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Financing Israel's War on Terrorism

Guaranteeing loan guarantees.

By Rand H. Fishbein



As Israel's war on terrorism drags on, officials in Jerusalem are increasingly worried that the country will be unable to finance its ongoing military campaign.

The Palestinian insurrection, now in its 20th month, has cost Israel dearly. Industrial production has fallen, exports have declined, and tourist revenue, a major source of income for the country, has all but evaporated. Israel's once vibrant economy is now in the doldrums, adding yet another layer of concern onto what is already a volatile situation.

To address the problem, the finance ministry is proposing major cuts in social expenditures as well as a new war tax on the population. But these actions are unlikely to stem the growing hemorrhage in government spending, or provide sufficient revenue to meet the nation's burgeoning military requirements.

What is needed is a bold approach, one that will provide the funds for sustained military operations without sacrificing either the country's military modernization plans or its much needed investment in industrial and social development.

For this, the answer may well lie in Israel once again approaching the United States with a request for a loan-guarantee package. These guarantees will allow Israel to go to the world's private financial markets and borrow funds at a more favorable repayment rate than might otherwise be possible under the current circumstances. Though today interest rates are low, many economists are predicting their steady rise by the end of the year.

Due in large part to the 20-month Palestinian war, Israel is running a \$2.7 billion budget deficit. Israelis, fearing continued economic uncertainty, have increased their overseas investments 35 percent since September 2001 to some NIS 22.8 billion. Moreover, the government recently devalued the Israeli shekel.

In light of these developments, the government of Israel should consider immediately convening a council of international financial experts, independent of its own finance ministry, to advise the cabinet on the optimal way to approach this idea. With Israel's economic crisis worsening by the day, there is no time to lose.

If approved by the government, Israel should initiate bipartisan discussions with congressional leaders, U.S. Treasury officials and key figures in the U.S. banking community, as soon as possible, on the size and structure of a possible loan guarantee package. With Congress now in the midst of its deliberations over the FY 2003 budget, and with the U.S. midterm elections looming, Israel will have to move quickly if it has any hope of Washington acting before the end of the year.

Loan guarantees are not cash advances, and they are not charity. Instead, they represent Washington's promise to repay Jerusalem's creditors in the event of default.

This is no different from the arrangement the U.S. government has with dozens of other countries where it backs loans for everything from housing construction and infrastructure development to trade promotion. Domestically, the U.S. government regularly provides loan guarantees to small businesses, exporters, and homebuyers to assist in promoting economic growth and opportunity.

Where Israel is concerned, this idea already has a precedent. In 1992, Israel received \$10 billion in loan guarantees from the U.S. to meet the extraordinary demands of refugee resettlement following the collapse of communism in Eastern Europe and the inflow of immigrants from Ethiopia. The program, first proposed by congressional supporters, has proven highly successful, with Israel meeting all of its obligations and repaying its creditors on time.

If structured along the lines of the 1992 program, the cost to the U.S. taxpayer would be *zero*. This would require that Israel now, as in the past, agree to cover both the subsidy cost of the guarantees as well as any transaction fees.

America would only incur a financial obligation if Israel failed to maintain its repayment schedule. This, however, is unlikely since Israel and Norway are the only two countries with perfect repayment records on U.S. government loans.

Today, the commercial marketplace may offer the best hope for Israel to secure a much needed infusion of budgetary liquidity. Given the mounting threats to Israel's security, a guarantee request in the amount of \$20-30 billion would appear to be reasonable. It would be an innovative way for the U.S. to aid its closest Middle Eastern ally without incurring additional financial expense.

The benefits to both countries of this arrangement are clear. For the U.S., a loan-guarantee package would:

- have no budget impact on the U.S., would not be scored as a financial outlay and would not contribute to a U.S. budget deficit;
- avoid the political controversy that often accompanies providing Israel with additional emergency cash assistance;
- help to boost the sagging U.S. economy by creating new jobs in the defense sector, since a large portion of the funds raised by Israel on the open market will likely be spent

in the United States;

- present a very low risk of default, since long-term prospects for Israel's high technology economy remain strong; and
- provide support for a key democratic ally in the war against terrorism, thereby helping to advance U.S. political and strategic objectives in the Middle East.

For Israel, a loan-guarantee package would:

- reduce the cost of commercial borrowing;
- provide the government with financial flexibility, allowing the Bank of Israel to draw down the guarantees as needed and in a manner most conducive to prudent debt management;
- help to ease the economic pressure that has resulted from the large call-up of Israeli reserve soldiers;
- permit the refinancing of pre-existing high interest debt with new low interest loans backed by guarantees, lessening the country's overall debt service;
- reduce the likelihood that Israel will have to cancel or postpone the receipt of long-lead military systems, many ordered from the U.S. before the current wave of unrest;
- spur job opportunity in Israel's high technology sector; and
- allow for the more rapid acquisition of goods and services needed to deal with the multitude of security threats.

At one time, Israel's military budget stood at over 20 percent of GDP. Today, that number has slipped to about 8 percent of GDP, reflecting the belief of successive Israeli governments that the Oslo process would soon bring a lasting peace. That belief was all but shattered with the collapse of the Camp David talks in the fall of 2000.

Israel's FY 2002 defense budget of just over NIS 41.6 billion (roughly \$10 billion) is inadequate to meet the country's basic defense needs, let alone a Palestinian war of attrition, the mounting danger posed by weapons of mass destruction, hostilities on the Lebanese front, and the growing threat of a regional conflict. Last month Israel's Defense Minister Ben-Eliezer proposed that the government back an emergency allocation of NIS 3 billion to meet the country's mounting defense requirements. But even this will be insufficient should Jerusalem remain on a war footing into the summer months.

At present, Israel is able to take advantage of the Pentagon's Defense Export Loan Guarantee (DELG) Program to meet some critical military needs. But the program has several drawbacks: First, borrowing countries are required to purchase only U.S. manufactured items and only those defined in the Arms Export Control Act (AECA). Second, in addition to the payment of exposure and transaction fees, borrowing countries are assessed additional fees to cover DELG program costs.

Third, the program's total borrowing authority is only \$15 billion for all eligible countries, leaving an amount insufficient to meet Israel's likely need. And fourth, the repayment period under the DELG is 12 years. Given its unique role in the war on terrorism, Israel may wish a longer amortization period.

Proposals to provide Israel with any additional direct cash assistance remain controversial. Upon coming to office, the Bush administration turned down a request by Israel to make good on a supplemental aid package of \$800 million promised by President Clinton. Clinton had offered the assistance in exchange for Israel's withdrawal from Southern Lebanon. Israel complied with the American request in May, 2000, but never received any help with the costs of its redeployment.

Then, in recent weeks, the White House asked Majority Whip Tom DeLay (R., Tex.) to withdraw his proposal to provide Israel with \$200 million in emergency assistance to help with its war on terrorism. The administration says it may reconsider the request now that at least one congressional committee has given its approval to the idea.

In the first month of Israel's military operation in the Palestinian territories, the country has spent over \$250 million on military mobilization to include about \$100 million on its activation of 25,000 reserve soldiers.

Despite concerns about Israel's economy, the underlying fundamentals remain strong. This, at least, is the view of the international rating agency, Standard and Poor's (S&P), which in an April 11th press release noted that Israel's "economy is in a good position to realize its high long-term growth potential, once the security situation improves and the global economy recovers." In the short-term, however, S&P lowered its outlook on Israel from stable to negative.

Three of the world's top credit-rating companies have threatened to downgrade Israel's credit rating still further, to BBB, if the government does not quickly implement even more drastic cuts. What began as a manageable military challenge to Israel now has burgeoned into a fiscal crisis requiring immediate and sustained action. Under these circumstances, U.S.-backed loan guarantees could provide at least a partial remedy to the problem.

Paradoxically, Israel's long-term economic prospects look good. Today, it sports one of the world's premier high technology sectors with over 100 companies now listed on the New York Stock Exchange. Over 77 companies are listed on the Nasdaq exchange, the second largest number of foreign firms after Canada. In 2000, the country's GDP grew by 5.9 percent, an extraordinary performance for a small country living under such difficult political conditions.

In keeping with both U.S. and IMF recommendations, Israel has made significant progress in recent years in breaking up its state-owned monopolies and privatizing a number of government-run industries. Given these positive long-term trends, Israel should have little difficulty in repaying its foreign loans, thereby posing little risk that the U.S. taxpayer will have to make good on its guarantee.

Since coming into office, Bush administration officials have reiterated the commitment of successive American presidents to maintain Israel's qualitative military edge. For this pledge to have meaning, however, it must be backed by practical steps.

The annual U.S. aid package to Israel of around \$2.3 billion represents a generous outpouring of American support. Yet, only a small portion of this assistance is spent directly in Israel. Instead, most of these funds are returned to the U.S. where they are used for the purchase of big-ticket items like aircraft, boats, spare parts, and support services. The high cost of these items means that much of Israel's annual aid from the U.S. is already obligated under existing contracts, thereby creating American jobs and helping to sustain U.S. industry.

In a world of exponentially growing threats and increasingly well-armed Arab-confrontation states, what discretionary funds remain in the Israeli budget to be reallocated for sustained wartime operations is minimal.

The U.S. war on terrorism, begun in earnest on September 11th, has transformed the way in which Americans view their world. No longer safe behind two great oceans, citizens can now better appreciate the daily horrors and the burdens under which Israelis continue to labor.

Following the tragedy of September 11th, the U.S. extended generous aid packages, some measured in the hundreds-of-millions of dollars, to nations willing to join in the war on terrorism. Israel is no less deserving, since by its geographic location and special circumstances it shares an unusual burden with the U.S. At the same time, Israel remains one of America's only reliable democratic allies in a region full of fair weather friends and shifting alliances.

Today, Israel finds itself in a battle for its national survival, a battle waged against the same terrorist forces that now threaten vital American interests around the globe. An offer of loan guarantees by the Bush administration would go a long way toward strengthening the antiterror coalition and hastening the defeat of those whom President Bush has termed, "enemies of civilization."

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