstood Credit," which praised Israel's economic restructuring, cited a decline in its external debt burden and predicted that the new immigration will bring economic growth. "We believe that the state of Israel is considerably higher in credit quality than generally is understood," said the Salomon Brothers' report.

"We are confident that an honest look at all the facts will show that Israel has the ability and commitment to pay these debts faithfully and on time," said AIPAC spokeswoman Toby Dershowitz.

The Ex-Im report, the CRS paper, and a Bank of Israel report issued last spring dispute in varying degrees the Israeli government's contention that the Shamir government is moving ahead on a program of economic reform. "Only a few of the recommendations of the program have been carried out," wrote Michael Bruno, the central bank's governor, in April.