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January 15, 1987

SOME NEW YEAR'S REFLECTIONS AND CONCERNS

By: Elmer L. Winter, Chairman

Zbralle Plenary

Dear Friend:

It is 7:00 a.m. . .January 1, 1987.

I am sitting in my den . . . thinking about CEGI. My thoughts go back to the spring of 1976 when I was asked by Prime Minister Rabin to create and head-up a group which we call CEGI. I ask myself, **"Did we make a difference over these past ten years? Did we help Israel move in the direction where she could stand on her own two feet -- economically speaking?"**

I admit that I am too close to the picture to come up with an objective answer. We will have to let the 300 Israeli companies and the thousands of U.S. companies that we have worked with grade us on our efforts to make meaningful business connections over these past ten years.

What about the future? That's more important! Let me share with you some serious concerns that trouble me . . . concerns that I am sure, are on your mind as well. Let me point out that these are my personal observations and may not represent the thinking of all of our Board members.

At the outset, let us be sure to give the Israelis credit for doing an outstanding job in stabilizing their economy over these past two years. Bringing the inflation rate down from 20% a month to 1½-2% a month was a tremendous accomplishment. Exports were up -- deficits were reduced -- prices and wages were stabilized, etc., etc. But there are problems ahead as Israel turns from economic stability to growth.

In some cases, we can play a helpful role in solving these problems -- recognizing that the Government of Israel has to make the changes. We can only advise as to how these changes will impact upon American support, investments, exports, etc.

What are my concerns?

CONCERN #1: Israel needs to develop a long-range plan as to how she can become one of the three major high technology centers in the world. Of necessity, Israel has had to think short-term to get out of her economic morass. Now Israel needs a blueprint as to how she will mobilize her own resources and utilize the strengths of world Jewry to develop a high technology structure that will be competitive to the U.S. and Japan.

Israel needs a plan for the development of a mini-Silicon Valley extending from Karmiel, through Haifa to Tel Aviv, to Jerusalem. This plan would tie together the various industrial and high-tech parks in that area, as well as the universities. We are working on a plan in CEGI to suggest to the Government of Israel to accomplish this program.

CONCERN #2: The Government of Israel needs to design and implement a comprehensive economic program to decrease the extent of government involvement in the capital markets; hold inflation to a low level; stimulate private investment; increase productivity; and expand exports. Finance Minister Nissim has proposed a far-reaching plan which he believes will reach these goals. This economic package . . . if agreed upon . . . will cut government budgets, reform the tax system, and free up the capital markets. This should substantially increase the G.N.P. and reduce Israel's balance of payments deficits.

Government-owned companies will be sold . . . interest rates lowered and subsidies eliminated.

This is good news for potential foreign investors. The proposed plan follows the recommendations of the U.S.-Israel Joint Economic Development Group (JEDG) . . . the inter-government board created to help Israel stabilize her economy and move on to growth.

We, in CEGI, have gone on record with a number of Israeli government ministers urging support for proposals that will substantially improve the investment climate in Israel.

CONCERN #3: We need to be concerned that Israel is overly dependent upon the U.S. for financial support. It can well be argued that Israel has a very high degree of support from President Reagan and our Congress at this particular point in time. However, Gramm-Rudman always lurks in the background. Congressmen will be comparing cuts in the U.S. social budget to foreign aid.

We need to concern ourselves about the funds allocated by our Congress to Israel. Our "Milwaukee Journal" has editorialized: "It is a mistake to devote $5.2 billion . . . about one-third of the total foreign aid budget . . . to just two countries, Israel and Egypt. These are two U.S. allies but they need foreign help far less than do some nations that are desperately poor."

I am concerned that support can erode if Israel becomes a scapegoat in the Contra-Iran affair.

Fortunately, President Reagan has just signed a bill cutting interest rates on $5 billion worth of Israel's debt to the point where Israel will benefit by some $200 million per annum. Keep in mind, however, that this adjustment of interest will become part of a balloon note which has to be paid by Israel in future years.

Frankly, I won't be comfortable or feel that our job has been done until such time as Israel can say to the U.S., "Thank you very much for your past support. We have now built our economy to the point where we can go it on our own. Hallelujah!"

CONCERN #4: Appropriate action must be taken to assist American high-tech companies operating in Israel . . . to be profitable. A number of American companies have been adversely affected as a result of price freezes, while there has been a 20% increase in wages in 1986. They have been hurt by the lack of devaluation of the Shekel and a reduction in government contracts. These American companies need assistance to maintain their operations on a profitable basis in Israel. They add substantial strength to the Israeli economy. American subsidiaries in Israel hire many of Israel's top-quality engineers and scientists. Many would emigrate if these companies were to close down their operations in Israel.

CONCERN #5: Israel needs to eliminate unnecessary "red tape" which hampers new investments and affects existing operations of American companies. The Government of Israel must face up to the fact that there is a perception that the "red tape" in Israel adversely affects operations by foreign companies.

Ten years ago, we in CEGI, initiated an independent study to determine how the "red tape" in Israel could be eliminated and a one-stop service provided. An excellent report was issued but, unfortunately, a good part of the recommendations were not adopted.

Max Fisher, Chairman of Operation Independence, has expressed the frustration of the Task Force over the lack of government action in clearing away the "red tape" that hinders foreign investment. Operation Independence is working with the Government of Israel to eliminate unnecessary "red tape" and to provide for a one-stop service.

We, in CEGI, are urging Israeli ministers to give the highest possible priority to taking all necessary steps to eliminate "red tape" and substitute in its place . . . "Red carpet treatment" for foreign investors.

CONCERN #6: We need to be concerned that FTA has not caught hold to any major degree in bringing investments to Israel. The U.S. and Israel entered into a unique Free Trade Agreement (FTA) which was intended to promote U.S. manufacture of products in Israel for export to Europe, duty-free. As of this writing, there has not been any sizable rush by American companies to open factories in Israel for export purposes.

We need to step-up our activities to sell FTA to American companies seeking to market their products in Europe, duty-free. Israel needs this added productive capacity.

We also need to be aware of the fact that, under EEC, Israel must cut its import duties (effective January 1, 1987) on products brought in from EEC countries. This will put a strain on Israeli manufacturers who will have to compete against European mass producers.

CONCERN #7: We need to help Israel shut-off her brain-drain through increased foreign investments. Israel cannot afford to lose her best and brightest engineers and scientists. The Absorption Ministry of Israel reported that 19% of Israelis in the 18-29 age group are likely to emigrate. 34% of those surveyed believe emigration is caused by employment opportunities abroad.

With the reduction in the personal income tax rates in the United States to 28%, it becomes increasingly more interesting for Israeli engineers and scientists to seek employment in the U.S. It was recently reported by Raphael Industries that over 70% of the 450 employees that they recently dismissed as the result of budget cut-backs have left the country and are working for high-tech companies in California.

This hemorrhaging of the "best and brightest" must be stopped. We can help if we can attract large numbers of U.S. high-tech companies to open facilities in Israel.

CONCERN #8: We have not convinced many American Jews that they need to go beyond giving to UJA and buying Israel Bonds and start doing business in Israel. One of my major disappointments over the past ten years has been the oft-repeated response that I get from American Jewish business leaders when I ask them about doing business in Israel. Their answer is, "I give to UJA. I buy Israel Bonds -- don't bother me with doing business in Israel."

We have to change this mind-set. In my opinion, we are using only 10% of the capacity that we have to help build the economy of Israel. We need a commitment from American Jews that they will "raise their corporate flags in Israel". They should be able to get the same personal satisfaction . . . as well as a fair profit-return . . . in doing business in Israel that they get from putting up a wing of a hospital or constructing a dormitory in their name in one of the universities in Israel.

CONCERN #9: We need to convince visitors to Israel that they should combine business and pleasure and meet with Israeli business executives.

All too often, I meet my American business friends in Israel. They are visiting the country on a pleasure trip or as part of a mission. They have not included business contacts -- which I believe is a mistake.

We need to develop a component on all missions to Israel so that American business executives will have the opportunity to meet with Israeli business executives and start discussions leading to investments, joint ventures, exports, etc.

CONCERN #10: **We have not given our Jewish Yuppies a vehicle to get a "piece of the action" in Israel**. I am constantly called by successful American Jewish business executives and professionals who say to me, "We have been successful in our businesses. We want to go beyond working for UJA and selling Israel bonds. We want a permanent connection to Israel. How do we get a piece of the action in Israel?"

We need to develop a vehicle so these Yuppies can become a part of the Israeli investment scene and become permanently attached to a venture that will give them not only a source of pride and accomplishment, but profits as well.

CONCERN #11: **We need to convince our Federations that they should add another component to their agenda -- helping to build the economy of Israel**. I have for a number of years, been urging Federations to consider expanding their role by serving as a catalyst to help build the economy of Israel. I believe that Federation programs will be strengthened if there is a strong and viable Israel that they helped to create.

Up to this point, the response from Federations has been minimal. However, in the past year I can see a substantial improvement in a number of Federations who recognize that they can play an important role in economic development of Israel.

Project Renewal programs must encompass an industrial component. Federations need to move beyond trying to remedy social problems in their Project Renewal area by helping to get their local companies to set up factories in their twin Israeli city. This will provide paychecks -- which are preferable to welfare checks.

CONCERN #12: **I am concerned about the cost of the Lavi**. There has been considerable controversy over the production of the Lavi. While producing the Lavi, according to Prime Minister Shamir, is a "matter of life and death," there are some serious cost factors that must be considered. $1.2 billion has been spent to develop the Lavi. Costs have risen.

Hirsh Goodman of the "Jerusalem Post", indicates that the hourly production cost has risen from the original estimate of $24.00 per hour to $37.00 per hour, as a result of the creeping rise in the value of the Shekel against the dollar. Goodman points out that the overall unit cost of the Lavi will be $50 million -- the same price as the F.15 and double the price of the F.16.

By buying planes from the U.S. instead of producing the Lavi, Goodman estimates that Israel could free $550 million per year for the local defense budget.

CONCERN #13: We need to be concerned about the lack of capital in Israel to fund emerging companies. I have talked to many young engineers and scientists in Israel who are developing new high-tech products that require capital. They cannot get the necessary financial support by way of seed money from the Government of Israel or from the Israeli banks.

Some of these capital-hungry companies are run by budding engineers and scientists who could be the leading Israeli entrepreneurs of the future. Without financial assistance, many will leave the country. We need a vehicle such as an Entrepreneurial Center, to help finance these future business leaders. We are examining some ideas as to how to make funds available on a selective basis.

CONCERN #14: There is not a strong preference at the consumer level to buy Israeli products in the U.S. We need to mobilize the purchasing power of American Jews to buy products in their stores that carry the label, "Made in Israel." There are many quality Israeli foods, wines, apparel, etc., that should be on every Jewish consumer's buying list.

CEGI is now working on a national program with a number of Jewish organizations that will tie-in our Shopper's Guide to their ongoing membership communications programs. This will add substantially to the much-needed exports from Israel.

CONCERN #15: We need to be concerned about the "bank share arrangement." Pinhas Landau of the "Jerusalem Post", referred to the bank share arrangement as a "time bomb set to explode in two stages."

The Government of Israel must redeem $1.5 billion of its obligations at the end of October 1987 and must redeem an additional $3.8 billion a year later.

As of this date, no plan has been announced by the Government of Israel as to how these shares will be paid on the two due dates. This problem hangs over the head of the Government

And so it goes . . . problems seeking solutions . . . in some instances we can help . . . and help we must.

On balance, it would seem that the Israeli Government is moving in the right direction. Changes will come about as there is a recognition by both Israeli major parties that economic growth must have a continuing high priority.

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Israeli Econ?

EXPORT-LED GROWTH STRATEGY FOR ISRAEL

EXECUTIVE SUMMARY

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THE MESSAGE OF THIS REPORT

Over the past 40 years, the public leadership of Israel has led the people of Israel on a series of successful quests which have required vision, determination, energy and intelligence to accomplish:

- The establishment in a hostile environment of the State of Israel from the ashes of the Holocaust;
- The creation of an impressive defense establishment to protect the state;
- The transformation of seemingly useless land into a garden of bountiful food and a source of useful minerals;
- The development of industry to bring self sufficiency in food, clothing, and shelter and the conveniences of modern day life to the people of Israel;
- The forging of an educational and research establishment unparalleled for a small nation.

All of these missions were acomplished by people who felt that they must be independent and self sufficient, for the non-Jewish world had often not been hospitable to the Jewish people.

After three decades of startling accomplishment, Israel's economy stagnated in the late 1970s and 1980s. The leaders of Israel had to borrow from abroad increasingly to maintain the living standards of the Israeli people, creating an uncomfortable dependence.

This report discusses a new quest which must be undertaken to assure Israel's economic prosperity. Israel has one of two choices for its economic future: dependence on or interdependence with the rest of the world. Israel is too small a country to be an independent economic island and still be prosperous. The scale required to develop, manufacture and market goods in today's world is too large. Israel must trade extensively and successfully.

Israel exports now, but unlike many small countries in Europe, its exports are not large and do not command a high value in the international economy. Achieving prosperity through increased high value exports is the quest addressed in this report.

This report is long and technical but it really has only four simple but powerful messages:

- The goal of increased exports must become a national priority;
- The strategy and culture of most Israeli firms needs to change from import substituter, defense supplier or raw material developer to focussed builder of international competitive advantage;

- Israelis must learn to market their products better;
- The uneasy relationship which exists between the Israeli government and Israeli businesses must be modernized: the businesses must be allowed to function more independently.

This report is offered as a call to action. Its specific recommendations are presented with our firm belief that they can be of help to Israel in its quest. However, more important than adopting any one of the recommendations is the understanding by all concerned that Israel's future depends on achieving economic prosperity through increased high value added exports.

Israel's choice is between economic dependence and stagnation or economic interdependence and prosperity. The choice will be made soon.

EXECUTIVE SUMMARY

EXPORT LED GROWTH: AN ISRAELI IMPERATIVE

THE PROBLEM

Israel's economy has lost its capacity to grow and to increase the living standards of its people. Between 1960 and 1973, the gross domestic product per person in Israel grew by over 100%. Between 1973 and 1986 it grew by only 9%. Since 1980, it has increased by only 0.3% per year.

In 1986 Israel's GDP per person was only 37% that of the United States, down from 39% in 1970. Israel now has a lower GDP per person than Ireland and Singapore and is one of the only developed countries in the world to decline relative to the U.S. since 1970 (Exhibits 1 and 2).

The increase in living standards experienced by Israelis during the 1980s has been made possible by a massive increase in foreign borrowing. Foreign debt now is almost $20 billion and 32% of Israel's exports go to pay the net debt servicing, up from 20% in 1979 (Exhibit 3).

THE NEED FOR EXPORT LED GROWTH

To increase living standards and reduce its foreign dependence, Israel must pursue export-led growth. Without exports the country cannot import the raw materials and industrial components needed for production. Moreover, Israel is too small to achieve efficient production scale in a wide variety of industries by serving its home market alone. Attempts to make these items for the local market alone would inevitably be inefficient. Israelis would have to pay high prices. The economy would be unproductive and would continue to stagnate.

Attempts to bring about growth through stimulating demand would result in greater inflation and a worse balance of international payments. Imports would increase, Israeli firms would divert product from export to the local market, and prices would rise in Israel.

The only solution to Israel's stagnation is increased exports.

THE EXPORT GOAL

The Jerusalem Institute of Management, using the economic model of the Israeli Finance Ministry, has projected the level of export growth which would be required to achieve a balance in Israel's external accounts (assuming a continuation of U.S. military assistance and private transfers from abroad) by 1995. Based on certain assumptions about the growth of domestic consumption, the service sector, and exports to territories, the model indicates that exports of goods must increase at a rate of 8.9% per year in constant 1985 dollars. (This excludes exports to the territories of Judea, Samaria and Gaza).

If this growth rate can be achieved, the model projects that GDP will grow by an average of 5.0% per year and GDP per capita by an average of 3.1% per year. Assumptions and model relationships can be changed to produce many different results, but it is clear that improved living standards and an end to international dependence will require significant export growth.

Substantial productivity improvements will have to be made to achieve this goal. This will not be easy since Israel's productivity growth has stagnated during the 1980s (Exhibit 4).

While this goal may sound ambitious, it can be achieved if appropriate actions are taken by business and government. Israel currently exports a much lower amount per person than other small countries (Exhibit 5). The growth we have set as a goal would take Israel only to Ireland's current level of exports per person, by 1995.

WHERE WILL THE GROWTH COME FROM

In real 1985 dollars (U.S. GNP deflated), Israel's export of goods grew by 9.6% per year from 1960 to 1970 and by 13.5% per year from 1970 to 1980. However, between 1980 and 1985, it declined by 2.5% per year.[1]

More than 20% of Israel's exports are made up of products based on natural endowments in agriculture (mainly citrus products, cotton and vegetables) and in minerals (mainly bromine, potash, phosphates and periclase).

Another 48% of its exports come in areas where Israel has some special advantage: 19% in defense products where Israel's government is a relatively large and sophisticated purchaser; 21% in diamonds where the emigration of Jews active in the diamond industry from Belgium in the 1940s transferred an established export industry to Israel; 2% in products sold to Marks & Spencer where Zionist sympathy provided the initial impetus; and 6% in products used in agriculture (for example for arid conditions) where Israel again has sophisticated purchasers.

Only 32% of Israel's exports originate in products where Israeli companies entered world markets based on advantages not due to local conditions.

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1 There are a number of ways to measure real export growth; no one is perfect. We have used dollars at average yearly exchange rates inflated with a U.S. GNP deflator to 1985 dollars. This has the advantage of making international comparisons possible, but the disadvantage of being affected by differences in the U.S. dollar exchange rate with other currencies. No matter which measure is used, the reality of export growth decline in the 1980s is clear.

During the 1970s all of these areas showed considerable export growth. In the 1980s exports of agricultural products and diamonds and most of the areas not based on a special Israeli advantage actually declined in real dollars and the growth in other areas slowed considerably.

The study team analyzed the future prospects of each of these export groups in depth. This was possible because Israel's exports are quite centralized with over 75% of exports coming from only 55 companies. By interviewing 150 companies in Israel and over 125 customers, partners, and competitors in the U.S. and Europe, it was possible to develop a view of growth prospects and impediments to growth.

The findings show that much of Israel's exports have reached a plateau. With the exception of agricultural technology markets, all other areas where Israel has some obvious advantage are unlikely to grow sufficiently to meet our growth targets.

Raw Materials Based Exports

Israel's agriculture is facing two constraints: increased competition from Brazil in citrus concentrate and from Spain, Portugal and Greece in various products as they enter the EEC; and a water constraint which limits the production potential of water intensive crops. Israel's farmers have been resourceful and have drawn international admiration for their success in developing Israel's arid land. Nevertheless, Israel's agricultural exports declined by 5.7% per year from 1980 to 1985. All of the ingenuity of Israel's farmers will be required to produce even a slight real growth during the next decade.

Israel has also shown great resourcefulness in developing its raw material based chemical industry. Extraction techniques are first rate, new technology has driven the development of downstream compounds to add value to the minerals, and bold marketing steps have been taken to secure distribution channels and customers in Europe and the U.S.

However, a changing competitive environment and evolving demand patterns threaten future prospects for growth. In potash the supply-demand balance is expected to be unfavorable for producers until the mid-1990s. Potash demand will grow only 1.3% per year in the U.S. and 1.0% in Europe. Meanwhile, new capacity is being planned or built in Africa, the Far East, South and North America, and Saudi Arabia. Growth of potassium nitrate, a major downstream product from potash, is also expected to be slow.

In phosphates Israel has maintained market share in Europe only by meeting prices which have declined by over 40% in the past five years. Substantial new capacity additions in Jordan and Tunisia will hinder a price recovery. Israel's production costs are not fully competitive in phosphates, and its deposits are of relatively low purity limiting downstream product opportunities.

Israel's bromine exports are also threatened by decreasing demand in ethylene dibromide and other end uses, although bromine exports overall should continue to increase. Periclase, which has grown rapidly in the past five years, will face significant increased competition from Mexico and Japan.

Israel's raw materials based chemicals have grown at 4.4% during the 1980s. It will be difficult to maintain that growth rate in these products over the next decade.

Special Market Exports

Diamonds experienced a price explosion in international markets in the 1970s. Prices collapsed in the early 1980s and total exports have still not recovered to 1980 levels. Over the last 40 years diamond trade in dollars has grown at a rate of 7% per year. Since the value added in Israel is only about 20% of total diamond exports, slight variations from this rate will not affect Israel's overall balance of payments.

Israel's exports to Marks & Spencer have grown by 6.6% during the past five years. Marks & Spencer imports only about 10% of its requirements, preferring to maintain as many British made goods in its stores as possible. Israeli goods now represent about 40% of its imports. Growth is likely to continue but will be constrained by overall store policies.

Israel's defense sector has grown in real terms between 1980 and 1985. Since our ability to study this sector was limited for national security reasons, it is hard for us to project potential future growth. We have projected two scenarios, one assuming a 3.7% growth rate into the future, and the other assuming an 8.9% growth (our target for all exports) as an optimistic assumption. Defense exports are subject to geopolitical factors and can often be volatile. Increasing the share of Israel's total exports accounted for by defense might entail considerable risk.

Of the special market based exports, only the agricultural technology based sector has no natural or externally imposed constraints. Nevertheless, exporters in this area face a number of challenges. Pesticides, which make up 33% of the sector's total exports, are facing severe price competition from Far East competitors, particularly Korea. Many of the other exports of this sector are plastic products which have low barriers to entry. It is common for purchasers of Israeli products from abroad to set up local sources of supply in their own countries to replace Israeli exports. Finally, kibbutzim are major exporters in this area. Ideological concerns about hiring outside labor sometimes restrict their growth.

Exhibit 6 shows the growth which can come from these constrained and special market export sectors (not including agricultural technology). It ranges from 4.8% to 6.5% per year, considerably lower than our goals. If the goals are to be achieved, other exporters including the agricultural technology sector must grow at 12.2% to 13.8% per year (Exhibit 7). How to accomplish this goal is the major focus of our study.

THE CHALLENGE OF GROWTH FOR OTHER EXPORTERS

Exports not based on the Israeli advantages, described above, accounted for about $1.9 billion in 1985. These exports originated in two very different types of firms: those set up primarily as import substituters to serve the Israeli market and those set up primarily for export. Since it is in these businesses where Israel's future growth will be won or lost, the problems confronting these exporters deserve careful attention.

Import Substituters

The vast majority of Israel's exporters in this category exist to serve the domestic market. They are provincial rather than international in outlook. They export less than 30% of their production, regarding exports as a way either to sell surplus production (a surplus mentality) or to make some money when good deals can be found (an opportunistic mentality). In aggregate, these import substituters exported $1.1 billion in 1985, down from $1.9 billion in 1980.

Most of these companies have always operated behind import barriers without having to worry about international competitiveness. Because they are import substituters, these firms often have very broad product lines produced in small quantities.

The transition from import substituter to sustained exporter is a difficult one. Areas of specialization must be built, foreign commercial relationships must be established, and significant investments made in product development, production capacity, and distribution.

A company set up for export lives or dies in its international business. One that has a profitable home market may choose to export (especially if there are general government subsidies to do so), but will withdraw without too much hesitation if the markets become more competitive.

This happened extensively in the 1980s as companies that had developed export markets to sell surplus production in the 1970s, withdrew in the face of increased international competition and more attractive conditions at home. Israel has a large base of import substitution companies. For Israel to achieve the necessary real growth rates in exports, many of these will have to become more successful exporters.

Export Oriented Companies

Beginning in the late 1960s, a new breed of Israeli companies formed, many with a technology base, to serve international markets. Exports made up well over 70% of their production from the beginning and their success totally depended on international markets. This group accounted for only $20 million in exports in 1970, grew to $342 million by 1980 and to $870 million by 1985. Exhibit 8 lists some members of this group, a few of which are Israeli business legends.

Beginning in the mid-1980s, several of the best known of these companies began to experience difficulty maintaining growth and profitability. The near bankruptcy of Elscint and two years of losses for Scitex, the biggest exporters of this group, have raised questions about the ability of young Israeli firms to reach significant size.

Companies trying to grow to a large size from a small home base face a number of problems:

- These companies usually focus on a particular market niche. If the niche remains small, the company does too. If it grows large, it attracts large competitors who can make life difficult for the small competitors.

- Markets for products now develop almost simultaneously around the world. A growth oriented company must develop an international network in the business rapidly. Being small and remote from major markets makes it difficult to have the type of intensive customer interaction necessary for good product development and market adaptation.

- Product life cycles are growing shorter while new product generations are becoming increasingly expensive to develop. Risks have increased greatly.

- All companies make mistakes in growing businesses. Large companies take write-offs and keep going, small companies often stall or go bankrupt.

Almost all of Israel's exporting companies are small in international terms, with sales no higher than $200 million each. Their typical pattern has been one of brilliant product development, good financial backing, rapid growth once a start-up phase has been passed, and then a flattening of growth due to some of the problems listed above.

Israel's export companies are aggressive and savvy. They must overcome the inherent problems of small home market base and small relative size, however, if they are to experience significant export growth.

The Marketing Problem

There is another problem which seems to plague many Israeli exporters, particularly the import substituters. It involves insufficient attention to and ability in international marketing.

There are many examples of Israeli firms which develop a leading product but lose its full commercial potential to competitors because they do not have the marketing, sales, or service network to support it adequately.

Our interviews often turned up extensive praise for Israeli products - from fashion clothing to electronic instruments - but strong disillusionment with the Israeli company's ability to promote and support the product.

Exhibit 9 lists quotes representative of many we heard from the roughly 125 market interviews conducted by Telesis. They graphically point to a serious problem of many Israeli companies - lack of marketing skill - which must be overcome if growth is to be achieved.

Other Constraints

Our interviews with Israeli companies and their customers also turned up some other constraints hindering their ability to grow.

One problem was best expressed by the outside board director of one of Israel's major companies when he said:

> "A major share of the time, energy, and attention of the chief executive and other top managers has had to be devoted to relationships with government ministries,
>
> The Bank of Israel, and large commercial banks because of the critical importance of government approvals (foreign currency, etc.) and government aid... combined with these programs.
>
> All this inevitably reduces the time and energy available for attention to competitive issues in the company's product markets..."

Problems with foreign exchange controls came up frequently in this regard.

Another issue often raised was the need to secure customers' finance for capital goods exports. Israel is sometimes not as generous as other countries in its provision of guarantees and thus competitive financing cannot be achieved.

New Firms

We have examined the role of new companies in Israel's export growth. Start-up companies take a long time to become significant exporters. Only nine companies formed since 1970 are in Israel's top fifty exporters making up about 9% of total industrial exports.

Start-up companies are unlikely to provide the major share of export growth in the next ten years, but they are crucial to Israel's long term economic development.

Israel has a healthy rate of start-ups. Moving from initial start-up to full commercialization is sometimes a problem, however. In a number of cases Israeli start-ups develop an innovation only to be beaten by a technological follower who is quicker to develop manufacturing and marketing capabilities and more professional management.

THE EXPORT TASK-SUMMARY

Israel must increase its exports of goods at 8.9% per year. Traditional sources of export growth in raw materials based industries, diamonds, defense, and Marks & Spencer will not provide the growth that is needed.

Most Israeli companies were formed behind import barriers to produce a small volume of a large number of goods to make Israel self sufficient. Others were formed to serve Israel's defense needs or to exploit raw materials. Very few were formed with international markets in mind and most of those which were are less than fifteen years old.

The transformation from import substituter, defense supplier and raw material developer to international exporter is very complex and difficult. The new breed of Israeli companies focussed on export also face serious constraints to growth due to the firms' small size, the small size of their home market and their remoteness from major customers. Most Israeli companies of all types lack marketing skills and must confront the difficulties of Israel as a business environment.

Building strong international companies that can export large quantities of high value products successfully is difficult from a small country base. It requires product focus and the building of long-term international price or cost advantage. Israel's firms will need to direct their efforts to this goal and change their corporate organizations and cultures to accomplish it.

RECOMMENDATIONS TO ISRAELI COMPANIES

Companies create exports, not countries. If Israel is to achieve the economic goals we have set, a large group of Israeli firms will have to change the way they do business and new export oriented firms will have to be established. Firms must think more strategically and define their international opportunities precisely.

Many will need to take risks far greater than they do now. Most will need to improve their marketing. Some must seek out partners abroad or look for ways to cooperate at home. All will need to know what makes for competitive advantage in their businesses.

The following recommendations, based on perceptions of the strengths and weaknesses of Israel's companies, provide directions for Israeli firms to follow:

Seeking Competitive Advantage

1. Israeli companies should build exports based on long-term competitive advantage, not surplus capacity. It is necessary to identify clearly and pursue the basis for competitive advantage and adapt if it changes.
2. Israeli companies should seek to increase value added per employee by developing competitive advantages based on factors other than low wage labor costs.
3. Israeli companies should focus on specific market niches which are appropriate to their capabilities. These companies are small in world terms and even if they are technologically capable of entering large markets, they cannot survive there over the long-term.

Marketing

4. In businesses where marketing scale is important, Israeli companies should aim to build foreign marketing systems they can control. Joint marketing agreements or OEM supply can be interim steps to that goal but should not be end-points in themselves.
5. Israeli companies with brand opportunities should look for ways to cooperate and secure scale to reduce the high costs of establishing branded products.
6. Service investment is critical to sales success. The sale is the start of a long-term relationship which the customer must find satisfying. Entry to a new market must be accompanied by investment in service capability.
7. Israeli companies should invest much more heavily in developing marketing skills in their people. In some companies this should be a crash program.
8. Product development should start with the market, not with the product.
9. Israeli firms competing in applications engineering intensive businesses must invest to standardize applications engineering rather than customizing each order.
10. Israeli companies must recognize that product innovation, by itself, rarely secures competitive advantage. Attention must also be paid to investing in other sources of potential advantage in the early stages of business development.

11. In areas requiring large scale R&D and where Israel has some inherent world class capabilities, companies should actively cooperate in joint development.

Manufacturing

12. Israeli companies should place more emphasis on manufacturing basics like cost control, quality control, machine maintenance, higher machine utilization, efficient production scheduling and meeting delivery timetables, rather than focussing mainly on automation.

Gaining a Price Premium

13. Israeli companies must seek out and invest in opportunities for sustainable competitive advantages based on achieving price premiums for superior quality products.

Management Capability

14. Israeli firms must accelerate their investments in managerial skill development.

THE GOVERNMENT ROLE

The Israeli government has always been deeply involved with the economic development of the country. The nature of that involvement has changed substantially over the years, as new economic challenges or opportunities arose.

For example, direct government investment to develop the mineral resources of the Negev and agriculture in the early years of the state was followed by a policy of industrialization through import substitution in the late 1950s. This was followed by government efforts to broaden and enhance Israel's military industries in the 1960s.

Over the last three decades, the government has played a major role in directing the flow of funds in the economy. In recent years the government's role has included increased encouragement to business-related research and development and greater aid to exporters.

The pattern of these diverse government activities adds up to an industrial policy, but not a clearly defined one. Indeed, many of Israel's industrial policies have been developed with other priorities in mind - two of the most significant being frontier settlement and military self sufficiency.

Exhibits 10, 11, and 12 summarize funds allocated in the current budget to industry. Some of the allocations, such as the exchange rate insurance, are designed to compensate Israel's exporters for the fact that currency devaluations have not kept pace with local inflation, which is higher than that in major competing countries. The regional development program provides capital grants to exporters who invest in certain parts of the country. Other policies subsidize manufacturing, agriculture, and tourism with income and employers tax exemptions. Another set of programs provides funds for research and development. Two important areas of government assistance, that provided to military companies and to firms which are in difficulty, are not accurately reflected in the chart since their amounts are not public information.

One of the most important aspects of Israel's industrial policy has been the achievement of free trade treaties both with the EEC and the United States. Israel's industrial policies also include elaborate exchange controls, capital controls and merger laws.

ISRAELI INDUSTRIAL POLICIES IN PERSPECTIVE

A number of small countries have tried to accelerate their economic development since World War II with active government involvement. Ireland, Portugal, Greece, Singapore and Taiwan have all followed the path of aggressive government incentives to attract foreign investment to their countries. More recently Ireland and Singapore have also established programs to encourage research and development, skills development, new company start-ups, technology transfer, and the general development of indigenous companies. Israel stands alone in basing its development on indigenously-owned industry. (Exhibit 13). Countries which have based their export growth on foreign firms have found it hard to increase their value added beyond a certain point since higher value activities like R&D, automated production, marketing and such are rarely located locally.

Israel has the problem of being a small country trying to industrialize but has developed a much stronger base of local companies and a stronger technical base than other small newly industrializing countries. For this reason, problems like the ones Israeli firms are facing have more often been addressed by developed countries. Programs which are relevant to Israel include:

- Programs in Sweden, France, and Japan for risk sharing in new products and markets
- Programs in Denmark and Germany to sponsor collaboration in marketing
- Programs in Canada, France, and Japan to restructure import substituters for export
- Programs in Germany, the U.S., and the U.K. to assist start-up firms
- Programs in Japan, France, Germany, and Europe to encourage R&D collaboration

- Programs in Sweden and Japan to minimize the bureaucracy associated with controls

We have chosen a number of successful examples from these programs which we discuss in detail in the full report.

Most developed countries have a wide variety of industrial incentive programs. Some speak a rhetoric of opposition to government industrial policies, but all use these policies extensively. On paper most countries appear to address a similar list of competitive and structural problems. In practice, many programs are wasteful or mere public relations while others are successful. Most successful programs share common ingredients including:

- Continuity of programs despite changes in political leadership
- A pragmatic rather than ideological debate about policies
- Incentives toward industries involved in foreign trade, rather than sheltered ones
- Decentralized identification of market opportunities (companies rather than bureaucracy) except where government is the key purchaser
- A focus on international competitiveness as the driving discipline for actions
- A focus on incentives to invest on a matching basis rather than a pure subsidy to sales
- A structuring of incentives to focus on specific competitive leverage points

Israel's industrial policies, with the exception of its R&D and BIRD (U.S. - Israel Bilateral Research and Development Foundation) programs, lack many of these characteristics. They change frequently, they tend toward subsidy rather than incentive, and they are not focussed on competitiveness.

RECOMMENDATIONS FOR GOVERNMENT, HISTADRUT, AND THE OPERATION INDEPENDENCE TASK FORCE

Perhaps the two most important forms of support that any government can provide for industry are to secure a stable macroeconomic environment from which to operate and to provide good knowledge (educated people and a research base) and physical (transportation and communication) infrastructures.

Israel's government has recently had a poor record on the macroeconomic environment. Its record on infrastructure has been mixed: strength in the State's knowledge infrastructure (in terms of the populace's educational attainment and the worldwide standing of the scientific community -- see Exhibits 14 and 15) is balanced by weaknesses in the physical infrastructure, most notably in the telecommunications system.

Many have studied the policies of Israel with regard to macroeconomics and infrastructure. We do not have much to add on these issues other than to indicate that a rekindling of the hyperinflation of recent years or an inability to improve the communications infrastructure will certainly jeopardize any growth program.

While these government roles are paramount, the government also has an important role to play in fostering industrial development in ways which specifically address the impediments to growth mentioned above. The Histadrut also has a crucial role to play in garnering public support for the importance of the export program and in helping implement it through its companies and its role in negotiating pay raises. The Operation Independence Task Force can play a catalyzing role as it is uniquely suited to mobilize commercial assistance for Israeli companies in export markets.

The roles of the government, the Histadrut, and the Task Force in achieving the goals set forth in this report have four parts: to create an export imperative in Israel; to assist in company restructuring by helping spread the risk of necessary investments; to assist in the effort to make Israel's firms better marketers; and to modernize the government/business relationship in Israel.

Creating an Export Imperative

Israel's economic prosperity depends upon dramatic growth in its exports. The government must take a leadership role in creating an export culture in Israel. Concretely, this means motivating companies to export and enhancing their capabilities to do so.

The motivation must come in order to stimulate companies with comfortable positions in the home market or in defense or raw materials businesses to turn to the difficult task of developing exports in products where there is no obvious or special home advantage. The motivation will also come from creating a national acceptance of the special importance of exports to the country. Nations with high living standards based on exports recognize exports as a national mission and subordinate other priorities to export success. This must happen in Israel.

Enhancing capabilities means assisting Israeli firms to overcome impediments to success which are rooted mainly in the small size of their home market, their relative infancy as international businesses, and the particular economic problems faced by Israel because of its geopolitical position.

Neither Adam Smith nor Karl Marx have much to say about this effort. Even in a purely free market world or a purely socialist world, Israeli firms would trade and would be at a competitive disadvantage because of the small home market. In the real world, not only is this true, but all nations try to assist their companies to enhance their capabilities to compete successfully. Israel must do this also.

To carry out these goals, we recommend that:

1. The government should ensure that adequate funds are available for export industry. Sufficient access to capital markets must be allowed to finance the needed growth. Export companies should not be penalized by having to pay higher rates for financing export activities than their international competitors.

2. The government and the Histadrut should promote a program to tie wage increases across the economy to productivity improvements in the export sector.

3. In keeping with the higher risks and cost of exporting, investments to create sustained competitive advantages in export markets should be assured a higher rate of profitability, if successful, than activities serving the local market. As a possible example, export firms could receive preferential depreciation schedules for capital investments for export and a sliding scale of tax credits for R&D and market related investments based on the proportion of sales they have in exports and their overseas export growth. This would penalize non-exporters and reward exporters, helping to motivate a sustained building of export positions. Any such set of incentives can be designed to be neutral in its revenue implications for the government.

The Restructuring of Industry - Spreading the Risk

We have said that a major restructuring must take place in Israel's industry. We have indicated that one of the biggest impediments to this process is the high risk for Israeli firms, which are small in international terms, to develop new products and markets. To encourage these investments by spreading the risks associated with them we recommend the following:

4. The government should establish a conditionally reimbursable loan fund which provides matching loans to companies for investment (capital, engineering, and marketing) in projects which involve entry into risky new products or markets for export. The loans the project -- no payback if the project fails and an above market payback if it succeeds. The fund should be administered by an independent agency (like the BIRD Foundation) outside of the government. Based on the experience of other countries, such a fund could be self-sustaining after its initial capitalization.

5. The government should continue the Chief Scientist and BIRD programs, increasing funding in relation to the expansion of the export economy. These programs have played a positive role in Israel's export development to date.

6. The government should license venture capital funds whose investors can receive tax incentives against personal income tax. Each fund would be required to invest at least 20% of its total capital as seed capital and would have to provide management assistance to companies it funds.

7. Many of Israel's larger companies are government owned. They should be free to and even encouraged to seek export opportunities outside of their base businesses. While diversification has sometimes not been a successful path for companies abroad, in Israel's case it is a necessity. Some large companies in military and chemical industries have limited growth prospects and yet have the managerial capability and business base to enter new businesses and increase exports.

8. The mergers law should be loosened to remove the tax penalty for mergers of companies in unrelated fields which are primarily exporters. Such combinations can often offer a stronger diversified base from which to develop new export businesses.

Breaking the Marketing Roadblock

We have indicated that Israeli companies have had particular problems with overseas marketing. Small funds exist today to assist companies to explore new markets but these are insufficient and focus mainly on trade shows and initial introductions rather than on building successful marketing organizations. We recommend that:

9. The government should redirect industry supports now given for capital investment in regions B and C to encourage marketing investments abroad. On a matching basis this might include assistance with investments in sales offices, advertising, promotion, market research, standards compliance, and product tailoring for a particular market. Regional development policies work best when they are narrowly focussed. Israel's regional incentives cover too much of the country and put too much focus on capital investment. A single development region should be targeted -- made up of region A and perhaps parts of region B. The funds currently allocated to this new region will then be more successful in encouraging development.

10. The government should establish the Prime Minister's marketing fellowships to be awarded to a significant number of young Israeli managers each year to spend a few years working for companies in foreign countries. These companies can be related industries or preferrably in customer or distribution organizations. The Operation Independence Task Force should assist with placements and also with sponsoring activities for the "fellows" to increase their familiarity with the marketplace.

11. The Operation Independence Task Force should help establish marketing companies in focussed areas like food, clothing, agricultural technology, or personal care products to assist groups of Israeli companies to build distribution and/or brand image in selected markets. The companies should receive initial encouragement from the Israeli government and Manufacturers' Association, though the goal should be a purely commercial relationship. These marketing companies should help Israeli manufacturers choose products for export and develop the quality and logistics structures necessary to serve the markets.

12. The Israeli government should assist in the formation of two types of customer financing mechanisms for capital goods exports: the provision of an "Israel risk" insurance scheme including credit guarantees, and the provision of attractive financing for prototype buyers to purchase and participate in the final development stages of prototype Israeli products.

Modernizing the Business Government Relationship

The uneasy relationship which exists between the Israeli government and Israeli businesses must change. The businesses must be allowed to function more independently.

The government had to be a very powerful guide for the nation in its infancy. The creation of national projects to build the Israeli agriculture and chemical industries had to be led by government. Imposing import barriers and fostering the development of import substituting companies to make Israel self sufficient had to be led by government. Building a strong defense industry had to be led by government. Developing the country's educational and research resources had to be led by government.

Now, however, the country is maturing. The government business relationship must mature as well. The government must continue to oversee Israel's economic development but the development will be led by hundreds of companies in thousands of businesses. The government role will be one of setting the national goals and then motivating, supporting, and creating incentives for the companies to succeed.

The new relationship must be one of partnership rather than one of control combined with largesse. In this regard, we recommend that:

13. The government should undertake a review of its industry regulations and taxing procedures with an eye toward making necessary approvals processes more efficient. In principle, prior advisory rulings on tax questions and time limits on approvals processes should be instituted and an attempt should be made to simplify forms and reduce paperwork.

14. The government should loosen exchange controls for Israeli managers traveling on business abroad and grant export companies automatic approvals on applications for marketing and other strategic investments if no action is taken within two weeks to stop the transactions. This would make it easier to conduct export business and will foster the needed development of Israeli multinationals.

15. The government should attempt to ensure greater predictability and continuity in industrial policies. Businesses will postpone long-range and risky investments in an atmosphere where major policy changes occur frequently.

In designing these recommendations we have been mindful of the government's current imperative to control its budget. Thus, we have proposed no major new expenditures. In some cases the proposals are revenue neutral and in others they can be financed by reducing funds spent on business activity elsewhere. The guiding principle of Israel's industrial policy expenditures should be to assist long-term export development. The overall pattern of business incentives needs to be adjusted accordingly.

The Israeli government has always been successful in the past in assuming the necessary role to address the needs of the country. We are confident it can adjust again.

FULFILLMENT OF THE GOAL

Resuming growth in Israel's living standards will not be easy. Major changes in the bahavior of Israel's companies and its government will be required.

We believe that the export led growth goals set in this report can be achieved. To do so, however, will require a strong national will, a commitment to focus on the problem, and a willingness to direct significant efforts towards its solution.

If Israel's government and companies dedicate themselves to the goal and work together toward its achievement, they can be successful.

EXHIBIT 1: GDP PER CAPITA, 1986

	1986 U.S.$	% OF U.S.
U.S.	$17,302	100
JAPAN	16,218	94
DENMARK	15,885	92
SWEDEN	15,665	91
GERMANY	14,774	85
FRANCE	12,841	74
BELGIUM	11,464	66
SINGAPORE	7,205	42
IRELAND	6,351	37
ISRAEL	6,245	36
KOREA	3,116	18

SOURCE: IMF (1986 Yearbook, February 1987)

EXHIBIT 2: GDP PER CAPITA RELATIVE TO UNITED STATES, 1960-1980

	1960	1970	1986
U.S.	100	100	100
JAPAN	16	40	94
DENMARK	46	65	92
SWEDEN	66	84	91
GERMANY	46	62	85
FRANCE	47	56	74
BELGIUM	43	54	66
SINGAPORE	15	18	42
IRELAND	22	27	37
ISRAEL	33	39	36
KOREA	6	6	18

SOURCE: IMF, OECD, World Bank, and U. S. Dept. of Commerce.

EXHIBIT 3: PROPORTION OF GOODS AND SERVICES EXPORTS REQUIRED TO PAY THE INTEREST ON ISRAEL'S FOREIGN DEBT

	%
1979	20
1980	21
1981	23
1982	26
1983	26
1984	30
1985	32

SOURCE: Bank of Israel Annual Reports, 1982 and 1985

EXHIBIT 4: THE SLOWDOWN IN ISRAEL'S PRODUCTIVITY GROWTH (% PER YEAR)

	1961-72	1975-81	1982-85
LABOR PRODUCTIVITY GROWTH	5.4	1.6	0.9
TOTAL FACTOR PRODUCTIVITY GROWTH	3.7	0.4	0.2

SOURCE: Bank of Israel Annual Reports, Various Editions

EXHIBIT 5: EXPORTS PER PERSON

	MERCHANDISE EXPORTS (MILLION 1985 $)	POPULATION (MILLION)	EXPORTS/PERSON ($)
SINGAPORE	$21,500	2.56	$8,398
SWITZERLAND	37,057	6.44	5,754
BELGIUM	47,150	9.85	4,787
HOLLAND	62,402	14.48	4,310
SWEDEN	30,174	8.35	3,614
DENMARK	17,116	5.11	3,350
IRELAND	10,305	3.55	2,903
AUSTRIA	16,955	7.56	2,243
ISRAEL	6,601[1]	4.24	1,557

[1] Includes exports to Judea, Samaria and Gaza.

SOURCE: IMF (1986 Yearbook, February 1987)

EXHIBIT 6: PROSPECTS FOR EXPORT SECTORS AT HISTORICAL AND EXPECTED GROWTH RATES

	1985 EXPORT 1985 $MM	REAL GROWTH RATE 1980-1985 ($)	1995 EXPORTS IF GROWTH CONTINUES AT HISTORICAL RATES 1985 $MM	EXPECTED GROWTH RATES	1995 EXPORTS AT EXPECTED GROWTH RATES 1985 $MM
AGRICULTURE & RAW MATERIALS BASED FUND	771	-5.7%	429	1%	852
RAW MATERIALS BASED CHEMICALS	487	+4.4%	749	+4.0%	721
DIAMONDS	1,263	-7.2%	598	+7.0%	2,485
MARKS & SPENSER	102	+6.6%	194	+6.6%	194
DEFENSE	1,160	N.A.	N.A.	+3.7%-8.9%	1,668-2,721
TOTAL OF THESE GROUPS	3,783	N.A.	N.A.	+4.8%-6.5%	5,920-6,971

SOURCE: Telesis

EXHIBIT 7: REQUIRED ANNUAL GROWTH RATE OF AGRICULTURAL TECHNOLOGY, IMPORT SUBSTITUTER, AND EXPORT COMPANIES TO ACHIEVE ASSUMED GROWTH-ORIENTED TARGETS

	1985 EXPORT 1985 $MM	REAL GROWTH RATE 1980-1985 (%)	1995 EXPORTS IF GROWTH CONTINUES AT HISTORICAL RATES 1985 $MM	REQUIRED GROWTH IF OTHER SECTORS BEHAVE AS EXPECTED: GROWTH	REQUIRED GROWTH IF OTHER SECTORS BEHAVE AS EXPECTED: EXPORTS $MM
AGRICULTURAL-BASED TECHNOLOGY	376	12.4%	1,205		
IMPORT SUBSTITUTERS	1,051	-11.6%	307	12.2% - 13.8%	7,291 - 8,344
EXPORT-ORIENTED	870	20.5%	5,630		
TOTAL OF THESE GROUPS	2,297	-1.6%	7,143		

SOURCE: Telesis

EXHIBIT 8: EXPORT-ORIENTED COMPANIES

	MM$ EXPORTS (1985 $)
SCITEX	109
ELSCINT	93
LUZ	38
NILIT	34
DELTA	31
ADIPAZ	27
ORMAT	25
LASER IND.	24
OPTROTECH	20
OTHERS	469
TOTAL:	870

SOURCE: Dun's Guide and company interviews

EXHIBIT 9: COMMENTS FROM EUROPEAN AND NORTH AMERICAN CUSTOMERS OF ISRAELI COMPANIES

"I'VE HAD TWO PROBLEMS WITH (NAME WITHHELD) THE ISRAELI COMPANY I WORK WITH: THEY DON'T UNDERSTAND HOW TO SERVICE A PRODUCT ONCE THEY SELL IT AND YOU NEVER CAN TRUST A DEAL WITH THEM. THEY ALWAYS WANT TO COME BACK AND REOPEN POINTS FOR NEGOTIATION."

MEDICAL ELECTRONICS CUSTOMER

"ISRAELI COMPANIES ALWAYS COMPLAIN ABOUT THEIR PROBLEMS AND EXPECT YOU TO BEAR THE EFFECTS. THEY ARE NEVER AT FAULT AND THEY NEVER ADMIT THAT THINGS CAN BE DONE BETTER THAN THEY DO THEM."

CLOTHING DISTRIBUTOR

"ISRAELIS ARE VERY NICE BUT IT IS DIFFICULT TO DO BUSINESS WITH THEM. THEY ARE VERY STUBBORN AND HAVE TO DO THINGS THEIR OWN WAY, DESPITE WHAT THE MARKET MAY WANT."

V.P. MARKETING, LARGE CONSUMER ELECTRONICS CHAIN

"ISRAELIS DO NOT KNOW HOW TO ADVERTISE THEMSELVES WELL. THEY KNOW HOW TO MAKE WAR BUT NOT HOW TO TELL PEOPLE WHAT ELSE THEY DO."

FOOD BROKER

"ONE OF ISRAELS' PROBLEMS IN MARKETING IS THAT THEY CAN'T LET GO. AND THEY CAN'T KNOW THE LOCAL MARKET BECAUSE THEY'RE NOT THERE.

FOOD COMPANY MARKETING MANAGER

"ISRAELIS CAN'T UNDERSTAND CREATIVITY IN ADVERTISING. THEY CAN'T DEAL WITH ANYTHING INTANGIBLE AND IT'S IN THEIR CULTURE NOT TO ADVERTISE.

V.P. SALES, ELECTRONICS FIRM

"IF YOU'VE DEALT WITH ISRAELIS YOU KNOW THERE'S AN ARROGANCE OF VIEW - THEY NEVER GIVE AN INCH TO THEIR PARTNERS OR THEIR CUSTOMERS."

V.P. MANUFACTURING COMPANY

"IT IS HARD FOR AN ISRAELI MANAGER TO BE PLUGGED INTO THE (CLOTHING) MARKET. BY THE TIME HE IS PRODUCING THE MARKET IS DIFFERENT."

PRESIDENT, CLOTHING MFG. CO.

"I HAVE TRIED TO HELP ISRAEL BY DOING BUSINESS THERE. BUT THE QUALITY WAS POOR AND SHIPMENTS WERE NOT UP TO PAR. I'LL SEND MONEY INSTEAD."

PRESIDENT, CLOTHING MFG. CO.

EXHIBIT 9 (CONTINUED):

"WHAT ISRAEL HAS THE CAPACITY TO DO IS BASIC RESEARCH, INEXPENSIVELY. THEY ARE LESS SUCCESSFUL IN PRODUCING A FINAL PRODUCT IN A PROFESSIONAL WAY WITH QUALITY CONTROL AND ALL THE TRIMMINGS. FRANKLY, OUR PROJECTS WITH THEM HAVE FLOUNDERED. WE SHOULD HAVE PURCHASED THEIR TECHNOLOGY AND DONE THE PRODUCTION HERE... THEIR TECHNOLOGY WAS EXCELLENT. THE QUALITY CONTROL WAS TERRIBLE. SO BAD IT LED TO THE ABANDONMENT OF THE PROJECT... AT THIS POINT ISRAEL HAS TWO PROBLEMS: ONE - THEY HAVE A BAD IMAGE, TWO - THE IMAGE IS JUSTIFIED. MANAGEMENT DOESN'T HAVE THE TYPE OF DISPOSITION THAT CAN INTERACT WITH CUSTOMERS SUCCESSFULLY. THEY ARE NOT PROMPT AND NOT CONCERNED."

R&D MANAGER OF A CANADIAN COMPANY
WHICH HAD A MARKETING AGREEMENT
WITH AN ISRAELI FIRM

"I AM EXTREMELY DISAPPOINTED AT HOW (THE KNOW-HOW/MARKETING) AGREEMENT, TURNED OUT. IT HAS NOT HAD ANY REAL SUCCESS. THEIR (THE ISRAELI FIRMS) PROCRASTINATION HAS BEEN VERY COSTLY TO THEM AND TO US. THEY ALWAYS HAD EXCUSES BUT IT TOOK THEM TWO YEARS LONGER THAN IT SHOULD HAVE JUST TO GET THE EQUIPMENT INSTALLED. SINCE THEN, THEIR PRODUCTION HAS NEVER SHOWN ME ANYTHING GOOD ENOUGH TO SELL IN THIS MARKET. POOR QUALITY. THEY DO NOT HAVE ENOUGH EXPERIENCE WITH MEETING CUSTOMERS' DEMANDS. WE SOLD THEM A PATENT FOR (A CERTAIN PRODUCT) IN 1982. NOT ONE INCH HAS BEEN PRODUCED YET. AND WE COULD SELL ALL THEY COULD MAKE. AND NOW THE OPPORTUNITY IS SLIPPING AWAY. WHILE THEY'VE BEEN PUTZING, THE REST OF THE WORLD HAS BEEN ADVANCING... THEY WOULD HAVE BEEN OUT OF BUSINESS BY NOW IF THE (ISRAELI) GOVERNMENT HADN'T BEEN SUPPORTING THEM VIGOROUSLY.

TOP MANAGER OF AN AMERICAN COMPANY
WHICH HAD A KNOW-HOW/MARKETING
AGREEMENT WITH AN ISRAELI FIRM

"NO FOREIGN COMPANY HAS EVER SUCCEEDED IN A BUSINESS VENTURE OF THIS SORT (BIOTECHNOLOGY/PHARMACEUTICALS) WITH AN ISRAELI COMPANY. ISREALIS ARE STUBBORN, NARROW-MINDED AND LESS SOPHISTICATED THAN THEY THINK THEY ARE. IT JUST PLAIN TAKES TOO MUCH EFFORT TO DO BUSINESS WITH THEM. THE REWARD IS NOT COMMENSURATE WITH THE DIFFICULTIES INVOLVED. BROAD-BASED BUSINESS VENTURES WITH ISRAELIS ARE NOT LIKELY TO SUCCEED."

TOP MANAGER OF A EUROPEAN
CORPORATION WHICH HAS A JOINT
VENTURE WITH AN ISRAELI COMPANY

EXHIBIT 10: SUBSIDIES TO BUSINESS SECTOR UNDER LAW FOR ENCOURAGEMENT OF INVESTMENT, 1984-1986 (MILLIONS $)

	1984	1985	1986 REVISED
INVESTMENT GRANTS	112[1]	149[2]	133[1]
SUBSIDIES ON DEVELOPMENT LOANS (BEING PHASED OUT)	55	11	3 (ESTIMATE
TAX CONCESSIONS	73	83	73 (ESTIMATE
TOTAL SUBSIDIES TO CAPITAL INVESTMENT	$240	$243	$209

SOURCE: Budget Documents and Interviews with Ministry of Finance and Ministry of Industry
1986 Exchange Rate 1.58 NIS = $1 U.S.

[1] Applies only to manufacturing

[2] Revised downward from original budget estimate of $152 Million

EXHIBIT 11: DIRECT ASSISTANCE TO EXPORTERS

	TOTAL VALUE OF INCENTIVE ($)	ESTIMATED % OF INCENTIVE TO MANUFACTURING
MEASURES TO COMPENSATE FOR SELF-IMPOSED DISINCENTIVES TO EXPORT		
EXCHANGE RATE INSURANCE	359	80%
PEACE IN GALILEE IMPORT TAX REBATE	N/A	N/A
REBATE OF IMPORTED SERVICE LEVY	40	80%
REBATE OF CUSTOMS AND PURCHASE TAX	N/A	N/A
TOTAL:	$399+	
EXPORT INCENTIVES		
FOREIGN TRADE RISK INSURANCE	39	80%
MARKETING ASSISTANCE GRANTS	5	80%
TOTAL:	$44	80%

NOTES: All numbers are from 1986 Budget and apply only to exporters in manufacturing, agriculture, and tourism.
Exchange Rate Used: 1.58 NIS = $1 U.S.

SOURCE: 1986 Budget, State Revenue Administration Report, Fogel Commission Report, and interviews at Ministry of Finance.

EXHIBIT 12: GENERAL TAX BENEFITS GIVEN TO MANUFACTURING, AGRICULTURE AND TOURISM, - 1986 (MILLION $)

TAX ADVANTAGE	VALUE
EMPLOYER'S TAX EXEMPTION[1] (COMPLETE EXEMPTION)	285
LOWER CORPORATE AND INCOME TAX RATE[2] (45% AS OF JULY, 1986)	37
IMPORTED SERVICES LEVY EXEMPTION[3]	25
PEACE IN GALILEE IMPORT TAX EXEMPTION	23
REDUCED EMPLOYEE TAXES ON 2ND AND[4] 3RD SHIFTS	17
SALES TAX EXEMPTION ON FACTORY SALES[2] TO EMPLOYEES	11
WAGE SUBSIDIES FOR EX-SOLDIERS IN FIRST JOBS	8
CUSTOMS AND PURCHASE TAX EXEMPTIONS[5]	7
TOTAL TAX BENEFITS	$413

NOTE: EXCHANGE RATE: 1.58 NIS = $1 U.S.

[1] Higher than original estimate.
[2] Applies to manufacturing and tourism.
[3] Figure includes only manufacturing. Exemption also applies to shipping, airlines, etc.
[4] Applies only to manufacturing and electricity branch.
[5] Full exemption is $66 Million but goes mainly to government agencies. Manufacturing received only $7 Million.

SOURCE: 1986 Budget, State Revenue Administration Report, and Interviews at Ministry of Finance, Taxation Division

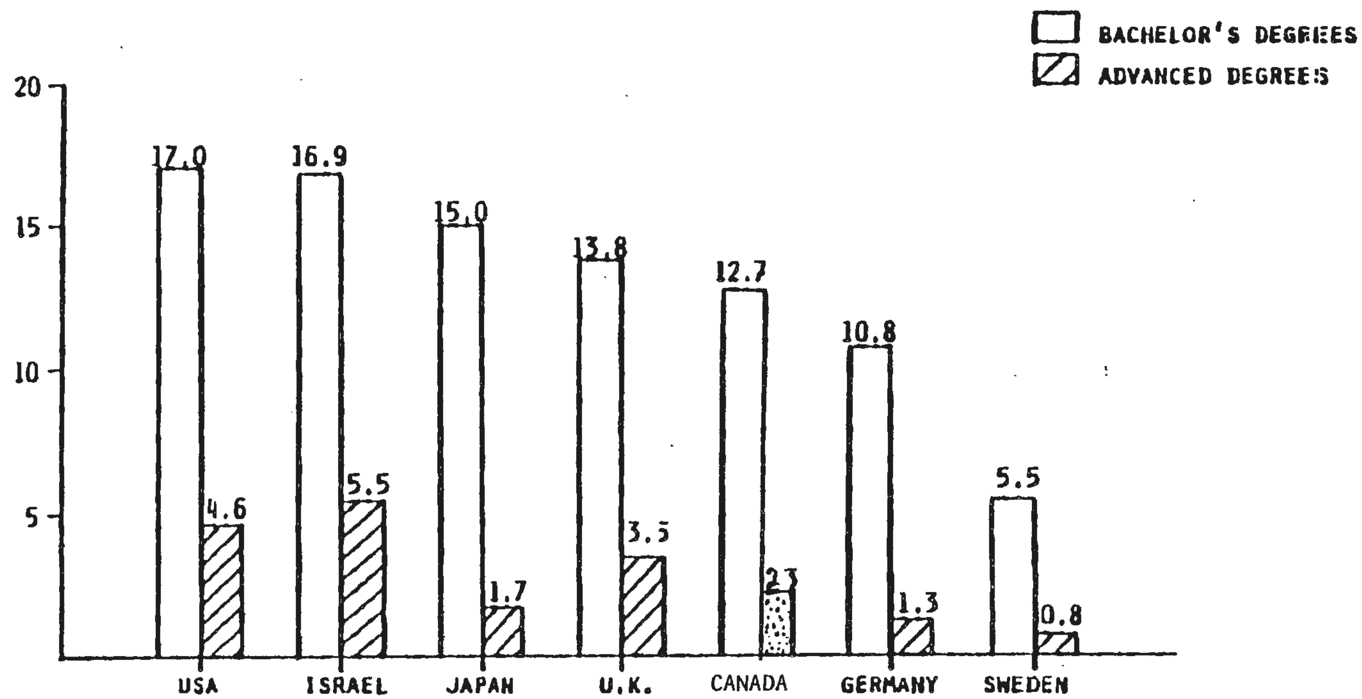
EXHIBIT 13: ROLE OF FOREIGN-OWNED COMPANIES IN SELECTED COUNTRIES

	EMPLOYMENT IN FOREIGN-OWNED COMPANIES AS A % OF TOTAL EMPLOYMENT		FOREIGN-OWNED COMPANIES' EXPORTS AS A % OF THEIR PRODUCTION
SMALL COUNTRIES			
SINGAPORE	51	(1980)	90-95
PUERTO RICO	73	(1980)	90-95
IRELAND	34	(1980)	90-95
BELGIUM	33	(1978)	68
SCOTLAND	19	(1975)	80-85[1]
ISRAEL	1	(1985)	50-60
LARGE COUNTRIES			
GERMANY	15	(1974)	17
UNITED STATES	3	(1977)	7

[1]Exports include shipments to England.

SOURCE: Singapore Economic Development Board; Scottish Development Agency; Fomento; ILO Reports on effects of multi-national enterprises in U.K., Germany, Belgium; and Telesis Analysis.

EXHIBIT 14: ADVANCED DEGREES AWARDED, NATURAL SCIENCE AND ENGINEERING BACHELOR'S IN ISRAEL VS. OTHER COUNTRIES
(DEGREES PER 10,000 PARTICIPANTS IN LABOR FORCE - 1982)



SOURCE: UNESCO and Israel National Council for Research and Development.

EXHIBIT 15: COMPARATIVE RANK OF ISRAELI SCIENTISTS IN TERMS OF SCIENTIFIC PUBLICATIONS AND CITATIONS

	RATIO OF[1] ISRAEL'S SHARE OF WORLD PUBLICATIONS RELATIVE TO ISRAEL'S SHARE OF DEVELOPED COUNTRY POPULATION	ISRAEL'S RANK[2] AMONG 15 COUNTRIES IN CITATIONS PER ARTICLE
BIOMEDICAL RESEARCH	3.1	3
PHYSICS	3.2	3
ENGINEERING & TECHNOLOGY	2.5	3
CHEMISTRY	1.7	4
MATHEMATICS	4.4	4
BIOLOGY	3.2	5
CLINICAL MEDICINE	3.2	6
EARTH & SPACE SCIENCES	2.3	9
TOTAL	2.8	N/A

[1] Includes Israel, U.S., Canada, Western Europe, East Germany, U.S.S.R., Japan, Australia, and New Zealand.

[2] Citations in the years 1973-1980 to papers published in the years 1973-1975. The fifteen countries in comparison were Israel, United States, United Kingdom, Federal Republic of Germany, France, U.S.S.R., Japan, German Democratic Republic, Canada, India, New Zeland, Italy, Australia, Sweden, and South Africa.

SOURCE: U.S. National Science Foundation, Computer Horizons Inc. and Telesis Analysis.

A NOTE ABOUT HOW WE DID THE STUDY

This project was commissioned and funded by the Manufacturers' Association of Israel, Hevrat Ovdim, the Operation Independence Task Force, and the Jerusalem Institute of Management Board of Directors. It was also encouraged and supported by the Government of Israel.

We interviewed over 150 managers, mainly in the manufacturing sector, including most of the country's major exporters. The interviews focused on gaining knowledge about such issues as: their main sources of competitive advantage, current and potential competitive positions, value added per employee, and employment and output growth potential. To understand the place of these firms in international markets, we also interviewed over 125 customers, competitors or partners of Israeli companies in North America and Europe.

Because we believe Israel must increase the number of its exporters, we devoted special attention to the study of a large number of start-up firms, both through interviews and in a statistical analysis of 900 firms that applied for grants from the Chief Scientist of the Ministry of Industry and Trade in the period from 1968 to 1985.

To achieve higher exports, Israeli firms must collaborate with universities and research institutions as well as with governments. To understand this perspective on exports, we spoke with the university professors and officials responsible for R&D, with heads of applied R&D institutions and with top civil servants (about 80 individuals). We also analyzed macro-economic data and rules and regulations pertaining to the business climate in Israel.

We wanted to place our analysis of Israel in an international context. We therefore analyzed relevant industrial policies abroad -- especially in Sweden, France, Germany, U.K., EEC, Canada, U.S., Japan, Singapore and elsewhere. Although no experience is directly transferrable from one country to another, other countries have faced problems similar to Israel's, and lessons can be learned from them. In this spirit, we reviewed government policies in Israel including various types of assistance and compared them to those of other countries.

In analyzing these issues it has not been the intention to suggest normative conclusions on relative expenditure devoted to exports versus other government purposes, or on methods of reducing all the constraints identified. We also do not wish to suggest that the government can (or should) choose winners. Exports are made by business firms, and they hold the major responsibility for the design and implementation of a strategy to achieve sustainable competitive advantages. The role of the government is to create a supportive climate for the right strategic investments that will give companies better chances of success.

It is our conclusion that export growth should be recognized as a major national priority in Israel, and an effort should be made to move more rapidly in the direction of national economic independence.

Israel as Public-Works Project

Can It Afford an Economy That Pays Its Own Way?

By Lawrence Meyer 174

JERUSALEM — With its military enemies and the plague of quadruple-digit inflation at least temporarily at bay, the Israeli government is approaching a decision of watershed dimensions that it has avoided for all the country's 37 years:

• Will it continue to build the Jewish State by using the nation's economy as a kind of massive public-works project — with all the featherbedding that the term implies?

• Or will it risk driving Jews from Israel by tolerating unemployment in order to steer Israel toward economic efficiency, encouraging enterprises that are productive and allowing those that are not to die? The goal would be building an economy that can support the Western lifestyle that Israel's citizens so clearly want.

The simple fact is that Israel's economy suffers from serious structural problems. It has a low-wage, labor-intensive Third World economy. However, it has managed — by massive borrowing — to satisfy First World tastes for such commodities as video cassette recorders, luxury automobiles and vacations abroad.

Stopping inflation — the problem that has pre-occupied both Israeli economists and the Reagan administration's policy-makers — will not change this fact. Even leaving out military expenditures, Israel will remain in serious economic trouble until it figures out how to climb out of its current stagnation, create productive jobs, export more than it imports, and pay its bills without massive handouts from abroad.

What life-support systems are to medicine, American foreign aid has become to Israeli life. Without the continuing flow of that aid — roughly 19 percent of the government's budget in 1985 — Israel would not be able to defend itself and to maintain a society that boasts five universities, sees one-seventh of its citizens travel abroad annually, has 50 percent of its work force employed in government, finance and service jobs (ranking behind only the United States and Canada — countries far more developed than Israel) and has 29 percent of its civilian workforce on the government — which is to say the public — payroll.

Compared with seven leading industrial countries (the United States, Germany, Japan, Canada, the United Kingdom, Italy and Sweden) Israel has the lowest percentage of workers employed in industrial jobs except Canada.

In its 1978 report, the Bank of Israel analyzed structural problems in the country's economy.

It found that in "recent years there has been a marked structural change in employment, with the public-services sector absorbing most of the additional manpower. Since the government's ability to siphon off more money through taxes is limited . . . and since a diminished dependence on external sources of finance [foreign aid] has become a prime national target, there is no escaping the need to reduce the share of public services in total resource use.

"In other words, the freezing, and perhaps even absolute decrease, of public sector employment is necessary for relieving pressure in the labor market and making more resources available to the business sector."

This warning was not heeded by the government of Menachem Begin. If anything, rather than reducing Israel's dependence on American foreign aid, the Likud government increased that dependence. Civilian consumption was not brought under control, even when the Israeli invasion of Lebanon in 1982 resulted in an absolute decline in productivity. Consumption in that year increased. An analysis of the distribution of employment in the Israeli economy among the various sectors finds no significant difference today from what the Bank of Israel described in 1978.

Of course there are reasons for the fix that Israel is in, reasons that make it all the more difficult to solve the problem.

One of the unique features of Israel as the Jewish State has been the role of the economy — even before the state was created — as an instrument of nation-building. In political Zionism — the ideology that saw the creation of a Jewish State as the only realistic solution to the "problem" of European Jewry — the state was the end-point. A corollary of Zionist ideology in the pre-state days held that Jews should do the work, among other reasons in order to provide jobs for the Jews who were coming to Palestine in answer to Zionism's call. In the history of the United States, immigrants came here to fill jobs. In Israel's history, jobs were created to hold immigrants.

After the state was founded, full employment became a governmental goal — not simply because it was better to have able-bodied persons working, and not simply because the country was desperately in need of development, but because Jews who did not have jobs would leave Israel. In the last 10 years in Israel, unemployment has run from a low of 2.9 percent in 1979 to the current rate which is somewhere between 7 and 8 percent, although the possibility of a rate as high as 11 percent has been mentioned.

Americans have grown accustomed to unemployment rates that Israelis find high precisely because the United States government has backed away from massive spending programs to stimulate employment. To a large extent, then, Israel's economy from its early days can be viewed as a kind of ongoing public-works project.

This strategy *has* had its benefits. In its first 30 years, Israel increased its exports by 3,600 percent, to use only one index of success. An infrastructure, including roads, bridges and a complex water-supply system, was built. But there is no way to measure how much more successful the Israeli economy would have been if higher unemployment rates — in the short term at least — had been tolerable.

They were not. Where other nations might use standards of efficiency to measure the benefit of investments, Israel was willing for years to subsidize businesses that otherwise could not survive because they provided jobs. By the same token, government payrolls were padded with unnecessary workers doing non-essential jobs because economic efficiency was not a primary consideration.

Not all the jobs in Israel were make-work to be sure. Thousands of jobs were created by privately-owned (and some government-owned) companies where economic efficiency was extremely important. Israel's sophisticated high-tech industries have to compete in world markets against other companies that receive no government subsidies or help. Some of these workers, better educated and often of European descent, prospered in their private-enterprise jobs. A wealthy class developed alongside the middle class and the poor.

This situation made it especially difficult for a popularly-elected government to change policies and to begin using economic efficiency as a standard for measuring policy. As consumption among wealthier Israelis increased, the poorer class of Israelis — often "Oriental" or Sephardic Jews — began to demand their own share of the pie. A succession of Israeli governments responded by continuing the official make-work policy, supplemented by a combination of subsidies and welfare programs.

This policy would have been expensive enough without the enormous defense costs that Israel has had to bear, especially in the last 18 years.

But whatever the reasons for Israel's economic predicament, the question now is what happens next? If — and despite the optimism of many Israelis on the subject, it's still a big if — if inflation is really under control now, where does the Israeli economy go from here? The central fact of the Israeli economy is that it is not growing. Indeed, after years of growing, the Israeli economy has been contracting.

According to figures released by the government's finance ministry, Israel's national income for 1985 will be about $400 million less than it was in 1981. Israel has three clear economic choices: continued contraction, stagnation or growth. The first two are obviously undesirable, but how can growth be resumed? Since the founding of the Jewish State, a substantial amount of economic growth has been achieved by borrowing — from other countries, especially the United States, from world Jewry and from banks. In the current Israeli government budget, debt service accounts for slightly more than half of the total. As a result, in the near term at least, Israel will probably have to forego large-scale borrowing as a way to resume growth.'

The other classic way of achieving economic growth is by increasing productivity, and this gets to the core of the problem: Increasing productivity in Israel would require substantial structural changes, changes that run against the Israeli ideological and political grain.

Israel has never had a year in which its exports exceeded its imports. The reason for achieving higher productivity would be to reverse this situation, turning a deficit into a surplus. If we think of productive labor as being that which brings capital into Israel — whether the job is in the industrial or service sector — then part of what Israel needs to become self-sufficient is clear. Thousands of workers now on government payrolls, or working in factories producing items under Israeli government contract, or working as social workers, are not doing productive labor under this definition. They are not helping Israel to pay its bills abroad, a vital necessity for a country that must import virtually all of its raw materials.

If it were within a government's power to wave a wand and move workers from one sector of the economy to another painlessly — that is, without unemployment — the problem still would not be solved. Israel is one of the most heavily unionized countries in the world. More than 75 percent of the Israeli workforce belongs to a union. Even white-collar workers and professionals have their union.

Virtually all the unions in Israel are components of the Histadrut, the unique labor union that is also a worker-owned industrial conglomerate and the largest non-governmental employer in Israel. Because of its size and power, and because the Histadrut pre-dated the state, it has been characterized as a state within a state.

As a labor union, the Histadrut watches out for the interest of its members, who vote for the leadership in periodic, partisan elections. And, as a labor union, the Histadrut enforces the work rules and principles it has negotiated with management to safeguard the union's idea of what is best for the workers. It will come as no surprise to anyone familiar with labor unions to say that the idea of a worker producing more without necessarily being paid more, or producing more without fully sharing in the benefit of his or her increased production does not sit well with unions.

Nor does the idea of laying people off on the basis of merit rather than seniority sit well with labor unions. Keeping a junior worker, who happens to be more capable, on the job while laying off a more senior worker is anathema to the labor-union ethic.

But that, in stark terms, is what increasing productivity is all about. What is needed now in Israel is a sea change in public policy. If the Israeli economy is ever to be self-sustaining, the Israeli government may have to tolerate a period of relatively high unemployment — perhaps 10 percent or more — and resist the temptation to create jobs to put people back to work. The whole idea of this exercise would be to let ingenuity — which Israelis have in abundance — guided by market demand, determine where Israeli workers earned their pay.

The joker in the deck is that no Israeli government — for practical as well as ideological reasons — can tolerate substantial emigration of Jews. Israel's most capable technicians, scientists and engineers are on a par with quality professionals anywhere in the Western world. If they cannot find work in Israel, they can find it abroad. It is no different for less highly-trained workers who also take the responsibility of providing for their families no less seriously.

The other major restraint against a basic restructuring of Israel's economy is political. Israel is a democracy, albeit one at present with a government of national unity. Under the best of circumstances, it is hard for democracies to undertake programs that require long-term sacrifice by the population. Even if the government's policy is well-conceived, the temptation by the opposition party to engage in demagoguery may prove irresistible.

Given the pre-existing splits in Israeli society — between the religious and non-religious, between European and Oriental Jews, between those who would give up the West Bank for peace and those who would not — it is hard to imagine — not inconceivable, but hard to imagine — that a government could sustain a long-term policy of austerity in order to restructure the economy without unrest creating pressure to change the government.

These are the Hobson's choices facing the Israeli government. It is understandable that Israelis, and those who wish them well in the United States, may fasten on the apparent success that Israel has enjoyed in curbing inflation. But that apparent success ought not to obscure the deeper, more complex and potentially far more momentous economic problem that Israel has yet to confront.

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IS ISRAEL GOOD FOR AMERICA?

SOME WEEKS AGO in these pages Joseph Sobran threw down the gauntlet: "I would like to hear arguments for the strategic advantages to the U.S. of close alliance with Israel from someone other than the partisans of Israel itself." I am, I confess, a partisan. But anyone convinced of the strategic benefits of closeness to Israel is bound to become a partisan of Israel's. Logically, however, the strength of the case is not dependent on the identity or predisposition of the advocate.

Israel traditionally has been a liberal cause. American Jews, always the core though never the entirety of pro-Israel sentiment in this country, have long been aligned in their majority on the liberal side of the spectrum. Gentile enthusiasts for Israel have often been those attracted to its powerful labor movement and socialistic experiments.

Yet President Reagan, the first President to bear the clear imprimatur of the modern conservative movement, has proved, no doubt in part influenced by NATIONAL REVIEW's own position on Israel over the years, to be the best friend Israel has ever had in the White House and has brought the United States and Israel closer than ever before. This closeness, ironically, is the fruit of an affinity between the world view of this conservative President and the perspective of the Jewish state founded by socialist visionaries.

That affinity is rooted in the nature of the global conflict. It is a conflict not only between the world's two preeminent military powers—the United States and the Soviet Union—but also between two contradictory visions of man's future—the democratic and the Communist—of which they are the models. The geostrategic and the ideological aspects of the conflict cannot be disentangled. Wherever Communism has triumphed it has done so by force of arms, but its victories of arms are almost always first prepared by ideological struggle—political and intellectual maneuvers designed to sap the unity and morale of its targets, or to cut them off from sources of support. Conversely, every military victory of Communism reinforces its mystique of inexorability, thereby strengthening its ideological arsenal even in a world that has grown skeptical of its promise of an earthly paradise.

To hold our own in this contest the United States needs to be able to fight in both realms. If we allow our military forces to atrophy, as we were prone to do during the 1970s, nothing else we do will rescue us. But we also need the ability to do battle in the political realm, to counter the Soviet claim to represent either a just or an inevitable future.

In both the military and the political realm we need allies. Our alliances, however, will always be unequal. No country in the world can protect itself against the Soviet Union without our help, and, conversely, in an all-out war with the Soviet Union, no other country's forces could be of much help to us. This circumstance, and the potency of our nuclear weapons, might argue for a policy of genuine isolationism.

Their Season of Mischief

BUT THE isolationist option comes up short on several counts, quite apart from any altruistic ones. The alternative to accepting the burden of helping others protect themselves is, as the libertarian theorist Earl Ravenal once candidly acknowledged, "to let our adversaries have their season of mischief in the world." Unfortunately, that season would be unlikely to end until we were indeed isolated. The United States would become a tense, claustrophobic place in a world where our vision of man's future had been defeated and the Communist vision apparently vindicated. Such a momentous challenge to the rightness of our way of life would weaken our social fabric and leave us open to subversion. True, we have our nuclear deterrent to defend us. But, were the Soviet Union able to bring to bear against us the preponderance of the world's human and material resources, it would surely find ways to circumvent, overwhelm, or render obsolete our defenses, however formidable those seem today.

No Better Defense

THERE IS, in short, no safer alternative to basing our own defense on a policy of alliances. The importance of these alliances is less for the event of all-out war than to help us avert all-out war by deterring regional adventurism by the Soviets and maintaining a global balance of power.

Of course, alliances entail costs. Not only do we ordinarily have to take on the lion's share of the burden of mutual defense, we also must bear some of the onus of our allies' quarrels. Israel is one ally that brings with it more than its share of enemies. Why make all those Arabs angry at us by allying ourselves with Israel?

The answer is that it is far from clear that our relationship with Israel diminishes our influence in the Arab world. Part of that world would despise us anyway for being modern, democratic, capitalistic, and non-Moslem. Other parts of it have grown closer to us precisely because of the influence we have with Israel and because Israel has demonstrated the advantages of a Western orientation. The further answer is that, whatever its liabilities, Israel also brings with it more assets than most of our other allies. It is a boon to us in both the military

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Israeli dev.

ISRAEL: JOINT ECONOMIC DEVELOPMENT GROUP

Q: What is the purpose of the U.S - Israeli Joint Economic Development Group which was announced during the visit of Israeli Prime Minister Peres?

A: -- We have established the U.S. - Israeli Joint Economic Development Group to strengthen our consulatations on Israel's economy and development efforts. The Group will be headed on the U.S. side by Allen Wallis, the Under Sectretary for Economic Affairs in the Department of State. On the technical working level a number of U.S. Agencies will participate, such as State, Treasury, AID, OMB, CEA and the NSC. The Group will have the benefit of advice from distinguished U.S. and Israeli economists.

-- The Group will discuss the full range of economic issues, including ways the U.S. could help support Israel's economic recovery and development efforts.

-- The meetings will be held periodically and the site will alternate between Israel and the United States. We expect the first meeting to take place in Washington at an early date.

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KEY ECONOMIC INDICATORS
In million of U.S. dollars unless noted

	1984	1985	1986 (est.)
Domestic Economy			
Population (millions)	4.16	4.24	4.31
Population growth (%)	2.0	1.8	1.7
GDP in current dollars (billion)	22.0	24.1	n/a
Per capita GDP, current dollars	5,288	5,684	n/a
GNP in current dollars (billion)	20.9	22.8	n/a
Per capita GNP, current dollars	5,024	5,377	n/a
GDP (millions NIS) (1980 prices)	116.0	120.0	122.0
GDP % change	1.7	2.8	1.6
GNP (millions NIS) (1980 prices)	109.0	113.0	115.0
GNP % change	0.3	3.6	1.6
Consumer Price Index % change	444.9	185.2	25.0
Interest rates (% monthly)	19.0	5.8	4.5 (a)
Wholesale price index (1977=100)	393.5	1,440.3	n/a
Production and Employment			
Labor Force (1,000s)	1.44	1.47	1.49
Unemployment (%)	5.9	6.7	7.4
Industrial production, % change, local currency 1983=100	4.9	2.7	n/a
Govt. oper. deficit, as % GDP	38.9	22.2	n/a
Industrial production index (1983 = 100)	104.9	107.7	n/a
Productivity growth/worker %	-1.8	1.4	1.6
Balance of Payments			
Merchandise exports (F.O.B.)	5,807.3	6,256.4	6,757.0
Merchandise imports (C.I.F.)	8,344.0	8,319.6	8,910.3
Trade balance	-2,536.7	2,063.2	2,153.3
Current account balance	-4,767	-3,972	3,500
Foreign direct investment (new gross)	184	217	n/a
Foreign Debt (year end)	2,367	2,385	n/a
Debt service paid (net)	2,837	3,049	n/a
Debt-service ratio as % of merchandise exports	49	49	n/a
Foreign exchange reserves (year end)	3,098.5	3,718.6	n/a
Average exchange rate for year (NIS=U.S.$1.00)	0.2935	1.1813	1.485 (a)
Foreign Investment	not available		
Total (cumulative)			
U.S. (cumulative or %)			
U.S.-Israel Trade			
U.S. exports to Israel (C.I.F.)	1,771.6	1,705.6	n/a
U.S. imports from Israel (F.O.B.)	1,644.6	2,134.1	n/a
U.S. trade balance with Israel	127.0	-428.5	n/a
U.S. share of Israeli exports	24.3	34.1	32.9 (a)
U.S. share of Israeli imports	21.2	20.5	22.0 (a)
U.S. Economic aid	1,200	1,950 (b)	1,950.0 (b/c)
U.S. Military aid	1,124	1,927	1,790.0

Principal U.S. exports (1985): machinery and mechanical equipment; agricultural products; optical and measuring instruments; metal and metal products.

Principal U.S. imports (1985): polished diamonds; mechanical instruments; chemicals; optical and medical instruments.

Sources: Central Bureau of Statistics, Bank of Israel, and Finance Ministry

Note: Using an average annual rate of exchange may produce misleading dollar accounting because the rate was changing so rapidly.
(a) Jan-June
(b) includes one-time grant of $750 million in Special Assistance
(c) does not include return of 4.3 % due to Gramm-Rudman-Hollings

CURRENT ECONOMIC SITUATION AND TRENDS

The New Economic Stabilization Program: Between November 1984 and June 1985 three package deals were concluded with the aim of reducing the rate of hyperinflation. Partners to these deals were private employers, the Histadrut Labor Federation, and the Government. They agreed to implement a general price freeze with periodic adjustments according to increases in input costs; salaried employees received only partial compensation for price rises.

These agreements provided a cooling-off period but failed to establish longer-term stability. In the second quarter of 1985, the rate of inflation accelerated again and almost returned to the average monthly rate for 1984. The improvement in the balance of payments in 1984 stopped in the first half of 1985, causing foreign currency reserves to fall. The inability of the package deals by themselves to reduce domestic demand, restore stability and arrest inflation showed that administrative measures without coordination with monetary and fiscal policy changes were inadequate. By mid-1985, the Government felt that a coordinated policy push was imperative to prevent economic collapse.

Effective July 1, 1985, the Government announced a comprehensive program for economic stabilization. This program was designed to attack simultaneously the two major problems afflicting the economy: balance of payments and inflation. The basic facets of the program included: (1) reducing the budget deficit (to the FY 84/85 budget limit); (2) cutting export and consumer subsidies; (3) devaluing the currency by 18.8 percent; (4) imposing price controls (initially for three months); (5) reducing civil service employment by three percent; (6) freeing the capital market and reducing the linkages which automatically pass through inflation; (7) imposing one-time increases in taxes; and (8) sustaining a stable exchange rate against the U.S. dollar. The government received additional authorizations to extend the price controls until December, 1986, but as signs of stability have become apparent, the price freeze is being gradually lifted. Wages were not officially frozen, but there was a policy against pay increases. It was also agreed that cost of living adjustments would be less than the rate of inflation.

Most observers regard the initial implementation of the program to have been successful in achieving its goals. The measures jolted the July 1985 CPI by 27.5 percent, but contributed to the relative stability of the second half of 1985. During the first ten months of the program (July 1985-April 1986) the CPI index rose only 52.9 percent. The foreign payments position improved so that Israel had a current account surplus of $1.098 million for 1985.

In addition to the success of the program, the Israeli economy has benefited from several fortunate events: the decline in the value of the dollar against the European currencies; the decline in the price of oil; the decline in foreign interest rates and the granting of an additional $1.5

billion in U.S. assistance (half for 1985 and half for 1986). These, however, are occurrences which will most likely not be available to sustain the Israeli economy in the future.

Other developments during the first seven months of 1986 point, moreover, to a potential erosion of the recovery process. They include: relief from immediate economic pressures; some pay increases for last year's erosion accorded both in the private and public sectors; Government failure to reduce the public sector as much as projected; renewed demand for consumer durables; non-implementation of new tax revenue measures and spending cuts; growth of exports below, and of imports above, estimates; and growing pressure on the Government to provide Government support to concerns, particularly major construction, shipping and health concerns, facing financial difficulties. These trends increase pressures for devaluations and price hikes, as well as widening the trade gap. Various economic commentators have warned that while the Government has reduced the budget deficit, it has not set in progress a process of renewed economic growth or structural change with which to sustain the progress already achieved.

In addition, October 1986 will bring the "rotation" in the leadership of the National Unity Government from the Labor Party to the Likud Party. While there is no change anticipated in the direction of or dedication to the Economic Stabilization Program, longer term forecasting is difficult.

National Accounts: Israel's economy grew moderately in 1985 after a slow growth in 1984. The Gross National Product (GNP) increased by 3.6 percent to $22.8 billion versus 0.3 percent growth the year before. Real private consumption remained stable at $14.3 billion, but per capita private consumption declined two percent. This decline was influenced by a decrease in foreign travel and in purchases of new automobiles. Total real public consumption increased 3.8 percent in 1985 (following seven percent growth in 1984) mainly due to a 25 percent rise in direct defense imports. On the other hand, domestic defense consumption decreased by seven percent in real terms largely as a result of a curtailment in domestic military purchases and the withdrawal from Lebanon. A drop of 14 percent in transfer payments, and of 34 percent in subsidies, contributed to the continued stability in civilian public consumption. Gross domestic investment (construction, machinery, equipment and transport) fell in real terms for the second consecutive year, i.e. by 10 percent. In residential construction alone, investment shrank by 14 percent.

The Government, however, anticipates renewed economic activity in the last half of 1986, so that growth overall for 1986 could be 2-3 percent.

Balance of Payments: The deficit in the balance of payments on goods and services declined to $3.972 billion in 1985, i.e. a drop of $795 million, or 17 percent less than in 1984. Exports of goods and services grew two percent to $10.688 billion, while imports declined four percent to $14.688 billion. Commodity exports increased 7.7 percent in dollar value (by over $500 million) to $6.256 billion, while non-military imports remained stable at about $8.32 billion. The deficit in the services account also narrowed by some $600 million due to a 12.6 percent drop in services (foreign travel, interest payments and transport services). Unilateral transfers, which amounted to $5.07 billion, more than covered the entire goods and services deficit in the current account. In 1985 the bulk of these transfers came from the U.S. Government; the balance constituted remittances from institutions (i.e., the United Jewish Appeal), personal restitutions from Germany, and transfers by individuals. The sizable surplus of unilateral transfers in the current account enabled the Israeli Government to keep its debt balance stable, to repay obligations, and to increase its foreign currency reserves by $620 million. Total external debt at the end of 1985 stood at $23.7 billion, of which 70 percent was long-term, 15 percent medium-term, and 15 percent short-term. Israel's foreign exchange reserves totalled $3.72 billion at year end (IMF definition).

All of the regular U.S. assistance in U.S. FY 85, $2.6 billion, was interest free for the first time. For FY 86 total regular assistance amounted to $2.871 billion. In addition the U.S. provided special assistance of $750 million each for FY 85 and FY 86, a one-time provision to assist Israel in implementing its economic program.

The official outlook for 1986 is for a continued improvement in the balance of payments. The government is forecasting a decline of $500 million in the current account, a rise of seven percent in exports, and an increase of seven percent in imports. The predicted improvement in the balance of payments is based on a strict adherence to the economic plan's guidelines, continued low petroleum prices, and further recovery in the economies of the United States and other western developed countries. To finance the 1986 shortfall, which will be about $3.5 billion, Israel will still have to rely on U.S. assistance, lending from the Bank of Israel, private and institutional remittances, and on commercial borrowing.

Trade: The United States remains Israel's largest single trading partner, although trade with the European Community is larger overall. Non-military Israeli imports from the United States decreased slightly from $1.77 billion in 1984 to $1.71 billion in 1985, or to 20.5 percent of Israel's merchandise imports. Israel's sales to the United States increased by nearly 30 percent to $2.13 billion and constituted 34 percent of total exports. For the first time, Israel had a surplus in its civilian trade with the United States in 1985 of $448 million.

Three trading arrangements help Israel: (1) the European Economic Community (EEC) agreement systematically lowers the duties between the EEC and Israel for non-agricultural products; (2) the U.S. Generalized Schedule of Preferences (GSP) allows 2,700 manufactures to enter the United States without duties; (3) the Free Trade Agreement (FTA) with the United States, which came into effect September 1, 1985, is similar to the EEC pact, and should increase trade between the two countries. The Agreement calls for mutual immediate duty free status for many products, progressive reductions on others, with further reductions on a third category still to be negotiated. The United States and Israel, under FTA, have also agreed to establish a committee to meet for discussions on "trade in services" with the goal of removing existing trade barriers. They are negotiating agreements on various services, including thus far tourism, telecommunications, and insurance.

Israel established the Red Sea port of Eilat as a Free Trade Area with significant benefits to local residents and entrepreneurs. The impact of this change has not yet been felt either in the region or on the economy.

Inflation: In nominal terms, the Israeli shekel depreciated vis-a-vis the dollar in 1985 by 134.8 percent, which means in real terms (after adjustments for domestic inflation) it appreciated against the U.S. dollar by some 18 percent. By contrast, in 1984 and in 1983, the shekel was devalued by 493 and 220 percent respectively. Since July 1, 1985 (when the shekel was devalued by 18.8 percent), the exchange rate of the dollar remained stable at around NIS 1.5 to one U.S. dollar. During the same period, the shekel was devalued by some 22 percent against European and Japanese currencies.

Inflation decelerated in 1985 after three years of consecutive steep increases. Prices rose 185.2 percent in 1985 compared with a rise of 444.5 percent in 1984 and of 190.7 percent in 1983. During the second half of 1985, the CPI went up by 45.4 percent, i.e. by the lowest six month rate since 1981. During the first third of 1986, inflation totaled only 5.2 percent, a rate prevailing in the early 70s. The relatively low inflation rate is expected to continue through 1986, reaching 18-25 percent for the year, assuming that the world oil prices stay at the current low level and that the economic plan's measures are fully implemented.

Prices and Wages: To simplify monetary calculations, effective January 1, 1986, all financial transactions were denominated in "new shekel" terms (NIS). One new shekel equals one thousand old shekels. Both currencies were intended to be in circulation during 1986, but beginning in September, 1986 old shekels must be redeemed at a bank. The change has no economic significance but may have contributed to the public's feeling that prices are becoming more stable.

Beginning August 1, 1986 the Government linked the shekel to a trade weighted basket of currencies of Israel's major trading partners. The unit composition of the basket is roughly: U.S. dollar 60 percent; the West German mark 20 percent; the pound sterling 10 percent; the French franc and the Japanese yen five percent each. The move is intended to reestablish some linkage with currencies other than the dollar and to minimize the degree of fluctuation against these currencies. The Government envisions that the rate of the basket would be 1.5 NIS to the basket.

Wage control during most of 1985 resulted, as planned, in a decline in real wages of 9.1 percent by year end. As part of the agreed economic plan, the first months of 1986 show an increase in labor costs and real wages in the private sector which as of June 1 were about four percent below the average 1984 level. For the public sector the decline remains somewhat larger.

The two-year public and private sector blanket wage agreements with the Histadrut Labor Federation expired March 31, 1986. Negotiations, underway since April, appeared to be under little pressure to reach a conclusion until recently. The Histadrut is seeking a real wage increase, but the Government has stated frequently that it will devalue the shekel, if necessary, to offset any major gains. Already negotiated is a cost of living agreement (COLA) which stipulates a 70 percent adjustment whenever the CPI increase exceeds a seven percent cumulative increase within a given time period. This weakens the linkage between wages and inflation somewhat. In addition, the Histadrut unilaterally announced that it will increase the minimum wage for its employees to 450 NIS/month beginning August 1. This is approximately 40 percent of the average wage and affects 20-25 percent of the work force. Many feel that wages remain too high, relative to productivity, to achieve greater employment without inflation or other disequilibria. Although workers now experience no significant wage erosion of their salaries during the month, and have benefitted from adjustments in the tax brackets to increase their take home pay, they still must bear the impact of increased expenses as subsidies and benefits are reduced.

Price controls have maintained price stability, and, with contracting demand, have produced no major shortages or black market suppliers. By the beginning of June 1986, more than half of the items in the CPI were no longer controlled. The Government is continuing to decontrol items throughout the summer. Eventually only a quarter of the items in the CPI, i.e. those provided by monopolies and cartels, or certain health and education services, will be controlled.

Employment and Productivity: The unemployment rate rose to 6.7 percent of the civilian labor force in 1985 from 5.9 percent in 1984. The largest increase came in the third quarter of 1985 when the unemployment rate reached 7.8 percent. There was some fear that the implementation of the economic plan, combined with slackening demand, would raise joblessness over 10 percent. The rate, however, declined to 7.1 percent in the last quarter, and has remained relatively stable at 7.2 percent during the first half of 1986. Productivity per worker, low by European and U.S. standards, increased 1.6 percent.

Monetary Policy: The Central Bank pursued a tight monetary policy which coincided with the objectives of the economic stabilization plan. Its aim was to prevent expansion of credit to the public at a time of price and wage control, and to attract more savings by keeping the real rate of interest high. This caused financial hardship to numerous enterprises during the slowdown of the second half of 1985. On the other hand, the policy contributed to the gradual transition from foreign-currency-linked liquid assets to longer-term, shekel denominated savings schemes. Towards the end of 1985, when inflation stabilized at a lower level, the central bank allowed interest rates to drop, albeit not as fast as inflation. The ordinary business borrowing rate declined from 19.0 percent per month in December 1984 to 5.8 percent per month in December 1985, and to 4.5 percent per month in March 1986. As of April 1986, commercial banks are making interest computations on a quarterly basis, in lieu of a monthly basis and credit card companies are billing monthly rather than biweekly.

Public Finance: For the Israeli fiscal year ending March 31, 1986, the government budget deficit was NIS 4.8 billion (about $3.5 billion) on total outlays of NIS 20.2 billion (some $14.8 billion). The budget deficit is defined as the portion of budget revenues which the Central Bank lends to the government. Such direct borrowing from the Central Bank adds to the inflationary pressures. By contrast, the budget deficit for the current fiscal year (1986/87) is forecast at NIS 1.3 billion ($0.82 billion), out of total expenditures of NIS 30.2 billion ($ 19.1 billion). The new budget is said to represent a 5.3 percent real cut in expenditures from that of the preceding fiscal year. The proposed budget, as of August 1, still depends on Knesset approval, with the imposition of additional taxes and levies yet to be decided.

In fiscal 1986/87, about 65 percent of the expenditures is devoted to defense and debt servicing; 16.5 percent for transfer payments; nine percent for civilian consumption; and 6.6 percent for investments. Of total anticipated revenues, 52 percent are expected from taxes and levies, 22.2 percent from foreign grants and loans (20 percent from the U.S. Government), and 16.5 percent from domestic loans and emissions.

During fiscal year 1984/85, the Government recycled 98 percent of its redeemed domestic loans and savings schemes. The government's capital raising reached $2.81 billion as against total budgetary redemptions of $2.93 billion. In October 1985 the Government was required to redeem $700 million worth of bank shares held by pensioners which it had guaranteed when the value of those shares collapsed in 1983.

Implications for the United States

Although the Israeli Government's austerity program has slowed market expansion and left a good number of Israeli companies, both large and small, in financial difficulties, several factors combine now to make Israel an especially attractive market for U.S. products. First, the FTA is reducing customs duties to zero for both countries; most items will reach that level by 1989, and the remainder by 1995. The immediate benefit of the FTA for the United States has been to place U.S. exporters on a par in most product areas with their European competitors who, through Israel's earlier Associate Agreement with the European Economic Community, have been enjoying a small but growing advantage in tariff rates. The FTA has also reduced the number of U.S. products requiring import licenses, and provides a more systematic procedure for both sides to work out any disagreements that develop over trade barriers. Second, the more competitive dollar has sparked a growing interest in a broad range of U.S. products. U.S. high-tech equipment, which has been the backbone of U.S. exports to Israel, has become even more attractive while, at the same time, new markets are opening up for all kinds of U.S. industrial and consumer goods and services. Israeli businessmen are making inquiries at the Embassy's commercial section regarding U.S. representations and sources. Renewed interest has been seen in such diverse items as in pumps, graphic arts materials and accessories and clothing and cookware. While the interest and curiosity are there, however, in many areas U.S. exporters will have to be aggressive if they are to dislodge existing commercial ties with European and Japanese competitors. A third factor, Israel's generally favorable orientation toward United States, complements the other factors and should support the penetration of U.S. goods into the market. Israelis generally appreciate U.S. culture, speak English and enjoy traveling to the United States. Given the other factors, this general interest in the United States facilitates market penetration, assuming there is a reciprocal commercial interest by the U.S. exporter.

Finally, the Israeli austerity program, for all its problems, provides the U.S. exporter a sounder, more confident market place than has been the case in recent years. Although it is too early to lose caution, the Government has been able to subdue inflation, decrease subsidies, improve foreign reserves and keep wages and prices in check.

Although, as mentioned above, the interest in U.S. products is broadening to the less sophisticated industrial as well as the consumer areas, the best prospects in the market continue to be in the high tech areas.

The demand for high performance metal working machinery and equipment (N/C, robotic, cutting and finishing machines) is based on a continuing demand from Israel's electronic, aircraft and defense industries. Total demand is around $200 million a year of which 75-80 percent is provided by imports. The demand is growing at above 15 percent a year. The U.S. share, about 20 percent, has been hurt in the past by the over-valued dollar and strong Japanese competition. U.S. exporters must seize the opportunity of the more reasonable dollar to win back some of the lost ground. The U.S. Pavilion in Technology 87, to be held in Tel Aviv in May 1987, provides an excellent vehicle to do this.

U.S. computers and their peripheral equipment also have a good market in Israel. In an import market of about $350 million, the United States holds 54 percent. Growth in the next three years is estimated at just under 20 percent. The Israeli defense establishment generates about 60-70 percent of the demand. The mini-computer market should expand significantly, especially in the services sector, in order to save on labor costs. An excellent opportunity to explore the Israeli market is the Computer Trade Mission being organized by the U.S. Department of Commerce for December 1986. The mission will also visit Greece and Turkey.

Software, which will also be featured in the December Trade Mission, has a $50 million import market in Israel and it is expected to grow at an annual rate of about 80 percent. Currently the U.S. has about a 35 percent share of this market. Israel has a healthy, growing software industry of its own, producing about $150 million annually; it is made up of over 120 software houses.

Electronic components are another good prospect for U.S. exporters. Out of a $200 million import market, the United States has about 60 percent. The continued growth of the Israeli electronics industry and the vital role played by American electronics firms as investors, licensors and technological advisors in this market, assures a strong favorable interest by Israeli firms in U.S. components.

The $100 million import market for telecommunications equipment is also dominated by the United States which holds a 50 percent share. The import market is expected to expand by just under 10 percent a year. Upcoming projects include a proposed Israeli satellite system, a second TV channel, and a possible cable TV network. Further, Bezek (the Israeli telecommunciations company) plans to upgrade its international and domestic communication facilities, including the development of a cellular telephone system. A Voice of America transmitter station in Israel is also being planned and will be an opportunity for U.S. exporters.

Other areas of interest include avionic equipment, which is dominated by U.S. companies, and medical equipment which, although a contracting market because of reductions in the government budget, still represents a sizeable amount of imports, $80 million. In this area, major pieces of equipment would be difficult to place but disposible materials and money saving devices would have attractive prospects.

With the more competitive dollar, consumer items come to the fore. The two major department stores have held or are planning promotions for U.S. textiles. Lingerie, children's clothing and flatware seem the most attractive in that area. Graphic arts materials, now in the hands of European suppliers, is another area that appears to be opening up to a more aggressive approach by U.S. exporters.

Summary

The Government of Israel instituted on July 1, 1985 an economic stabilization program, designed to tackle the two major problems facing the economy: a balance of payments (BOP) deficit and hyperinflation. To date they have been relatively successful in improving the BOP situation and very successful in containing inflation, in part due to the program and in part due to felicitious international circumstances. The current account of the balance of payments shows a surplus of $1.098 billion; the level of inflation is only one to two percent a month and foreign exchange reserves have increased while foreign debt has decreased.

Maintaining the progress achieved and making further progress are now the goals, and the Government recognizes that it faces several difficulties: restraining of excessive increases during the nationwide wage negotiations; controlling public and private pressure for assistance, particularly for businesses in distress; limiting rising consumer demand; directing a growth scenario for the economy and opening the capital market. In addition, the position of Prime Minister shifts from the Labor Party to the Likud Party in October.

Although the economic program has slowed market expansion, several factors combine to make Israel an attractive market for U.S. products: the Free Trade Agreement is reducing customs duties to zero for both countries; it is also reducing the number of items requiring import licences; the more competitive dollar has ignited interest in a broader range of U.S. products; Israelis have a favorable orientation towards the U.S. and U.S. products; and, most importantly, the economic program provides the U.S. exporter a sounder, more confident marketplace than has been the situation in recent years. In this environment both the standard high-tech exports, as well as the less sophisticated industrial and consumer items, should do well in the foreseeable future.

Israel's Economy

FORUM

A step in the right direction

Stuart Eizenstadt on the need for modernization of the Israeli economy

EVEN WITH the Iranian arms sale controversy reverberating in Jerusalem, Prime Minister Shamir should give top priority to completing the job of resuscitating the Israeli economy Shimon Peres so ably began. Indeed, Israel's involvement in the Iranian fiasco now threatening the credibility of the Reagan presidency is itself a reflection of Israel's increased economic dependence on the United States as its economy floundered.

Israel's capacity to be a truly independent state and to defend itself in the hostile Middle East depends fundamentally on a solid economic foundation. But Israel's economy 18 months ago was on the brink of disaster. Inflation was raging at an annual rate of 450 per cent. Foreign reserves were dangerously low. The trade deficit was staggering. Budget deficits reached 17 per cent of GNP – more than three times the U.S. level. Growth was stagnant.

Since the economic plan was put into effect by the unity government in July 1985, the economy has been saved from the precipice. Inflation was reduced to an annual rate of under 20 per cent, without causing a severe recession, by a unique combination of budget controls. The Israeli shekel was stabilized. Foreign reserves were up.

While plunging world oil prices, the devaluation of the dollar, and an emergency infusion of U.S. economic aid helped, Israel itself deserves much of the credit. The Histadrut labour federation accepted a temporary drop in the standard of living for Israeli workers. Subsidies on most goods were sharply curtailed. The Bank of Israel won more independence and is in strong hands with a solid monetary policy. The consumer binge and wildly inflationary economic policies became relics of the past.

But the very success of the programme could lead the public to believe – incorrectly – that the battle was over, that victory can be declared, and business go on as usual. Such a misconception is dangerous, because to win the war, Israel must continue to reduce its budget deficit, cut remaining subsidies, and seek additional wage restraints tied to productivity. Moreover, this will only set the stage for what must be a second – and more difficult – phase in the Israeli economic recovery programme: a fundamental restructuring of its economy.

The economic recovery plan has failed to restore high levels of growth and to create sufficient jobs for Israel's growing labour force. Israel's trade deficit has risen in recent months, and unemployment remains high. From 1950 until 1972, Israel was a model Third World economy, with real growth exceeding 9 per cent annually and single-digit inflation levels. But from the Yom Kippur War of 1973 through the end of the decade, growth dropped dramatically to only about 2.5 per cent per annum. By the early 1980s it dropped to under 1.5 per cent, while inflation soared to triple-digit levels.

ISRAEL'S REBIRTH after World War II was meant to fulfil the Zionist ideal of gathering in dispersed Jews from around the world to a Jewish homeland. But Israel's anemic economy has failed even to retain many of its own citizens. An estimated 300,000 Israelis – almost 10 per cent of the Jewish population – have left to live in the U.S., due to inadequate economic opportunity. 1985 was the first year in the history of the state in which more people left Israel than came; and 1986 continued the trend.

Moshe Nissim (Isaac Harari)

Israel's heavily centralized, semi-socialist economy, essential in the early stages of defending the state and absorbing hundreds of thousands of Jewish emigrants from war-ravaged Europe and the poor nations of North Africa and the Middle East, is outmoded for today's competitive world environment.

Israel has the highest per capita debt in the free world – a debt repayment which consumes over half the nation's export earnings and a third of its budget. Almost one in every three salaried workers is employed by the government.

High levels of U.S. aid to Israel, and some relief from the burdensome debt owed to the U.S. – which the Reagan administration is now prepared to support are critical.

But only major reforms can restore adequate levels of growth and new jobs essential to Israel's economic future and national security. Israel need not remake its economy into a mirror image of America's and must find its own way.

HOWEVER it is time Israel's political leadership of all ideologies faced the fact that the economy will not be restored to health, that Israel will not stem the flow of emigrants and attract more immigrants, that Israel will not realize its full strength and potential, without a fundamental reordering and modernization of its economy.

Following are the steps which should be taken to revitalize the still-ailing Israeli economy.

First, Israel needs a thorough restructuring of its capital markets. The government controls virtually all borrowing and lending, rationing credit to the private sector as a fiscal intermediary. The government's monopoly in capital markets must end: it must limit its own borrowing, and permit the private sector to compete for funds. At the same time, to make Israeli equities more attractive, it must rehabilitate its stock market, still shaken from the collapse in 1983, by affording greater protection for investors.

Second, the Israeli tax system must be revised dramatically. Taxes change frequently, often retroactively, and are horribly complicated and unclear, with varying tax rates depending upon the nature of the enterprise, its location, and its percentage of foreign ownership.

Israelis are the most heavily-taxed people in the free world. Tax rates are very high – over 50 per cent for businessmen, 60 per cent for individuals, and, at times of high inflation, up to 100 per cent for capital gains. Tax receipts and other levies comprise a gigantic 50 per cent of the GNP, more than twice the U.S. level.

Israel should simplify its tax code and retroactive regulations, broaden its base, and, when matched by budget cuts Finance Minister Nissim correctly set as a prerequisite, reduce tax rates.

Third, government regulatory barriers administered by a bloated bureaucracy, which discourage domestic and foreign investment, should be reduced. Businesses have to navigate through a withering variety of agencies at different stages of their operation. This should be replaced by streamlined, one-stop shopping and a major deregulation.

Fourth, Israel must bite the bullet and move away from the indexation of financial assets and wages to consumer price-rises in order to achieve control over monetary policy and break the back of inflation once and for all.

THE PLAN put forward by Finance Minister Moshe Nissim is a move in the right direction.

The modernization of the Israel economy will require boldness on the part of the Israel government and the public. If the economy continues to stagnate and inflationary pressures resume, if the short-term successes lead to a resumption of business as usual, Israel cannot depend on further emergency assistance from the U.S. government. The days of wine and roses are over in terms of large annual increases in U.S. aid to Israel, given the severe budget pressures imposed by the Gramm-Rudman-Hollings Balanced Budget Act.

A country which has sacrificed so bravely on the battlefield in five wars can certainly rise to the task.

(This article was written before the recent cabinet decisions.)

The writer, a lawyer who was President Carter's chief domestic policy adviser, is chairman of the American Jewish Committee's Institute on American Jewish-Israel Relations.

DURING THE recent riots in France, some 500,000 students from

Let's take to the streets!

confronting Israeli society as a whole.

JOYCE STARR

Israel's fragile economy

First of two articles

By 1984, when the present National Unity Government was established with Shimon Peres as prime minister, Israel was in a strategic economic crisis.

Inflation was 440 percent, the wage and price spiral was out of control, and foreign reserves were at a critical low. Israel's $23 billion external debt, exceeding $7,000 per capita, was one of the highest in the world, and highly volatile commercial loans stood at $7 billion.

For the first time in its history, Israel's credit standing on the world market was in jeopardy. A major confrontation with the Arab states in 1984-85 could well have eroded Israel's financial situation to the breaking point.

The National Unity Government under the leadership of Mr. Peres turned the tide by assuming responsibility for crucial but exceedingly unpopular economic reforms. Heretofore, Israeli leaders across the political spectrum had inevitably conceded to internal demands for expanding defense and social programs. Amnon Neubach, economic adviser to Prime Minister Peres, pointed out that "in the 1960s and 1970s, the lobbies for bigger defense budgets, subsidies, and social benefits were virtually shouting at the government, but hardly a voice could be heard calling for improvements in the economic infrastructure of the country."

However, as a result of the new economic program and the austerity measures launched in July 1985, the inflation rate in the last quarter of 1985 dropped to 12 percent. The annual projection for 1986 is only 16 percent, with inflation running 1 to 2 percent over the past few months. Wage and price agreements had been in effect for more than a year by mid-1986, foreign reserves showed a $1.5 billion increase, and the budget deficit was cut by almost $1.6 billion.

Israel's trade deficit was reduced in 1985 by approximately 25 percent. Exports increased by 3 to 4 percent, (primarily in textiles and chemicals), in spite of shrinking trade opportunities.

For the first time in long years, the finance ministry did not resort to printing money, the favorite salvo of previous governments.

These improvements could, however, erode as a result of the October 1986 rotation in leadership or with new elections. Prime Minister Yitzhak Shamir, in his previous tenure as prime minister, was much less involved in economic matters (although his supporters claim he is knowledgeable on the subject), and unlike Mr. Peres, is not expected to use the office of the prime minister to introduce wide economic reform.

Yet, Israel still faces the overriding need to reshape the structure of its economy, particularly its tax base and its capital market. Foreign investment in industry is almost marginal (less than $40 million in 1985) and indigenous annual investment in the country has remained at about $1.5 billion for the last several years.

A recent economic survey compared Israel's growth rate — 2 to 3 percent in 1986 — with those of seven major western industrial nations. Israel placed at the bottom of the ladder. "For the time being," complained the Israel *High Technology Newsletter*, "growth appears to be more of a 'buzzword' than part and parcel of a concerted national effort."

Massachusetts Institute of Technology Professor Stanley Fisher, Secretary of State George Shultz's representative to economic discussions with Israel and one of the shapers of Israel's new economic program, warned the Israeli Knesset on June 15, 1986, that the program was in "fragile shape." According to Mr. Fisher, the government has yet to reduce spending, with the reduction in the budgetary deficit attributable to additional taxes, not to cutbacks in expenditures. Mr. Fisher also pointed to "worrisome data" in the sphere of wage pressures, with salaries quickly returning to pre-program dimensions.

At the beginning of August, Prime Minister Peres received a "secret" letter from George Shultz congratulating him on the economic successes of the past year but stressing the urgent need for reform

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Dr. Joyce Starr is director of the Near East Studies Program of the Center for Strategic and International Studies. This article is based on a chapter she prepared for the 1987 National Defense University publication on interservice rivalry among Western Allies.

Zorund's (Clinic)

7/9/86

TO: Secretary George P. Shultz

FROM: Herbert Stein
Stanley Fischer

SUBJECT: Meetings with Israeli officials and economists, Jerusalem, June 15 - 18. 1986

The economic situation in Israel seems calm for the short run but worrisome for the longer run. That is, inflation will probably not accelerate and there will be no balance of payments crisis during 1986. But there is little sign of preparation either to adapt the claims upon the economy to its resources in a sustainable way or to undertake the structural reforms that would stimulate growth of productivity.

Attention of policy makers focuses on the national wage negotiations now under way and likely to continue for some months. Real wages have regained the levels of a year ago, before the stabilization program and their next move is important and uncertain. The government regards the national negotiation as critical. Both Mr. Peres and Mr. Shamir promised to "stand firm." The U.S. delegation strongly supported this position. We emphasized, what they surely already knew, that if wages rose too much they would suffer either devaluation with a revival of inflation and inflation fears or unemployment.

We all may have made too much of the national negotiation. A bad agreement would be very troublesome, but even a "good" agreement would leave many problems. A good agreement might provide no wage increase beyond partial and delayed indexing. That is what the government wants. Actual wages, however, are determined not by the national agreement alone but by that plus industry and company negotiations. The outcome seems to be significantly influenced by market conditions. So the question is whether market conditions can be created that will prevent a rise of real wages or preferably bring about a reduction because, as the IMF report said, real wages are "too high to achieve full employment with internal and external equilibrium."

This is a question about monetary-fiscal policy, unemployment and politics. Can the political process tolerate a degree of monetary-fiscal restraint that will reduce real wages even if the cost is a further increase in unemployment, presumably temporary? Unemployment rose after the stabilization program was introduced to 7.9 percent in July and August 1985 compared to numbers mainly in the 5 to 6 percent range before that. Although the rate has since declined, it still remains around 7 percent. Despite that, opinion polls show much satisfaction with the government's handling of the economic situation.

However, we see little willingness to face another round of disinflation. A common view is that the Bank of Israel overdid tightness right after the program began and that interest rates are still too high, causing difficulty for various businesses. (As in the United States people believe that the benefits of a lower inflation rate could have been achieved without the pain if only the monetary authority had behaved a little differently.) Great satisfaction is being expressed at the appointment of Michael Bruno as Governor of the Bank of Israel. Mr. Peres describes him as a "tough nut". The U.S. delegation also expressed its pleasure at the appointment of Mr. Bruno. But whether he will escape the usual syndrome of Central Bankers--which is to concentrate on incomes policy and the budget to the exclusion of monetary policy--is uncertain.

Whether budget policy will share the burden of restraint, somewhat tempering the necessary level of interest rates, is also unclear. Mr. Peres assured us of his intention to find offsets for the increase in expenditures already allowed beyond the budget--about $215 million. But the fiscal year is one-quarter over and the offsets are not in sight.

The Ministry of Finance gave us two alternative estimates of Israel's resources and their uses in 1986 "updated" from the estimates underlying the budget. They both show much bigger increases in consumption than was forecast in the budget, decreases in investment instead of an increase, smaller growth of exports and bigger growth of imports. These are all moves in the wrong direction. They also show bigger increases in total output than had previously been estimated, but this apparently results from more demand and has inflationary implications. These revisions are all in the wrong direction. They become consistent with some improvement in the balance of payment mainly because of the decline of oil prices.

Discussions of economic growth in the JEDG dealt with two subjects--taxation and capital markets. The tax system of another country, when first described, always seems confusing and illogical. In the case of Israel one finds that this is not just a first impression; it is the fundamental truth. Israel has in extreme form a combination of taxes and transfers that is inefficient in income distribution but quite effective in distorting the economy. The nominal tax rate on corporations is very high, but when that is combined with various incentives and grants the tax on the investment that actually occurs is probably negative. On paper lots of room exists for tax reform that would broaden and equalize the tax base and reduce rates. But no one seems to regard this as a realistic possibility in the visible future.

Some steps have been taken to liberate the capital markets, but they are marginal. Reduction of the government deficit increases the share of the national saving that is available for private use. But the government does not make that freely available for private use. It directs the private use by a system of permits and subsidies. That is not only because the government thinks it knows which private uses are best. The government also wants the system of credit rationing as a way to hold down the interest on the government debt--i.e. to tax savers. And no one seems to foresee any basic change in this either.

From time to time reference is made to the "47 point growth program" that Emanuel Sharon is supposed to be helping to develop. But Sharon never tells us any of the 47 points and one feels that he knows we would not take any of them seriously.

There is no economic growth policy in Israel. "Economic planning" cannot be a growth policy for Israel; that is how they got to "no growth." Israel's growth policy has to be to liberate the forces of the market. But except for economists almost no one is Israel appreciates that. The free market is not part of this tradition or culture and there seems to be hardly any political force behind it.

The revival of economic growth is much more critical for Israel than it is, for example, for the United States. One of Israel's fundamental questions is whether highly productive, mobile people will stay in a small country that:

a) Has the highest defense burden in the world, especially when the cost of conscription is included,

b) Has one of the highest social welfare burdens in the world,

c) Confronts continuous military insecurity and terrorism, and

d) Is torn by internal dissensions.

No economic policy will create in Israel the living conditions of Palo Alto anytime in the foreseeable future. Moreover, that is not necessary. Israelis have an attachment to their country which makes them willing to pay some cost, in sacrificed income, to remain Israelis. But the cost must not be too great. And there should be some promise that the cost will decline. Growth could give that promise by raising per capita incomes towards the American-European level, even though very gradually, and also reducing the relative burden of defense.

The viability of the Israeli society could also be strengthened if the burden of defense and social welfare programs on the most productive elements of the population could be reduced by other means in addition to the revival of growth. Since the social welfare programs are commonly regarded as untouchable this consideration focuses attention on the defense burden. The idea of "doing something" about defense seemed more active on this trip than in earlier visits. This idea has three forms:

a) That Israel's defense forces are unnecessarily large for the threat they face,

b) That better decisions would permit Israel to obtain its necessary defense more cheaply. The Lavi is an important element in this argument, but not the only one,

c) That the U.S. should and will pay a larger share of the cost of defending Israel.

These ideas are in the air, but outside government. We gently raised the defense budget issue with Mr. Peres, but received no productive response.

<u>What is to Be Done</u>?

The U.S. representatives should present it own positive ideas about the requirements for growth and survivablity more explicitly than it has done so far. We did put together a U.S. program for stabilization. We have not done that for growth. We have listened to briefings by medium-level officials about taxes, capital markets, etc. and have raised some questions. But we have not put forward any proposals.

This is, of course, a much more delicate subject than economic stabilization. The stabilization ideas were fairly "scientific" and "neutral." Proposals for growth and survivability will raise fundamental issues of philosophy and priorities. But if the U.S. does not raise these issues there doesn't seem to be any way of getting them to the attention of decision-makers or the public. Our effort should not be to spell out the details of a program but to stimulate active thinking along the lines of liberalization and strengthening of incentives.

We should try to give the U.S. Jewish community our view of the Israeli economic problem and requirements in the hope that they can influence the Israeli government.

In view of the close connection of defense and economics in Israel there should be more interaction between DoD and State on this connection and some interaction between the joint economic and military groups. One would hope that more cooperation between the defense and economic element in the Israeli government would emerge.

The meetings of the JEDG have become less useful than they were at first. As long as we discuss stabilization we have nothing to say that we have not said many times and that they don't know perfectly well. Our edging into other subjects has not been at a sufficiently basic level and perhaps not with the right cast of characters. We should now try to elevate the discussion.

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Israel's Econ

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Economy's impact on Israel's defenses

Second of two articles.

Although Israel's economic problems are felt throughout the country, they have had an especially dramatic and deleterious effect on the defense community.

Israel's defense budget climbed from 7 percent of its gross national product in the mid-1950s to 36 percent in 1979, averaging approximately 20 to 25 percent through 1985. But in 1985-86, the defense ministry absorbed the largest erosion in its budget compared to other arms of the Israeli government — relinquishing close to $600 million in anticipated increases.

As a result, training hours for pilots, tank crews, and crucial defense personnel, for example, have been significantly reduced, some argue beyond the red line of acceptable limits. As Ze'ev Schiff points out in *Israel's Eroding Edge in the Middle East Military Balance*, the economic crisis and forced austerity measures have meant the closure of operational units, including air force combat squadrons, dwindling stocks of ammunition and equipment, and a slowdown or elimination of programs to develop weapons and ordnance systems.

Speaking at a Tel Aviv Chamber of Commerce luncheon on June 16, Defense Minister Rabin told his audience, "I don't think there were forced retirements from the career army in the past like there are today. We're speaking of thousands." Mr. Rabin added that more dismissals and early retirements would be forthcoming at such critical defense firms as RAFAEL (the Armament Development Authority) and Israel Aircraft Industries.

As of 1987, the United States will have provided Israel with almost $20 billion in military and economic assistance (in current prices), making it the largest single U.S. foreign aid recipient. This pattern of assistance began in 1973, when President Richard M. Nixon for the first time sought more than $2 billion in military aid for one country, in this instance to replace equipment lost in the Yom Kippur War.

But even Israel's most ardent supporters recognize that the days of wine and roses on Capitol Hill are coming to an end. Tom Dine, executive director of the American Israel Public Affairs Committee lobby (AIPAC), told a reporter on July 3, "the future is not aid." Mr. Dine said aid levels would not increase unless "there is a Syrian-Israeli war and Israel was 'flattened' economically after many weeks of fighting." Short of that scenario, he stressed, Israel's future is in high-technology exports.

Testifying before a House of Representatives subcommittee in mid-August, Assistant Secretary of State Richard Murphy made the "bold" political statement that U.S. economic and defense aid to Israel would not grow in the next few years and might even be cut.

His remark elicited no adverse reaction from Israeli supporters on Capitol Hill. In the 1987 fiscal budget, U.S. aid to Israel remained fixed at $3 billion, a de facto decrease for the first time since 1973. Senior Israeli officials estimate that this amount could even shrink to $2 billion as a consequence of Gramm-Rudman-Hollings restrictions.

Yet in 1985, Israel's annual debt repayment to the United States (principal plus interest) amounted to $1 billion. A congressional plan that year to reduce interest obligations on Israel's total $10 billion debt to the United States was quickly withdrawn, although preliminary discussions are now under way between the two governments.

Debt service as a percentage of total exports was 25 percent in 1984 and could climb to 39 percent by 1987.

The country presently exports more than $4.5 billion in industrial goods annually, of which close to $1 billion, or about 20 percent, are defense-related, accounting for 60,000 jobs, or one-fifth of the total work force. Economic, political, and security problems, however, stand in the way of future growth. Indeed, according to expert opinion, most of the country's "show-case" defense firms were operating in the red at the close of 1985 and had demonstrated no signs of improvement by the third quarter of 1986.

A 1984 report issued by the Jaffee Center for Strategic Studies in Tel Aviv suggests that defense exports reached a peak as early as 1981.

Regional factors created heavy constraints: political and economic crises in South America reduced arms purchases by nations that were previously major customers; Israel's large Iranian market was (formally) shut down with the fall of the shah's regime in 1979; and there has been increasing competition in the Far East from Western suppliers that found their principal Middle East markets contracting.

The frozen dollar and 25-35 percent wage increases in 1985-86 also threatened defense export competitiveness. Until 1985, Israel's Ministry of Defense provided the economic net, or "cushion," for the country's defense firms by buying large quantities of arms and military products, a level of support that is obviously no longer feasible.

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Israel's economic difficulties also bode ill for the allocation of research and development funds for new defense projects. Israel's defense budget presently stands at $4 billion. Of this amount, 10 to 15 percent is spent on rese~~arch and~~ development. Given austerity priorities, this level is likely to remain constant or even decline in the coming years. But an even more imposing problem is the fact that the major portion of the annual R&D military budget was committed for the past several years and is designated for several years hen~~ce to just two~~ proj~~ects:~~ $220 million annually for the Lavi fighter aircraft, (the largest national project Israel has ever undertaken), and $15 million annually for the Merkava tank.

To complicate matters, the status of the Lavi project is surrounded by controversy. By the beginning of August, it was clear to senior Israeli officials that the Lavi will have difficulty surviving an intensive U.S. Department of Defense campaign against its further development and production — despite the fact that $1.2 billion in R&D funds was already invested (all of it deriving from U.S. military aid grants). A total of $2.4 billion in R&D monies will be invested if the project moves to production; correspondingly, as much as $1.2 billion in R&D funds could be saved if the project is cancelled.

Pentagon experts have reached the conclusion that the manufacture of the Lavi will harm Israel's security, draining dollars from the development and purchase of new weapons systems for the ground and naval forces. Senior officers in the Israeli navy and army have openly criticized the project. "If the Lavi flies, the army will lie on the ground," Maj. Gen. Amir Drori, ground forces commander, told reporters. Moreover, even if an American co-production partner could be found to defray the development costs of the Lavi, it will necessitate reshaping an increasingly expensive aircraft for an export market that no one is certain exists.

Israel Aircraft Industries officials argue that cancellation of the project will mean the loss of thousands of jobs and the possible emigration of many of Israel's best engineers. But whether or not the project goes forward, research and development on the Lavi is nearing a final phase that will free top engineering talent in defense industry to put their skills to other challenges. As of mid-1986, however, few such possibilities were yet on the drawing board, principally due to a shortage of funds.

While initial U.S. Department of Defense contracts for Israel's participation in the U.S. Strategic Defense Initiative program will not solve the financial dilemma, they do alleviate it. More significant, Israel's Ministry of Defense is hoping that the prospect of expanded involvement in the Strategic Defense Initiative will be viewed as an important intellectual stimulus and incentive during the upcoming period of transition on the Lavi — irrespective of a decision to move into production or to cancel the project. In either case, the country's R&D defense community is expected to suffer disruptive consequences.

Also on the positive side of the ledger, in 1979 Israel signed a memorandum of agreement with the United States enabling Israeli companies to compete with U.S. firms in selling defense equipment and entering into joint R&D projects with the Department of Defense and the U.S. armed services. The agreement was extended in 1984.

Participation in the Strategic Defense Initiative has proven a major step in improving Israel's standing, both with the Department of Defense and with U.S. firms. Companies that long were hesitant to have visible or substantial dealings with Israel have already made contact or entered into specific agreements on SDI teaming relationships -- a status Israel long sought, but hardly deemed possible within such a short time frame.

Involvement in SDI has also opened the way to other newly evolving U.S. high technology research programs, such as the Air Defense Initiative and the Conventional Defense Initiative. Further, only a few months after joining SDI, Israel was also accorded a role in Eureka, the European technological initiative.

A series of amendments was passed by Congress in late October marking a breakthrough in preferential treatment toward Israel in defense purchasing, research and development, and testing contracts. Under the amendments, Israel will be allowed to compete for a block of $40 million funds for non-NATO allies for research and development on defense equipment and a $50 million fund for (TBM) (anti-Tactical Ballistic Missile) research, as part of the SDI program.

"There are many ways in which we cooperate for mutual strategic benefit," Mr. Rabin declared during an August visit to the United States. "There is a readiness in the U.S. military to cooperate in ways that were inconceivable in the past."