

The Center for International Economic Growth

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ECONOMIC REFORM, NOT LOAN GUARANTEES: ISRAEL'S ONLY PATH TO PROSPERITY

INTRODUCTION

Last Friday, Israeli Ambassador to the United States Zalman Shoval met with Secretary of State James Baker to press Israel's request for quick approval of a U.S. guarantee for \$10 billion in loans to Israel. Two weeks ago, Shoval is believed to have discussed the matter in a private session with Vice President Dan Quayle. Israel claims to need \$2 billion a year in loans for each of the next five years to help absorb an estimated one million Jewish immigrants expected to arrive from the former Soviet Union by 1995. If the Israeli government is unable to pay back these loans, then the American and foreign banks that make them will call upon the U.S. to make good on its guarantees.

On extremely persuasive economic grounds, Israel would be unwise to take the loan guarantees and become further dependent on massive foreign economic assistance. And it would be unwise for America to grant the guarantees—unless they are tied to firm and measurable commitments by Israel to accelerate dramatically its long-promised but slow-moving reform of its economy by cutting its budget, reducing and reforming taxes, privatizing government-owned companies, and deregulating extensively the private sector.

Wrong Reason. The loan guarantee issue thus should be clear cut. It is not. Analysis of it has been muddied badly by actions of the Bush Administration. Baker and George Bush so far balk at the guarantees. The trouble is they do so for a very wrong reason: to force Israel to make concessions in the current round of Middle East peace talks. The Administration claims that it is using the loan guarantee matter to force Israel to stop building settlements in the occupied territories. What seems more likely is that the threat to deny the guarantees is part of

the Bush Administration's efforts to tilt American policy unprecedentedly against Israel.¹

Purely Economic Matter. The Bush-Baker policy thus ties the guarantees to the peace process. This prevents the issue from being considered on its own economic merits. It may well be impossible, in fact, today to untangle Israel's request for \$10 billion in U.S. guarantees from the Arab-Israeli talks. It is wrong for the U.S. to impose political and security conditions on the granting of the guarantees; it is unwise for Israel to accept such conditions. If the guarantee issue is inextricably entwined with the peace talks, then Israel should withdraw its request and resubmit it when it cannot be used against Israel in the peace process.

That the loan guarantee is an economic matter, in fact, is stressed repeatedly by Israeli and American Jewish community leaders.² However, it is Israel's economic ills that make a \$10 billion loan guarantee unwise for either Israel or America. Such funds only will allow Israel to continue the budget and economic policies that in the past couple of decades have virtually stagnated what once was an economic miracle. Such policies in the long run, moreover, will make Israel even less economically able to absorb more immigrants. Rather than addicting Israel further to debt, America should help Israel convert to a free market system.

NO CLEAR CASE FOR LOANS

The Israeli government claims that the \$10 billion in loans to be guaranteed by the U.S. are needed as part of the estimated \$70 billion cost of absorbing the expected one million immigrants. Israel plans to cover part of this cost with its own funds, part through contributions from Europe, and the rest through borrowing. Israel claims that over 80 percent of the \$10 billion that is to be backed by the U.S. will be used for housing, with the rest going for roads, sewers, water systems, and other infrastructure. Some of the funds also are to go to commercial banks to finance business investments.

Israel, however, has not made a convincing case that it needs so much money or that it has any even semi-solid plans for using the money. American policy makers (and Heritage Foundation staffers) repeatedly have pressed Israel, without success, for more details of where the \$10 billion figure has come from. They have asked how the funds exactly will be spent, how many housing units are to be built and where? The answers repeatedly are vague. Observes a Wall Street expert very familiar with the Israeli economy: "It's a soft number."

1 See James A. Phillips, "Maintaining a Balanced U.S. Policy on Middle East Peace," Heritage Foundation *Executive Memorandum* No. 318, January 13, 1992.

2 See Foreign Broadcast Information Service - Near East and South East Asia (FBIS-NE) reports on September 9, 1991 (p. 21), September 13, 1991 (p. 15), October 4, 1991 (p. 22), and *Near East Report* on October 7, 1991 (p. 172).

In fact, according to a top Israeli official, no list of specific purchases was compiled to determine the amount of foreign borrowing required. Rather, the Israeli government used some economic formula based on assumptions concerning how much capital may be needed to absorb the immigrants. Perhaps this formula is valid. Yet the Israelis have not released it. Were it made public, American policy makers would at least be better able to judge the merits of Israel's loan request. On the face of it, moreover, it seems strange that foreign borrowing is required for housing. After all, the new immigrants will provide plenty of labor, while building materials are readily available in Israel. Imports requiring foreign currency are not needed for this.

Disturbing Questions. To be sure, Israel would welcome an extra \$10 billion in hard currency. What country would not? But without substantial economic reforms, the huge new loans will be squandered by wasteful government spending habits and economic policies that discourage job creation and hinder economic growth. While Israel's budget is not available in English for study by American policy makers being asked to approve loan guarantees, what facts are known raise disturbing questions about Israel's need for foreign assistance. Last August, for example, the Israeli government announced it would hire 15,000 new government employees. Another 880 government jobs are being created for archaeologists. This means, apparently, that the Israeli government prefers to spend money on make-work jobs rather than on housing for immigrants.

Speaking about his country's budget, Israeli Finance Minister Yitzhak Moda'i acknowledged last month:

Every year it is more and more wild. This year the Knesset [parliament] will pencil in money that simply isn't there. The Finance Minister will then have to go door-to-door, to try to raise the money from the U.S. and from diaspora Jewry. Then you will say, and rightly so, that the government is inconsistent in its economic policy.³

Recent history teaches that extending loan guarantees simply will allow Israel to delay economic reform. In the 1980s, the International Monetary Fund and World Bank loaned billions of dollars to debt-ridden Argentina, Brazil, Mexico, and other developing countries. This was wasted on money-losing state industries and bloated government payrolls. Only when no more large handouts were available were reformers in these countries able to push through the free market policies that have begun fueling prosperity and raising living standards.

3 Hugh Carnegie, "Anarchic Bargaining Distorts Israel's Budget," *Financial Times*, January 2, 1992, p. 3.

PHANTOM ECONOMIC REFORMS

Israel's economy needs such reforms. Its economy today is dominated by the government. Jerusalem's 1992 budget equals more than 80 percent of the country's gross domestic product, while the government employs at least 30 percent of the workforce. The top personal tax rate is nearly 50 percent and the corporate rate 40 percent. The government owns almost 94 percent of the land and about 200 companies. Until recently, obtaining a building permit required dozens of steps and could take up to five years. It is little wonder that Israeli businesses do not have the capital to expand, to create new jobs, or to build more private housing.

Complained Daniel Doron, Director of the Jerusalem-based Israel Center for Social and Economic Progress, at a Heritage Foundation lecture last September 20:

Despite some very halting steps toward privatization, [the government] still controls the import of many staples. It sanctions dozens of monopolies... Government denies free or easy access to the market and ties the hands of producers with onerous labor laws. It imposes on labor and employers punitive taxes that destroy their competitiveness and nip in the bud new enterprises.⁴

If housing is needed for immigrants, meanwhile, the Israeli government seems hardly the best agent to provide it. Last year, to accommodate the first wave of immigrants, the government built housing far from where the jobs were. Most immigrants refused to move into the new buildings, preferring to crowd into urban housing, often with several families in each apartment. They wanted to be close to work. That this project was a failure is conceded privately by Israeli officials—who admit further that the projects that will be financed or encouraged by the new money will be planned and executed by the same bureaucrats responsible for the earlier failures.

Poor Credit Risk. Without major economic reform, Israel is a poor credit risk.⁵ Though Israeli officials boast that their country never has missed a debt payment, the only way it pays its current debts to the U.S. is from the \$1.2 billion of Economic Support Fund money received annually from the U.S. (U.S. military aid to Israel, depending on how it is calculated, is another \$1.8 billion to \$2.8 billion annually.) Using foreign aid to pay off loans does not impress economists who, when determining a country's credit-worthiness, typically look not at a

4 Daniel Doron, "Israel's Economic Challenge: How the U.S. Can Help," *Heritage Lecture* No. 350, September 20, 1991, p. 3.

5 See Jim McGee, "U.S. Credit Analysts Fault Israel on Economic Reforms," *Washington Post*, October 3, 1991, p. A1.

country's past debt-payment record but at its future potential for servicing its debt.

Here Israel scores very low. Standard and Poor's Corporation, for example, currently gives Israel a BBB- credit rating for long-term government bonds not backed by the U.S. This is Standard and Poor's lowest rating for investment grade bonds.

Message from Banks. The best indicator of Israel's ability to repay, of course, is the reluctance of banks to lend Israel money without a U.S. guarantee. These banks are saying something to which Israel should listen. Some Israeli officials deny this and insist that their problem is not obtaining bank loans. The problem, they say, is the high interest rates for the loans. According to these officials, international banks will reduce interest rates if the U.S. guarantees the loan.

If lower interest rates thus are the main reason for Israel seeking the loan guarantee, there is an easier solution than the guarantee—if Israel, of course, makes the convincing case for new massive loans. Washington could consider giving an annual grant to Israel for the difference between the higher commercial rate that Israel would pay without the guarantee and the lower rate that Israel could have obtained with a guarantee. The advantage of this is that America would not be a guarantor of or co-partner with the Israeli economy. If Israel then defaulted on its loan, it would be a matter between Israel and the banks.

What would be avoided would be the enormous political damage to Israel's reputation in America were Israel to default on guaranteed loans. This kind of default surely would trigger a parade of American and foreign banks coming to the U.S. Treasury to collect the billions owed to them by Israel. Owing money directly to foreign banks, without the shield of a U.S. guarantee, moreover, could impose enough discipline on Israeli leaders to prompt economic reform.

NO FREE GUARANTEES

The American taxpayer should be wary of granting "guarantees" of any kind. Proponents of such guarantees typically glibly assure skeptics that they cost nothing. At one time, perhaps, this may have seemed plausible. But in the past decade, Americans to their horror have learned that loan guarantees come back to bite.⁶ In 1990 alone, defaults by middle class American college graduates on loans underwritten by the U.S. government cost the Treasury \$2.5 billion. Guaranteed accounts in Savings and Loans will cost the taxpayers hundreds of billions of dollars. And countries that long had had perfect credit histories, in the past decade walked away from their debts, leaving Western banks and countries holding the bag.

⁶ See Ronald Utt, Ph.D., "The Six Trillion Dollar Debt Iceberg: A Review of the Government's Risk Exposure," *Heritage Backgrounder* No. 774, June 28, 1990.

America thus painfully has learned that "guarantees" are not cost-free or risk-free. If Israel needs money to meet real humanitarian needs, let it ask for an outright humanitarian grant. America seldom has refused such genuine requests. Guaranteeing loans likely will create future debt problems.

That Israel desperately needs economic reform is recognized by many Israelis who propose bold plans to follow the path of Argentina, Mexico, and other developing countries that have begun growing rapidly after adopting free market policies. And the Israeli government in recent years also has recognized the need for economic reform, unveiling one reform after another. Yet Israeli officials admit that while some progress has been made, the reforms have remained mainly words. Last October's overview of the Israeli economy by the Bank of Israel and the Ministries of Finance and of Economics and Planning, states:

Although the government has acted in the right direction, it has not yet succeeded in carrying out all the reforms on which it has decided...particularly as regards the privatization of government corporations. A more resolute implementation of these reforms might have facilitated faster sustainable growth and more employment.⁷

Israel will have little incentive to abandon its failed economic policies if the U.S. continues to bail it out.

CONCLUSION

The weight of the economic evidence argues strongly that Washington should refuse Israel's request for loan guarantees. To refuse in the current geopolitical climate, however, in the midst of the peace talks, would appear to punish Israel unfairly. Yet, to accede to the request, in its current form, also would be unfair to Israel and to American taxpayers.

Thus what now would be best for Israel and America would be for Israel to withdraw its request for loan guarantees. For one thing, withdrawing the request would remove pressure from Israel to compromise its negotiating positions in its talks with the Arabs and would deny Bush and Baker a lever to press Israel on the settlements in the occupied territories. Israel should not allow its critics to hold it hostage over the loans.

Time for True Reform. For another thing, withdrawing the loan guarantee request would give Israel the time to develop a true reform plan which would reduce or even eliminate the need for assistance.⁸ Finance Minister Moda'i, in fact, has implied that he recognizes the value of a push from America. Last

⁷ Bank of Israel, Ministry of Finance and Ministry of Economics and Planning, "National Budget for 1992-1994," October, 1991, p. 3.

⁸ See Stanley Fischer and Herbert Stein, "Overhaul the Israeli Economy," *New York Times*, October 12, 1991, p. A29.

December 12, he told the Jerusalem Kol Israel radio: "There may be economic linkages, but I welcome these because, if the guarantees are accompanied by conditions for reforms in the Israeli economy, I also believe that reforms are needed. We will make the reforms without them being conditional. That is why such conditions will not bother me at all."⁹

One Condition. When the time comes that the issue of U.S. loan guarantees to Israel can be decided on its economic merits, the U.S. should give it sympathetic consideration. The U.S. should impose only one condition: that Israel make the economic reforms needed to enable Israel to pay back the loans. If Israel refuses to make such reforms, no amount of foreign loans or guarantees will help Israel for long.

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⁹ Jerusalem Kol Israel Radio in Hebrew, translated in FBIS-NE, December 13, 1991, p. 44-45.

For Further Information

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Note: This publication in English is a government analysis of recent Israeli economic performance, current policy and future trends. The actual 1992 budget for the State of Israel is not available in English.

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