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The Israeli-Syrian Arms Race: Running on Foreign Aid

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A Research Paper

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The Israeli-Syrian Arms Race: Running on Foreign Aid [redacted] 25X1

A Research Paper

This paper was prepared by [redacted] 25X1
[redacted] Office of Near Eastern and South 25X1
Asian Analysis. It was coordinated with the
Directorate of Operations. [redacted] 25X1

Comments and queries are welcome and may be
directed to the Chief, Arab-Israeli Division, NESA,
[redacted] 25X1

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The Israeli-Syrian Arms Race: Running on Foreign Aid [redacted] 25X1

Summary

Information available as of 1 March 1988 was used in this report.

Israel and Syria are committed to an expensive arms race that heavily burdens their economies and ensures their continued dependence on foreign aid. Israel is likely to maintain annual defense spending in the $4.5-5.5 billion range well into the 1990s to ensure its military's qualitative edge over potential Arab adversaries, especially Syria, by purchasing and developing state-of-the-art military systems. Syria will have great difficulty in sustaining defense spending at the present $3.6 billion annual level needed to import advanced weapons and maintain large numbers of full-time soldiers. [redacted] 25X1

Massive defense programs coupled with limited domestic resources—including manpower and finances—leave both countries with defense burdens that rank among the world's highest. Syria devotes 17 percent of its gross domestic product to the defense budget, while military outlays consume about 10 percent of the Israeli gross domestic product. Our econometric analysis suggests that the two countries' defense burdens will continue to dampen investment and the growth of gross domestic product and are major factors behind their budget and foreign payments deficits. [redacted] 25X1

Israel's defense program receives steadier foreign support than that of Syria. The outlook for foreign aid from Syria's benefactors, especially Arab donors, is less certain than for Israel, which obtains almost all its military aid from the United States:

- Cash grants to Syria from moderate Arab states have fallen 65 percent since the early 1980s. Following the expiration of 1978 Baghdad summit payments later this year, Arab support could fall further and require Damascus to make deeper cuts in defense spending. Soviet-Syrian relations are likely to remain stable, and weaker support from other benefactors will strengthen Moscow's potential leverage with Damascus.

- US financial assistance will be the critical factor determining Israel's ability to import the military hardware needed for its modernization program. Israel has relied on US military assistance to purchase nearly all Israeli military imports since 1973. Nearly all the $1.8 billion in aid programed through September 1989 is earmarked for existing arms contracts or otherwise committed and does not provide enough money to finance all of Israel's military procurement plans, which Tel Aviv expects will cost $2.5 billion by then. [redacted] 25X1

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Both countries will continue to pursue a guns-and-butter policy that minimizes cuts in public welfare spending, even in the face of their heavy defense burdens. The repressive Damascus regime, however, has shown itself more willing than Tel Aviv to sacrifice living standards to maintain high defense spending. The regime is almost certain to continue to devote most of its resources to the military at the expense of needed civilian programs in areas such as agriculture and electrical power generation. Israel, on the other hand, has less latitude to reduce civilian outlays to help protect domestic military spending. [redacted] 25X1

Nagging structural problems in Israel's economy—including persistently high inflation and a heavy tax burden—will hold real economic growth to about 3.0 percent through 1990, about the rate Israel has experienced since it began its austerity program in 1985. Even in the unlikely event the economy grows at the officially planned rate of 3 to 4 percent per year, the defense burden will remain heavy. [redacted] 25X1

Both countries will be compelled to adjust their force structures to accommodate the realities of fewer domestic resources and insufficient financial aid. Israel's wide margin of military superiority over Syria is almost certain to hold steady and may even grow:

- Although budgetary belt-tightening in Israel has trimmed operational expenses, it has not led to major cutbacks in manpower or hardware that would produce significant cost savings over the long term. Tel Aviv will continue to focus on spending for high-technology weapon systems to replace older and obsolete equipment in its inventory. Despite Syria's impressive array of hardware, Israel's air force and armor units will remain the best in the Middle East, and Israel's military training, leadership, and better educated manpower pool will give it an advantage in future conflicts.

- Syria's economic weaknesses have a profound effect on its military. The military's recent reductions in maneuver training, cuts in imports of spare parts and updated equipment, and the release of many skilled personnel will hinder its operational readiness and performance. Sluggish economic growth and uncertainty over aid levels probably will keep Damascus's military buildup at a near standstill and may impose further force cuts. The main consequence will be additional incentives to develop unconventional systems, principally chemical and biological weapons, to supplant weakened conventional forces. [redacted] 25X1

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Contents

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Scope Note

This paper analyzes the economic burden the arms race between Israel and Syria places on both states. It examines defense spending and foreign military aid for each country. Direct comparisons between the two states' defense budgets are complex. For example, Syria provides no details on its spending beyond the Defense Ministry allocation. Comparisons of US and Soviet military aid to the two countries are dissimilar and complicated. [redacted] 25X1

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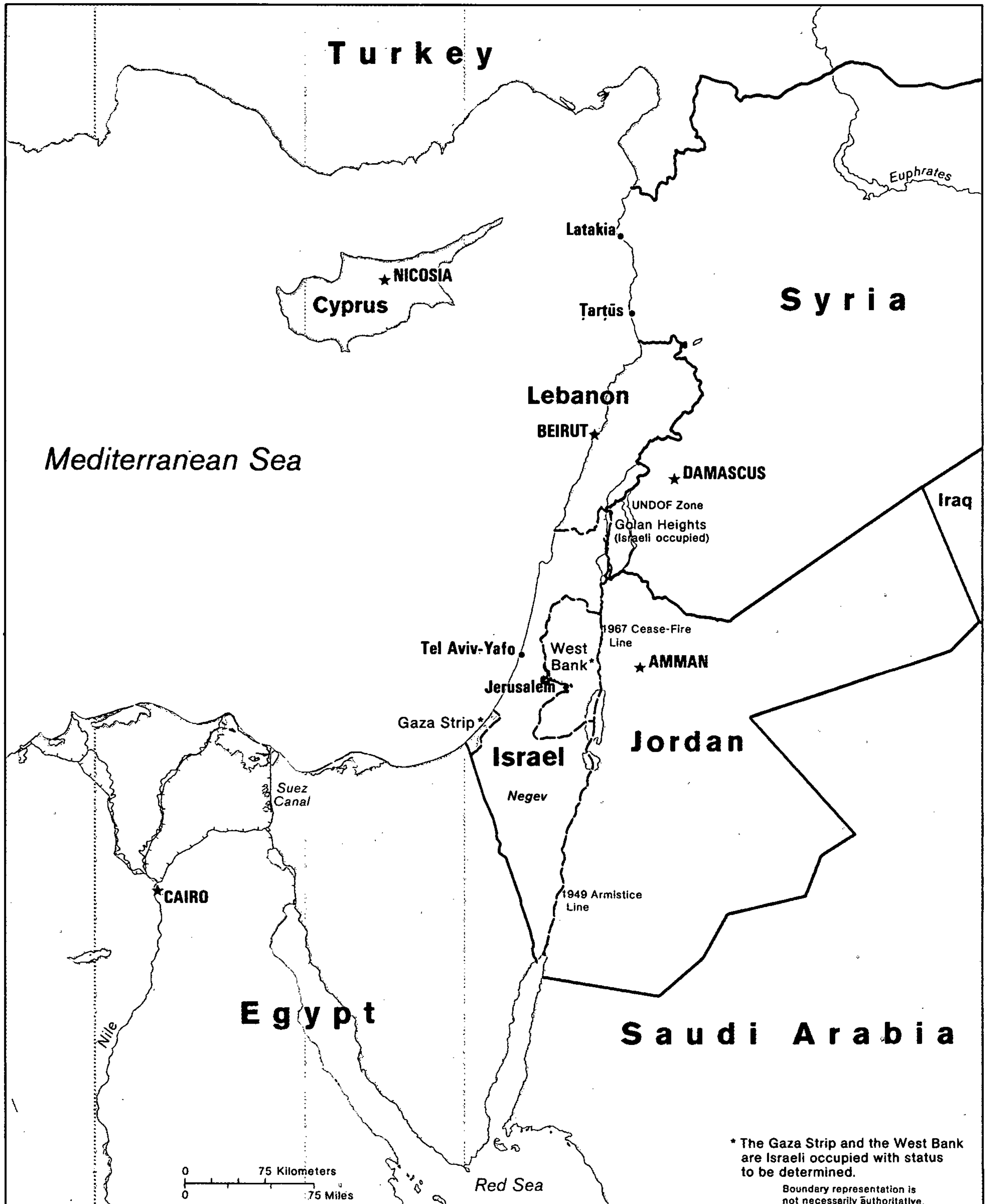
Turkey
Euphrates
Latakia
NICOSIA
Cyprus
Tartūs
Syria
Lebanon
BEIRUT
Mediterranean Sea
DAMASCUS
UNDOF Zone
Golan Heights
(Israeli occupied)
Iraq
1967 Cease-Fire Line
Tel Aviv-Yafo
West Bank*
AMMAN
Jerusalem
Gaza Strip*
Jordan
Israel
Suez Canal
Negev
CAIRO
1949 Armistice Line
Egypt
Nile
Saudi Arabia
* The Gaza Strip and the West Bank are Israeli occupied with status to be determined.
Boundary representation is not necessarily authoritative.
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The Israeli-Syrian Arms Race: Running on Foreign Aid 25X1

Differing Israeli and Syrian national priorities and perspectives drive the arms race between the two countries. In its quest for "strategic parity," Damascus is bent on strengthening its armed forces, first, to deter an Israeli attack and, second, to threaten a credible offensive to retake the Golan Heights. Syria's President Assad also relies on the military to guard against internal dissent, to protect national unity, to project influence in Lebanon, and to centralize power in his hands. Israel's determination to preserve its territorial integrity and to ensure its long-term survival impels its military modernization effort. Israel believes that Syria's growing military capability poses the greatest long-term danger to its national security.

The Arms Race and the Defense Burden

Israel's security strategy emphasizes costly, high-technology weaponry and extensive training and support for its personnel. Syria has concentrated on developing one of the strongest armed forces of any Arab country through massive acquisition of modern weapons and force buildup. As a result, the two primary antagonists in the region have among the highest defense burdens—those of finances and manpower—in the world. Israel is better suited than Syria to maintain and develop its defense program because it has a more sophisticated and diversified economy and a more skilled labor force.

Israel. Israel's military spending strategy in the 1980s focuses on streamlining its armed forces by eliminating marginal units while increasing the combat effectiveness of remaining units. Instead of expanding its existing inventory, the Israel Defense Force (IDF) is emphasizing the development and acquisition of more lethal, high-technology weaponry, according to the US Embassy in Tel Aviv. For example, Israel is improving the design of its Merkava tank as well as upgrading its inventory of almost 3,500 older tanks. Underscoring the preeminent role Israel places on airpower, the air force is procuring advanced weapon systems such as Popeye, a long-range precision-guided munition, to improve its ground attack capability. Tel Aviv also is investing in the development of antiballistic-missile research to counter Syria's growing surface-to-surface missile inventory. 25X1

Allocations to the military—particularly for modernization programs—have placed a heavy burden on Israel's narrow physical resource base. US Embassy reporting and official Israeli data indicate that, as a share of gross domestic product, domestic defense spending has absorbed 10 to 14 percent of the total output during the 1980s. By 1987 defense spending was roughly $2.8 billion or about 10 percent of gross domestic product, according to our estimate. Although significantly lower than during the 1970s, 25X1 when the burden averaged roughly 20 percent, the current figure is still one of the highest ratios in the world. In comparison, defense spending among NATO members averages about 5 percent of the total output, for the United States about 6 to 7 percent, and, according to our estimate, for the USSR approximately 15 percent. 25X1

We believe that the demands the military has placed on domestic resources have contributed to the diversion of goods and services that otherwise would have been designated for civilian investment. Although other variables play a role—especially interest rate levels—our econometric analysis suggests that in- 25X1 creases in domestic spending for defense have contributed to declines in gross investment since 1980. In particular, Tel Aviv has traded off rapid progress on its ambitious program to develop alternative sources of energy, according to the US Embassy. Highway construction projects also have taken a backseat to defense spending, according to the press. The shortfall of resources for the civilian sector even contributed to delays in the government timetable for the construction of six new Israeli settlements in the occupied territories by the end of 1986. 25X1

Data Shortcomings and the True Defense Burden

We believe that the official data of both Israel and Syria understate actual military spending and cloud the true impact of the defense burden on their economies. Because both sides closely guard this information for reasons of national security, much is not officially published, and published information lacks sufficient detail to permit analyzing the true level of defense expenditures. Unacknowledged defense spending is concealed within civilian budget line items, making it impossible to distinguish the military's share of total spending. Unidentified uses of foreign exchange and poor audit trails for military aid also are responsible for underreporting of defense spending.

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Israel makes among the world's largest commitments of labor to the military in relation to its population. On the basis of military manpower ratios—the number of active-duty military personnel per 1,000 population—Israel's defense burden measured nearly 34.3 in 1987. If part-time IDF reservists—who total about 400,000—are included, Israel's military manpower ratio leaps to 129.

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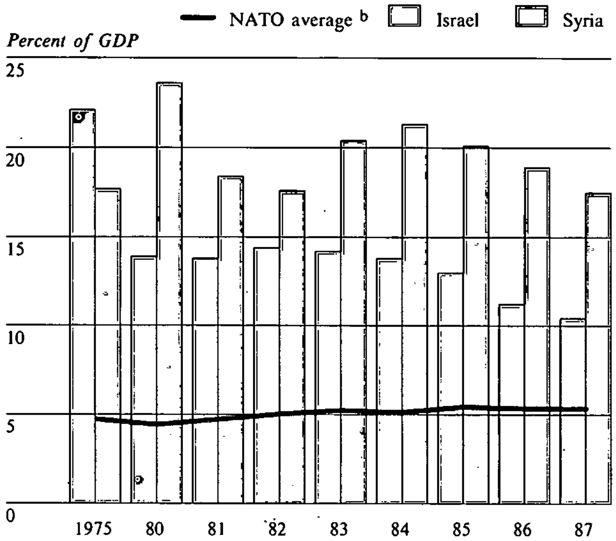
Israel's large manpower ratio suggests that it is stretching its labor pool to maintain current military manpower levels. Tel Aviv has a universal draft that requires nearly all 18-year-old Israelis—male and female—to serve at least two years in the armed forces. A Jewish population of about 3.6 million—of

Figure 1
Israel-Syria: Defense Burdens, 1975-87 [a]
Real Defense Outlays/GDP



[a] Israel data reflects domestic defense spending in constant prices. Syria data reflects total defense spending less estimated financial concessions from arms suppliers.
[b] Defense spending as a share of GNP.

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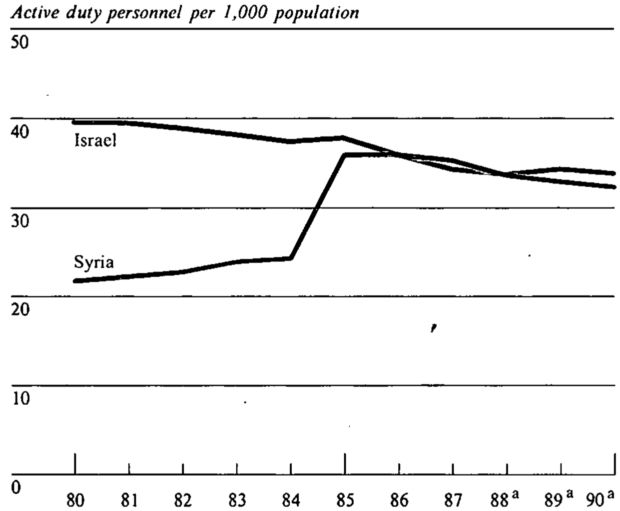
Figure 2
Israel-Syria: Military Manpower Ratios, 1980-90



[a] Projected.

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which only about 700,000 qualify for military service—leaves Israel little room to expand the size of its military forces.

Syria. Syria has placed primary emphasis on gaining numerical superiority over Israel in weapons and manpower. On the basis of observed deliveries, we estimate that the Soviets have transferred more than $15 billion in military equipment to Syria since 1980, making Syria the second leading importer (behind Iraq) of Soviet weapons in the Third World. Massive Soviet deliveries have allowed Syria to surpass Israel in some key equipment categories with more than 300 helicopters, 580 fighter aircraft, and more than 2,700 artillery pieces. Syria's tank force—more than 3,700—approaches Israel's and exceeds that of Great Britain and France combined. By 1985 the Syrian Arab Army had expanded from six to nine divisions. The authorized personnel strength of the armed forces has grown to almost 400,000, triple the level preceding the Arab-Israeli war in 1973 and almost double the level of 1980.

Syria's economic and military structures are markedly different from Israel's and in most respects less able to support high defense spending. We estimate that total military outlays, including arms imports, increased 350 percent from 1975 before peaking at almost 6 billion in 1983. Military spending has declined since then as Damascus has reduced its weapons imports and begun to consolidate its forces and integrate new weapons into its arsenal. 25X1

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Syria devotes a higher share of its resources to defense than does Israel. Syria's defense burden has averaged almost 20 percent of gross domestic product during the 1980s. Although total Israeli and Syrian spending has been roughly equal over the past five years ($21.7 billion and $21.6 billion, respectively), Syria's burden is heavier because its economy is smaller. 25X1

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Table 1
Israel-Syria:
Defense Spending, 1975-89

Million US $

	Defense Budget	Defense Imports	Total
Israel			
1975	2,393	1,774	4,167
1980	2,792	1,655	4,447
1981	2,998	2,165	5,163
1982	3,210	1,486	4,696
1983	3,166	1,015	4,181
1984	2,729	1,436	4,165
1985	2,553	1,792	4,345
1986 [a]	2,538	1,114	3,652
1987 [a]	2,800	2,600	5,400
1988 [b]	3,100		
1989 [b]	3,400		
Syria [c d]			
1975	939	376	1,315
1980	2,243	3,207	5,450
1981	2,216	2,592	4,808
1982	2,300	1,200	3,500
1983	2,388	3,595	5,983
1984	2,629	2,265	4,894
1985	2,474	1,564	4,038
1986 [a]	2,066	984	3,050
1987 [a]	1,814	1,810	3,624
1988 [b]	1,800		
1989 [b]	1,700		

[a] Estimated.
[b] Projected.
[c] Syrian budget data converted at: 1975, SP 3.49/$1; 1980, SP 3.925/$1; 1981, SP 4.28/$1; 1982, SP 4.65/$1; 1983, SP 4.735/$1; 1984, SP 5.033/$1; 1985, SP 5.57/$1; 1986, SP 6.582/$1; 1987, SP 7.275/$1.
[d] Defense budget data probably include some imports. Defense import figures are our estimates. Total spending figure may include double counting of imports.

[redacted]

We believe military spending has had an adverse long-term effect on economic development in Syria and is a key cause of the underlying economic malaise. Although defense spending initially stimulated the economy by mobilizing available resources and attracting politically motivated outside financial support for both the military and civilian sectors, the long-term impact has been to retard economic growth by absorbing human and financial resources and slowing implementation of development plans. Heavy military expenditures also have expanded state budget deficits and accelerated inflation. Massive arms imports, only partly offset by credits, have worsened the foreign payments deficit. [redacted] 25X1

As in Israel, military manpower requirements are a drain on the Syrian economy. The most recent data on military manpower ratios indicate that Syria ranks fourth worldwide, well behind Iraq and about equal to North Korea and Israel. We estimate that Syria's armed forces grew from 7.7 percent of the labor force in 1979 to more than 15 percent by 1987. The principal manpower burden is in the technical fields, where, until recently, Syria often forced skilled reservists and conscripts to stay in active service beyond the minimum requirement. This practice compounded the shortage of skilled labor in civilian enterprises. [redacted] 25X1

The burden of this rapid growth through conscription is partly offset by lack of productive alternatives to defense employment in Syria's sluggish economy. Likewise, the budgetary burden of conscription of unskilled troops is not severe. Privates serving their compulsory duty are paid only about $15 per month. [redacted] 25X1

Budgetary Impact

High spending for national defense and civilian welfare programs has left Israel and especially Syria with budget problems and heavy debt burdens. Both countries have financed substantial portions of their deficits through inflationary domestic borrowing and money creation. Likewise, the military's priority claim on budget resources probably has crowded out domestic investment projects. [redacted] 25X1

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Israel. Tel Aviv's decision to maintain high levels of military spending—which consume about 10 percent of budget expenditures, according to official statistics—has been an important factor behind the government's economic difficulties during the 1980s, in our judgment. Domestic defense expenditures grew rapidly up to the Israeli invasion of Lebanon in 1982 and

Israel: Defense Budget Decision Making

The Israeli military's annual budget cycle begins with the Ministry of Defense intelligence estimate of the potential threat to Israel. On the basis of this assessment, the Israel Defense Force's (IDF) planning branch establishes the general order of battle the military will need to meet the perceived threat, according to US Embassy reporting. Divided into five-year time frames, longer term force structure projections are cast in terms of general intentions and requirements, while near-term plans reflect more specific acquisition programs and requests.

In formulating their spending programs, IDF and Defense Ministry economic advisers take into consideration the resource constraints that affect the overall implementation of the plan. Using a computer model, the planners compare anticipated military activity with available economic resources, including manpower levels. The Defense Ministry also assesses technical advances made by its potential adversaries to determine research and development spending needed to maintain Israel's qualitative edge. Toward the end of the yearly budget cycle, the Defense Ministry factors in gaps in the projected force structure and acquisition plans to be filled by US systems purchased with US military aid.

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The Defense Ministry budget proposal then wends its way through the approval process. The planning branch along with the service commanders rank spending priorities, which are given final approval by the IDF Chief of Staff. The approved defense budget is next submitted to the Ministry of Finance, where it is integrated with the requests from the other ministries into an overall projection of revenues and budget deficit, according to the US Embassy. After revising the Defense Ministry proposals, the Finance Ministry responds with its allocation to the Defense Ministry—normally a compromise between the defense spending target and the revenue available from the projected government budget. Finally, various Knesset committees—and eventually the full Knesset—approve the budget, generally with little change.

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During the budget year, the Defense Ministry can reallocate funds among defense line items to meet unanticipated changes in military needs. Juggling budget categories, however, cannot exceed established guidelines, according to the US Embassy. For example, military pay may not go beyond that authorized in existing wage agreements. Moreover, reallocations above government-prescribed ceilings require the prior approval of the Finance Ministry or the Knesset subcommittee that oversees the defense budget.

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The Ministry of Finance has little political leverage to cut the defense budget, given Israel's obsession with national security.

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reached an alltime high of about $3.2 billion that year—about 15-percent increase over the 1980 level, according to official statistics. Despite government mandates to reduce defense outlays by $1.2 billion over the next three years because of mounting budget deficits and growing inflation, the military was still spending about $2.8 billion in 1987.

The government has bowed to intense lobbying from powerful interest groups in the civilian sector by leaving intact the operating budget for most nondefense programs, including spending on health and education, which accounts for about 10 percent of

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operating expenditures. Tel Aviv was particularly loath to cut spending significantly for politically sacrosanct social programs that included transfer payments and subsidies. As the economy's largest employer, the government also was unwilling to risk labor discontent—especially within Histadrut, Israel's powerful trade union federation—by reducing wages or laying off government workers. To provide financial breathing space, Tel Aviv apparently took the politically expedient course of sacrificing development outlays, which fell from over $1 billion in 1986 to approximately $930 million in 1987. Despite these cuts, total budget outlays reached nearly $20 billion in 1987, as compared with about $18.7 billion in 1986.

Israel has been unable to spread domestic revenues thin enough to cover spending on both guns and butter. The government's attempt both to field a modern defense force and to preserve costly welfare programs turned Israel's 1986 budget surplus to a $625 million deficit last year, or about 2 percent of gross domestic product. Despite having one of the world's highest tax burdens—as a share of gross domestic product gross taxes rose from about 45 percent in 1980 to over 52 percent in 1986—sluggish economic growth helped depress government tax revenues. Nontax revenue, including interest income and profits from state-owned enterprises, performed even worse.

Israel's reluctance to deal with the deficit by imposing sharper cuts in either domestic defense or civilian spending has left the government with a sizable internal debt service that has become the single largest expenditure in the budget. By 1987 the debt amounted to roughly $37 billion or nearly 120 percent of gross domestic product. In 1987 the government had to meet approximately $10 billion in total debt obligations—repayments that accounted for about 50 percent of total budget spending, according to official statistics. Although data are not available for the military's portion of the debt, we believe this share is substantial because of the amount defense consumes in the budget. Repayments of defense debts have increased the military burden and retarded investment in the private sector. The government's overwhelming need for financing has crowded out investors who must compete for funds in domestic capital markets and has helped fuel a 16- to 20-percent inflation rate. 25X1

Syria. Syria's expansionary fiscal policies have produced structural budget deficits that are consistently larger than Israel's. The overall deficit averaged about 19 percent of gross domestic product from 1980 to 1985. During this period, almost all categories of spending—both civilian and defense—grew at similarly high rates. Damascus has made progress over the past two years in curbing the deficit, but the narrow tax base and reliance on foreign aid make substantial improvements in fiscal performance almost impossible. 25X1

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Syria's budget deficits arise from Damascus's attempt to combine its military buildup with rapid economic development and high welfare spending. In general, Syria has increased spending on a range of items rather than reallocate resources from welfare spending to defense:

- Published defense budget figures, which we believe represent mainly domestic outlays, show a 55-percent nominal increase from 1980 to 1985, the final year for which actual data are available, and accounted for 30 to 40 percent of the total budget.

- During the same period, budget data show that investment outlays for transportation and utilities increased by 174 percent and agriculture and irrigation by 131 percent. Explicit price subsidies grew 293 percent, while state spending on education increased 74 percent. 25X1

- In contrast, public investment in manufacturing, mining, and power generation fell 42 percent from 1980 to 1985. By 1985 public investment in these sectors was only 14 percent of total public investment, as compared with 37 percent in 1980. 25X1

The effects of favoring civilian welfare and defense spending over investment in industry have been mixed. High current expenditures have had little positive impact on growth and have accelerated inflation. Syrian public investment in industry during the 1970s was poorly implemented and probably not absorbed. We believe continued high investment through the 1980s would have resulted in a similar waste of resources.

Declining external support has forced Damascus to rely on domestic resources to finance budget deficits. Before 1982 deficits were largely covered by official transfers, or grants, from Arab donors, which funded 53 percent of budget deficits during the period 1980-82. Foreign grants and loans have fallen sharply since 1982, and we estimate official transfers covered less than 25 percent of planned deficits during 1983-86.

Syria's state-owned banking sector is financing a growing share of the government's budget deficits and other liabilities of the public sector, a policy that has stimulated inflation. Growth of domestic credit, fueled by government borrowing, reached 37 percent per year during the period 1980-85. Treasury borrowing by 1985 amounted to 11 percent of gross domestic product, or about $1.6 billion. Damascus has curtailed its borrowing since 1986, but past expansionary fiscal policies have produced high inflation—102 percent last year—according to an unofficial survey conducted by the US Embassy in Damascus.

Foreign Payments Impact

Both Israel and Syria depend heavily on arms imports to meet their defense needs. Although Israel has a domestic defense industry, it cannot meet most of the IDF's requirements and, as a result, the Israelis must import most major weapon systems from the United States. Nevertheless, the ability to earn foreign exchange from arms exports gives Israel an advantage over Syria, which has a limited indigenous weapons production capability. Because neither country has adequate foreign exchange to afford military purchases along with civilian imports, each has accumulated sizable foreign payments deficits and external debts. Damascus, however, is suffering a much more severe foreign payments crisis that is only beginning to abate.

Israel. Accounting for about 18 percent of total imports, direct defense imports—which have averaged $1.7 billion since 1980—have been a major contributor to Israel's chronic foreign payments shortfalls. Indirect defense imports, which include spending for raw materials used by the domestic defense industry, have added another $500-900 million to the annual defense import bill, according to official data. 25X1

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Israeli arms exports probably have offset most of the cost of the indirect defense imports and have helped defray military research and development costs. By 1986 defense exports climbed to approximately $1.2 billion from $666 million in 1980, according to official data and press sources. Israel sells mostly small arms, ammunition, and communications and electronic gear overseas, but sales also have included large items such as Kfir fighter airplanes and obsolete equipment such as M-51 Super Sherman tanks. These exports have fallen short of covering the costs of direct military imports. 25X1 25X1

Tel Aviv has amassed a military debt to the United States of about $8.5 billion, over half of the government's foreign debt. Repayments on this debt impose additional burdens on Israel's foreign payments. To make the 1987 payment of about $1.1 billion, most of which was in interest, Israel used nearly all of the $1.2 billion of US Economic Support Funds, which could have been devoted to civilian spending priorities. These funds, however, have allowed Israel to hold its debt service ratio—repayment on military debt from exports, services, and unilateral transfer payments—at about 10 percent, a figure well below the 25-percent threshold that international lenders consider to be too high. 25X1 25X1

Syria. The most critical and immediate economic burden imposed by Syria's defense spending is on foreign payments. Syria's current account, even excluding most arms imports, has accumulated a deficit of more than $4.1 billion since 1980. Adding to this deficit, Syria has imported more than $17 billion of arms, financed primarily with Soviet military credits.

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Israel's Defense Industry: A Troubled Asset

As an export leader, a major employer, and the domestic supplier of arms to the Israel Defense Force, Israel's defense industry plays a central role in the economy. Weapons producers employ about 100,000 industrial workers who account for about one-third of the total industrial work force in the economy, according to the Israeli press. Most defense work is concentrated in machinery and electronics—two of Israel's fastest growing industrial sectors. Now accounting for nearly 20 percent of total merchandise sold abroad, arms exports have become Israel's second-largest trade category after diamonds, according to official data and the press. Moreover, the defense industry is an important training ground for scientists and engineers who move on to the civilian sector. Civilian industries, including those in communications, optics, lasers, and microcomputers, also take advantage of research and development spinoffs from defense firms.

Israel's defense industry is a highly sophisticated organization that is engaged in the research, design, development, and production of selected state-of-the-art weapon systems. The multitiered complex involves the government, private companies, and Israel's trade union federation, Histadrut. The largest government-owned or -controlled firms are Israel Aircraft Industries, Rafael (the Defense Ministry's development authority), and Israel Military Industries. Histadrut owns Koor Industries, Tadiran (the electronics giant), and Soltam, a producer of ground forces equipment. The private sector consists of more than 100 companies, including Elbit Computers and El-Op Electro-Optic Industries. Other organizations augment the military-industrial sector by providing marketing and trade services. For example, SIBAT, an agency under the control of the Ministry of Defense, is responsible for monitoring Israeli arms exports.

The defense industry has fallen on hard times in recent years because of inflexible monetary policy, increased production costs, lack of investment capital, and budget austerity. Cutbacks of about $600 million in the domestic military budget since 1983 have resulted in up to a 50-percent reduction in IDF orders for locally produced arms, according to the press. Rising costs for imported raw materials also have made the industry less competitive. Salary costs at Israel Aircraft Industries, moreover, increased from about $460 million in 1985 to $550 million in 1986. Insufficient research and development funding has made startup costs for new weapon systems prohibitive. Israel can use only $400 million of fiscal year 1988 US assistance locally to boost domestic demand. Even so, about two-thirds of these funds went to help defray costs of the Lavi cancellation.

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The growth in arms exports—which account for about 80 percent of total Israeli defense industries production, according to public statements by Defense Minister Rabin—has slowed as well, because of an overvalued currency and rising production costs. Other Third World arms competitors—such as Brazil and South Korea, which sell comparable equipment—can underprice Israel in the world arms market. Moreover, these countries are not hampered by the political limitations that restrict the potential market for Israeli arms. Countries that purchase from Israel, such as Argentina and Kenya, are having financial problems that are forcing them to scale back procurement plans. Several other buyers, such as Southeast Asian countries, are financially stable and reliable customers.

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Slumping sales at home and abroad apparently have thrown the industry into a recession. Some firms, such as Soltam, are operating in the red, and as many as 200 smaller firms linked to defense may be forced to shut down, according to the press. Flagging business has led to a substantial increase in unemployment within the industry. Because of a drop in total sales, firms including Israel Military Industries, Israel Aircraft Industries, and Tadiran have laid off 5,000 to 7,000 workers—many highly skilled engineers and scientists—over the last two years, according to press reports. Rabin and other defense spokesmen have publicly stated that as many as 3,500 more employees may lose their jobs. Given the poor state of the industry, we believe Israel may be overly optimistic in its plans to find alternative employment for workers laid off from the Lavi project.

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Figure 3
Israel: Military and Civilian Imports, 1975-87

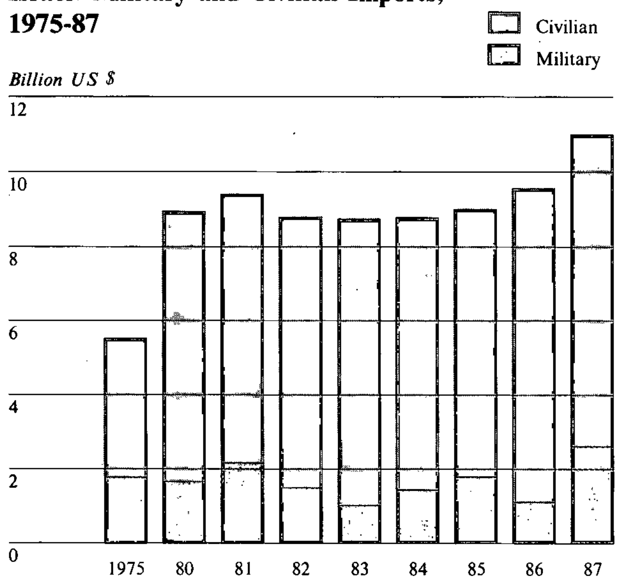

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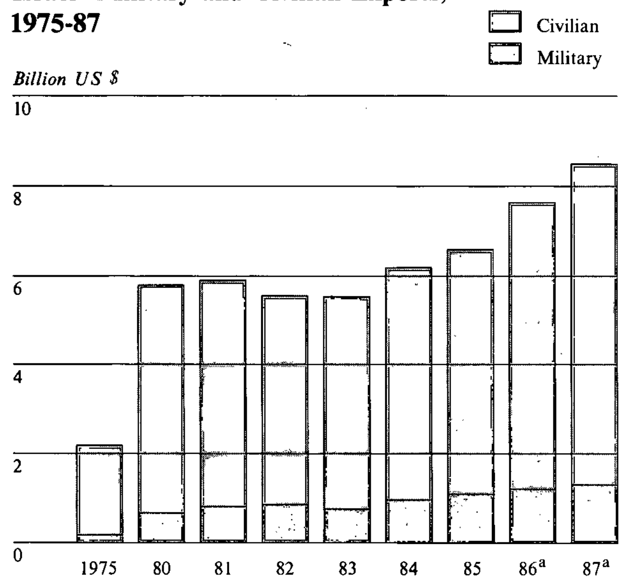
Figure 4
Israel: Military and Civilian Exports, 1975-87



[a] Estimated.

[redacted] 316994 5-88 25X1

We believe that these purchases, combined with debt service payments, follow-on support, and arms purchased from the West, have weakened the country's foreign payments position. [redacted]

Poor finances have intensified the competition for foreign exchange resources and even curtailed military imports. Foreign exchange earnings from oil exports, worker remittances, and official transfers have fallen by more than one-third from 1982, and foreign exchange reserves, last published in mid-1986, were only $10 million, equivalent to only two days of imports. Private importers have been denied foreign exchange through official banking channels since 1985, while the military continues to receive priority allocation of foreign exchange. Critical shortages are hurting the military, forcing the suspension of most military contracts requiring payment in foreign exchange. [redacted]

Damascus receives most of its arms imports from the USSR and East European sellers on credit, but even these transactions strain Syria's current account. Syrian debt to Western entities is fairly low at $4.4 billion, while debt to the Soviets may total $13 billion. On the basis of Syria's arms imports and terms common in Soviet arms contracts, our analysis indicates that Syrian obligations falling due in 1987 have totaled more than $1.3 billion—an amount far exceeding Damascus's ability to pay. [redacted] [redacted] special agreements negotiated since 1982 may have reduced current payment obligations by about half. Syria probably confines its current payments to the Soviets and East Europeans to aircraft and weapon system overhauls, selected spare parts imports, specialized training, and possibly down-payments on new contracts. As Syria's weapons inventory has grown, these related payments—payable in

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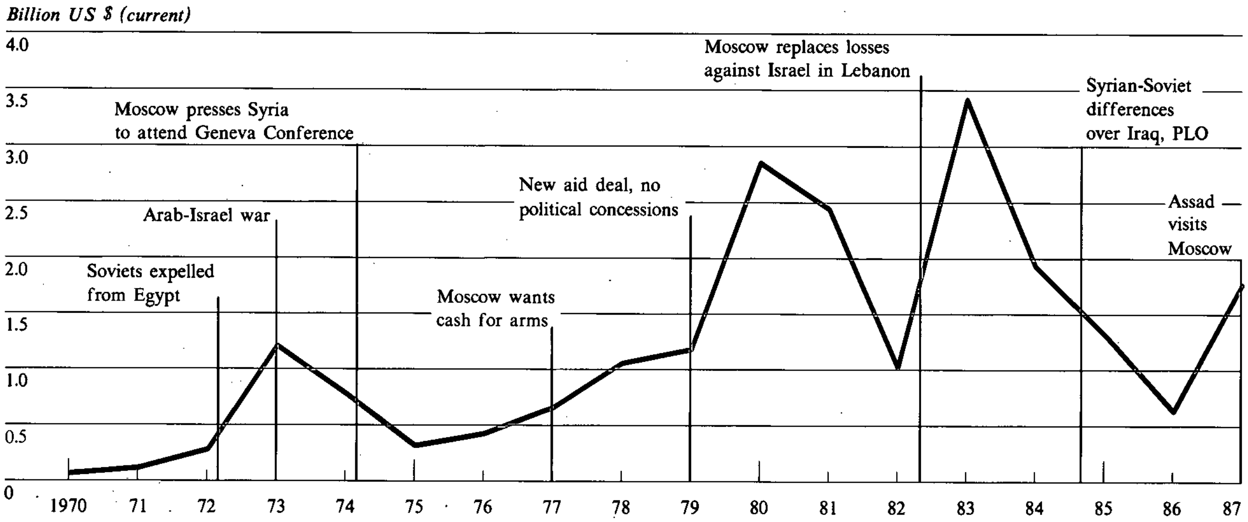
Figure 5
Syria: Imports of Soviet Arms, 1970-87



[redacted] 316995 5-88 25X1

hard currency and on commercial terms—also have grown and absorb a higher share of Damascus's foreign exchange resources. [redacted] 25X1

Damascus is pursuing development of indigenous arms manufacturing to curtail imports and debt. The Syrian Industrial Establishment for Defense is involved in production of small arms and tank and artillery ammunition independently and with some East European firms. [redacted] The firm recently was denied an export license by London, but Damascus will attempt to continue the project. Beyond these efforts, Damascus remains overwhelmingly dependent on imports. Syrian military exports are not substantial and consist mainly of reexported artillery, small arms, and ammunition to Iran and Libya. In addition, Syria earns foreign exchange from the estimated 1,000 military advisers and pilots stationed in Libya. [redacted] 25X1

Foreign Aid—A Sine Qua Non

Massive foreign aid is the fuel that drives the Israeli and Syrian military machines. US military assistance to Israel—about $1.8 billion annually—has been stable and finances almost all Israeli arms imports. Syria, on the other hand, is straining under the pressure of reduced aid from the moderate Arab countries and Iran and more uncertain support from the Soviets. [redacted] 25X1

Israel. Loans and grants from the United States have allowed Israel to pursue its military modernization program without forcing major sacrifices in civilian imports or exhausting foreign exchange reserves. Foreign Military Sales funds, which averaged $1.6 billion during the period 1982-86, have financed [redacted] 25X1

25X1

Table 2
Israel: US Military Aid Received, 1982-89

Billion US $

Year [a]	Amount
1982	1.4
1983	1.7
1984	1.7
1985	1.4
1986	1.8
1987	1.8
1988	1.8
1989	1.8

[a] For US fiscal year beginning 1 October.

[redacted]

Israel converts $300 million of these funds into local currency to help support the domestic defense industry. Since 1985, US military assistance to Israel has been on a grant basis. Before that time, approximately half the assistance was provided as loans, which Israel is obligated to repay. [redacted]

To reduce its overall future debt-service burden, Ministry of Finance officials have expressed a desire to refinance Israel's outstanding debt at a lower interest rate, according to the US Embassy. The Israelis believe that interest rates have dropped enough since mid-1987 to warrant negotiations to reduce interest payments on old debts. US requirements that prohibit such reductions, however, have inhibited changing interest payments. For fiscal year 1989, interest will represent about 80 percent of Israel's scheduled $1.2 billion debt repayment, according to the Embassy. [redacted]

Programed US military aid through September 1989 will leave Israel scant money to fund the IDF's new procurement plans that the Israelis anticipate will cost $2.5 billion. The IDF will face a nearly $650 million shortfall in defense budget allocations for new weapon systems during this time. Payments on existing contracts will use up about $2.2 billion of the $4.6 billion available during this period, according to the Embassy. Over $1.3 billion is earmarked for the Israeli defense industries, and another $1.1 billion for follow-on support will almost exhaust the balance. [redacted] 25X1

Syria. Since the late 1970s a major infusion of cash grants from the Arab Gulf states (particularly Saudi Arabia) and credits from the Soviet Union have financed the Syrian military buildup. Damascus has also reaped substantial benefits from Iranian oil aid since 1982. Nonetheless, total aid levels have declined steadily since 1982, requiring that Damascus accumulate debt and reduce foreign exchange costs. Likewise, Soviet arms deliveries have steadily decreased since 1983, until a recent upturn. Further reductions in aid from Moscow or the Arab Gulf states could send the economy into a tailspin and force a marked change in Syria's military capability. [redacted] 25X1 25X1

Cash transfers to Syria from Arab states were formalized at the Arab summit meeting in Baghdad in 1978, which called for underwriting the military capabilities of the states confronting Israel. Arab aid peaked at $1.7 billion in 1981, and we believe that the Arab cash aid has covered most Syrian military purchases from the West—$332 million since 1980—and downpayments on Soviet and East European equipment. 25X1 The purchase of 50 Gazelle helicopters from France in 1980, for instance, was financed by a cash grant from Saudi Arabia. By 1987, Arab cash assistance had dwindled by 65 percent to about $600 million. [redacted] as foreign 25X1 exchange receipts have dwindled, Baghdad payments have been channeled from defense to essential civilian transactions, such as food and pharmaceutical imports. Compounding these difficulties, donors at the Arab summit meeting in Amman in November 1987 25X1 declined to renew the Baghdad payments, which formally expire this year. [redacted] 25X1

Tehran's support, in the form of free oil, price discounts, and delayed payments, totaled more than $1 billion in 1982 and 1983. By 1987 free and discounted oil support was worth only about $110 million. Damascus's debt to Iran for past oil deliveries—almost certain never to be repaid—was almost $1.5 billion by mid-1987. [redacted] 25X1

Table 3
Syria: Economic Aid, 1980-87

Million US $

	1980	1981	1982	1983	1984	1985	1986	1987
USSR	25	30	40	35	90	60	110	NA
Eastern Europe	25	25	35	35	50	55	100	NA
Western bilateral	65	65	70	75	15	15	NA	NA
Arab and Western multi-lateral	85	105	40	105	90	115	NA	NA
Arab official transfers [a]	1,520	1,710	1,290	1,220	1,120	910	670	600

Note: Official gross disbursements, rounded.

[a] CIA estimate.

The balance of Syria's arms imports has been financed by credits from Moscow and, to a lesser extent, East European suppliers. Most Soviet military assistance is provided to Syria without payment discounts, causing Damascus's overall debt to balloon. Soviet military credits have apparently decreased in recent years—deliveries during 1984-87 averaged $1.4 billion versus more than $2.4 billion for 1980-83—as Damascus became less able to afford and effectively absorb new equipment. A rebound in 1987 to more than $1.8 billion from the low level of the previous year is explained primarily by the delivery of a squadron of MIG-29s promised over a year earlier.

Economic and military ties between Syria and the USSR remain solid, but tensions have increased over the past two years as Moscow has sought closer ties to other states in the region and has been more willing to act contrary to Syria's regional goals in pursuit of its own policies. Syria's weak record on debt payments further strains ties by transforming a large portion of Soviet arms sales into de facto "grants" through successive debt reschedulings, debt forgiveness, and indirect Syrian borrowing via accumulated payment arrears. 25X1

As Syrian debt grows, Moscow is pressing for political and military concessions by Damascus in exchange for financial relief. For instance, Damascus apparently agreed in late 1987 to allow Moscow to build a naval repair and maintenance facility near Tartus in return for additional coastal defense equipment and the cancellation of part of Syria's military debt, according to reports 25X1 25X1 On the financial side, we expect that repayments to Moscow will remain near the bottom on Syria's list of creditors. Any increase in foreign exchange resources will probably go toward essential purchases from the West. 25X1

Syria's financial woes have forced Damascus to cover a larger share of its arms imports through barter. We believe that a share of Syrian exports to the USSR—which average about $350 million per year—is credited against the military debt to supplement Damascus's low payments. Most recently, Syria contracted for more than $2 million in explosives from Yugoslavia in return for phosphates. Syria is pressing other military and civilian trade partners to accept phosphates, cotton, and textiles instead of cash. 25X1 25X1

Easing the Burden—Short-Lived Gains

Israel and Syria both introduced economic austerity programs—that included reduced military spending—to reduce expanding foreign payments and domestic budget deficits and curb inflation. After initial gains during 1985-86, Tel Aviv's stabilization program apparently lost momentum by 1987. We believe that improvements in budget and foreign payment deficits owed more to US supplemental aid than to the austerity measures. Syria has shown less resolve to address basic weaknesses and by 1987 was taking only halting steps toward additional reform. Syria's autocratic regime gives it the leverage to maintain high defense spending at the expense of civilian living standards. 25X1 25X1

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[redacted] 25X1

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Israel. By 1985 the effects of government overspending had reached crisis proportions. The foreign payments deficit had reached about $700 million by midyear, and the budget deficit's share of gross domestic product had risen to about 17 percent—the highest ratio since the 1973 oil price shock, according to official statistics. Foreign exchange reserves fell to about $2.4 billion from $3.8 billion in 1982. To help finance the budget deficit, Israel's money supply had grown about 310 percent annually from mid-1982 to late 1985, according to Bank of Israel reports. Fueled largely by increases in domestic borrowing and money creation needed to finance the budget deficits, the inflation rate had soared to an annual rate of about 400 percent. [redacted]

Apparently recognizing that the growing defense budget had become untenable, the military reluctantly supported the government's 1985 Economic Stabilization Plan. According to the US Embassy, the military's budget strategy called for economizing in five major areas: personnel pay, order of battle, research and development procurement, training, and logistic stockpiles. The austerity program trimmed 1984 domestic defense spending just 7 percent to approximately $2.5 billion in 1986, according to official statistics. As a result, the military's share of budget spending fell only about 5 percent from the 1984 level. The failure of this ratio to decline further was due in part to a slowdown in the real gross domestic product growth rate from 2.8 percent in 1985 to 2.2 percent in 1986. [redacted] 25X1

The reduction in military spending contributed to an improved economic picture during 1985-86, in our judgment. Cutbacks of $678 million in direct defense imports from 1985 to 1986, for example, offset about half the $1.2 billion increase in the nondefense import bill and permitted an improvement in the total trade deficit during this period. During 1985-86 Israel ran budget surpluses of $62 million and $231 million and enjoyed foreign payments surpluses of over $1 billion in each of those years. By the end of 1986 the annual inflation rate had plummeted from triple digits in 1985 to about 20 percent. [redacted] 25X1

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We believe that other events were more important to the success of Israel's stabilization program than cuts in defense spending:

- Israel received US supplemental assistance of $750 million in both 1985 and 1986. These funds were responsible for most of the foreign payments surplus in those years, in our judgment.
- The near halving of world oil prices between 1985 and 1986—to about $15 per barrel—saved Tel Aviv roughly $240 million in foreign exchange, according to official statistics.
- Israel had a $100 million savings on foreign payments as a result of lower world interest rates, according to the US Embassy. [redacted]

In 1987 increases in both foreign and domestic military spending helped reverse favorable trends in the budget and foreign payments. Concerned about the impact of a smaller defense budget on the IDF's deterrent capability, military planners—especially Defense Minister Rabin—rejected additional restraints on military spending. As a result, domestic military expenditures increased last year about 10 percent over 1986 to $2.8 billion, according to the US Embassy. We estimate that direct military imports in 1987 more than doubled the 1986 level, climbing to about $2.6 billion. This increase was an important reason behind the deterioration in Israel's foreign payments that swung from a $1.3 billion surplus in 1986 to over $1.1 billion in the red last year, according to official statistics. [redacted]

Syria. By 1986, Syria's high military spending, combined with many other factors, caused the economy to slip into crisis. The oil market crash hit Syria particularly hard, cutting sharply into oil export earnings, worker remittances, and, to a lesser extent, Arab aid payments. Foreign exchange reserves, always low, fell to practically nil during the year, and the Syrian pound lost half its value in the unofficial market. We estimate real gross domestic product shrank, and growing numbers of public and private businesses had to close or curtail operations. [redacted]

Austerity measures, though not comprehensive, were introduced in 1986 to reverse the economic decline. Imports were slashed by $1 billion, with sharp reductions in petroleum, foods, machinery, and consumer goods. Defense and other expenditures were frozen or cut to slow inflation. We calculate that military spending, including imports, may have declined 25 percent to about $3 billion. Damascus also introduced new taxes to collect customs fees lost on smuggled consumer goods and reduced subsidies for gasoline, meat, and other items. Several partial devaluations were announced, including an exchange rate that implicitly recognized the black-market rate. Compounding the unfavorable economic environment were the economic and political sanctions imposed in November 1986 by the European Economic Community (EC) and the United States in response to Syrian involvement in terrorism, which represented an unprecedented psychological shock to the economy and prompted the leadership to initiate several reforms. 25X1
[redacted] 25X1

Damascus continued to adhere, more or less, to its austerity measures through 1987. Damascus reduced the 1987 planned budget deficit in domestic currency by 21 percent and even cut the defense budget by 3 percent, although defense remains the dominant spending category. Total spending was cut 5 percent, and Damascus optimistically expects strong growth in revenues. Civilian current expenditures—including education, subsidies, and interest on public debt—will remain constant, and investments continue to bear most of the cuts. Total investments were budgeted to decline 10 percent, with Damascus favoring investment in electricity and irrigation projects over industrial enterprises. [redacted] 25X1

Syria's austerity policies and the recent increase in oil output have not corrected the economy's fundamental problems. As a result, Damascus will probably be forced to decide between cuts in military spending and civilian investment, and economic growth will remain sluggish. We believe Assad has little desire to take the dramatic, often painful steps to correct Syria's basic weaknesses—the heavy military burden, overvalued exchange rates, inefficient public sector, weakened private sector, and poor fiscal performance. Instead, we are confident the regime will cling to its present strategy and rely on stopgap measures to forestall crises. Moreover, the regime can rely on its powerful internal security apparatus to quell public objections to high defense spending. [redacted] 25X1

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Military Consequences

Although the armed forces of both Israel and Syria have felt the impact of austerity, we believe the military balance has remained heavily in Israel's favor. Tel Aviv's spending reductions include postponing procurement, drawing down inventories, and scrapping the Lavi program. These measures have had little qualitative impact on the relative combat capabilities of Israel. Damascus's military buildup has slowed considerably in recent years, and reductions in personnel, training, active units, and imports have combined to weaken offensive and defensive capabilities.

Israel. Although budgetary belt-tightening—affecting all branches of the IDF—has trimmed operational expenses, it has not led to major reductions in manpower or hardware that would mean major cost savings over the long term. According to US Embassy discussions with Ministry of Defense officials, active military units have drawn down their armor and artillery inventories by 10 to 15 percent since 1985, mainly by retiring older equipment to the reserves. Despite this transfer, the IDF retains its preausterity inventory of about 3,900 tanks and approximately 2,000 artillery pieces.

The cancellation of the Lavi fighter-aircraft project—the centerpiece of Israel's defense modernization effort—was the most important concession the government made to the reality of scarcer financial resources. By the time Tel Aviv scrapped the Lavi in August 1987, the government had sunk nearly $2 billion in US funding into development of the fighter. Had the Lavi gone into production, these costs would have made the airplane substantially more expensive than the $17 million price tag of the US F-16, its most likely alternative. Ironically, nearly all the IDF leadership, led by the Minister of Defense, supported the decision to abort the Lavi program. They feared the program would have prevented the development of other weapon systems essential to modernizing the IDF and, at worst, would have crippled the economy, according to US Embassy reports.

The military also postponed some procurement, reduced the level of maintenance, and curtailed training programs, according to the US Embassy. For example, armor units cut engine-running hours for training purposes roughly 50 percent, and the air force decreased flying time for its pilots. The IDF has reduced active-duty manpower about 10 percent and cut the civilian work force at the Ministry of Defense about 15 percent since 1984, primarily through attrition, according to the US Embassy. The IDF also reduced purchases from Israel's defense industry. Other cost-cutting measures include a sharp drop in the general standard of living within the IDF. The Embassy reports that rations are spartan and that housing upkeep has almost disappeared. Although spending cutbacks have resulted in a slightly leaner 25X1 IDF, they have not significantly reduced the IDF's combat capability nor seriously eroded morale, in our view. 25X1

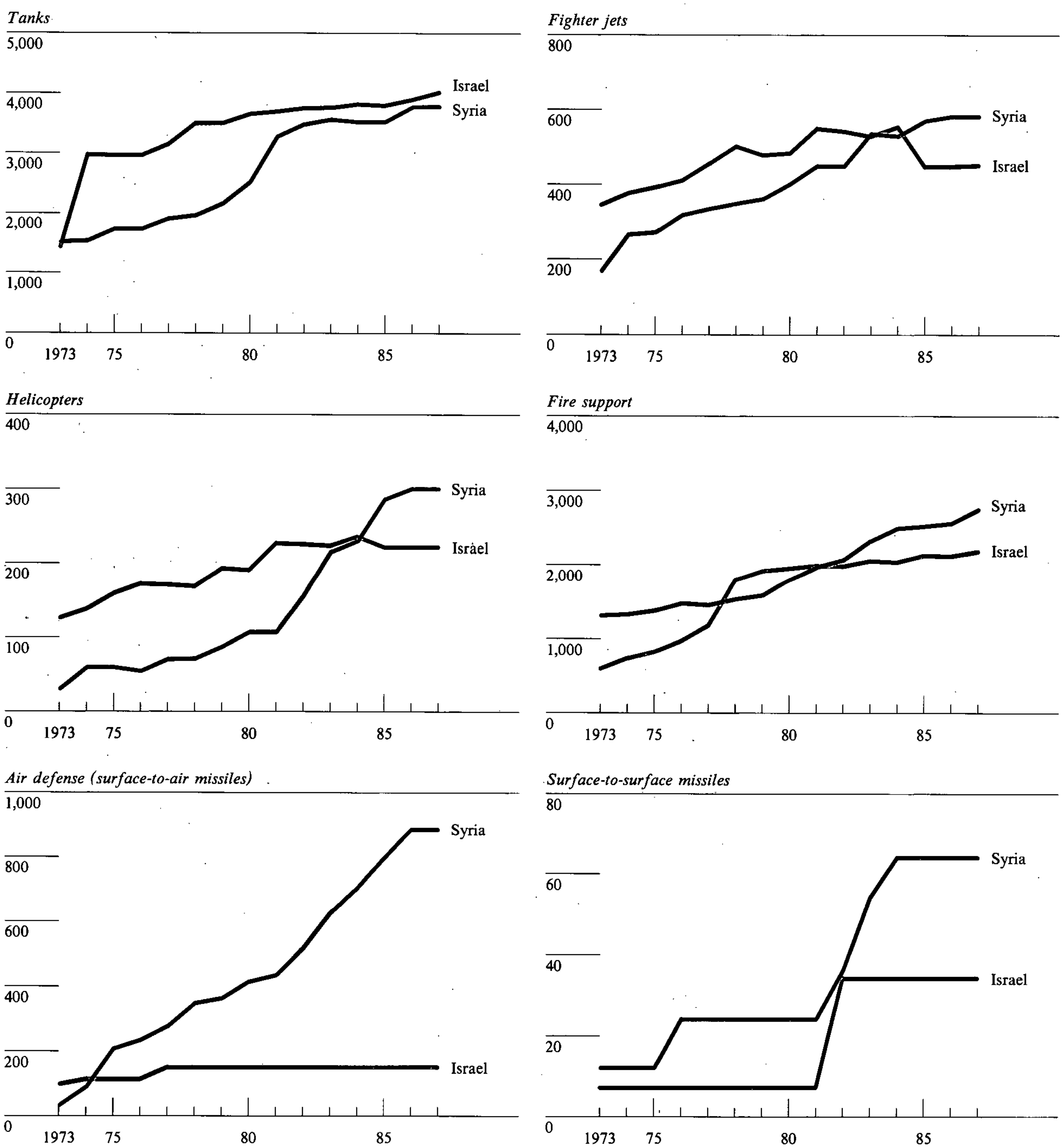
Syria. In Syria, the weak economy has thwarted Assad's efforts to attain strategic parity with Israel and forced substantial reductions in military spending. Most cuts were initiated in late 1986 and involve the Army. We believe that many of the recent measures, such as reorganization of the ground forces, were made at the Soviets' behest and are designed to cut costs, streamline the overgrown Army, and boost operational efficiency. There is little evidence of 25X1 economy efforts in the Air Force, air defense, Navy, or specialized units such as electronic warfare and communications. 25X1

Syria's most visible cuts are in personnel expenditures. The basic goal is to reduce the number of relatively well-paid reservists and replace them with professional officers and lower paid conscripts. Recent actions, such as early retirements for officers, shortened active-duty requirements, and the cancellation of combat pay in Lebanon, probably reduced the size of the ground forces and, according to Israeli estimates, total defense outlays by 5 percent. 25X1

Perhaps most important for Syrian combat readiness, the military is releasing all reservists at the end of their tour of duty. Syria formerly retained reserve officers, especially those with technical skills, on 25X1 active duty long beyond their required length of service. Such a move will reduce the number of skilled

Figure 7
Israel - Syria: Military Balance, 1973-87

Note scale change



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personnel and, for at least the near term, harm capabilities—especially in the highly technical air defense and communications fields. [redacted]

Compounding its personnel weaknesses, Syria is experiencing shortfalls of military imports. There is a chronic shortage of medical and pharmaceutical supplies at Syrian military and civilian facilities—a situation made worse by the cancellation of pending supply contracts in early 1987. Austerity also has forced reductions in spare parts for equipment and Western-origin goods. Syria could not afford upgraded technology for its Soviet-made tanks and suffered a shortage of spare parts. [redacted]

Compared with Israel, Syria's support for troops is deficient. Damascus's total spending per man in uniform is decreasing and amounts to about $8,000 annually. This amount is about half of Israel's spending, demonstrating the capital-intensive nature of Israel's technologically advanced armed forces and their superior training. Syrian troops receive an inadequate allocation of essentials such as food. Administrative units are allocated the equivalent of only $6 monthly to cover each soldier's food ration. [redacted] 25X1 25X1 25X1 25X1

Since late 1985, Damascus has sharply curtailed its military training. [redacted] the primary constraints on training are inadequate stocks of fuel and ammunition. [redacted] 25X1 25X1 25X1

Damascus has suspended several construction projects and reduced fringe benefits for officers. [redacted] 25X1 25X1

We believe that many benefits formerly enjoyed by most officers are now limited to selected colonels and generals. [redacted] 25X1 25X1

To compensate for scaling down its conventional forces, Damascus is expanding its chemical and biological weapons program. The importance attached to

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Scaling Down the Syrian Army

Consistent with its greater emphasis on efficiency in the Army, Damascus made an important decision in late 1986 to reduce the number of active brigades by 25 percent. [redacted] *the Soviets pushed for the deactivation of selected brigades, a move that will boost manning levels of remaining units to about 70 percent of authorized strength and ultimately may enhance unit training and combat effectiveness. The plan entails storing the equipment of an entire brigade from each of the regular ground forces divisions and distributing most personnel to the unaffected brigades in the same division.* [redacted]

The deactivation effort apparently has proceeded slowly. By late 1987 we had observed only three brigades that were deactivated with their equipment stored, [redacted] *It remains unclear whether the reorganization is temporary or a permanent change for the Army. We suspect that chronic manpower and financial constraints will make the reorganization a long-term phenomenon. In addition, Syria's plans to create two new divisions in northern Syria probably have been shelved. Syria will continue the buildup of a new elite armored division in Damascus, the Republican Guards.* [redacted] this program is reflected by the generous funding Syria provided to the Scientific Studies and Research Center, a facility associated with the program. The US Embassy in Damascus reported that the center received a substantial share of the second Baghdad payment from Riyadh in 1987, despite the critical need for funds to relieve a wheat and flour shortage at the time. Later in the year the center received the majority of another cash grant from an Arab Gulf state. [redacted]

Outlook

We believe that Israel's defense spending will pull further ahead of Syria's over the next several years. After two years of austerity, Israeli military spending is starting to expand again. The IDF's claim on resources will retard civilian investment and probably widen the budget deficit, but we believe that political consensus in Tel Aviv will override economic pressures to reduce defense spending. Damascus's resolve to maintain defense spending is equally strong, but the weak economy probably will force further reductions in defense spending. Projected gains in real gross domestic product growth and the current account balance will not obviate Damascus's need for massive foreign support. [redacted]

Israel. Although Tel Aviv has reduced defense spending over the past two years, we believe that the IDF's reemphasis on technological superiority under the leadership of its new Chief of Staff, Lt. Gen. Dan Shomron, probably will preclude further reductions in Israel's defense burden into the 1990s. Shomron's program calls for increased reliance on costly high-technology weapon systems, balanced by a slight reduction in the size of the IDF, to meet the requirements of the future battlefield. According to the US Embassy, a recent Knesset subcommittee report unanimously endorsing Shomron's doctrine reflects the broad support the plan enjoys among civilian and military officials, academics, and the defense industry. [redacted]

We believe that Israel will maintain total annual defense spending in the $4.5-5.5 billion range through 1990—a development that will add to the strain on foreign payments. Israel's shopping list for high-technology arms will mean continued large defense import bills. Israeli acquisition plans call for spending about $5.7 billion on major new US weapon systems and upgrades between 1987 and 1991, according to the US Embassy. Given current trends for other foreign exchange income and spending, our econometric model indicates that the current account deficit will hover around $1 billion annually through the end of this decade. [redacted] 25X1

In making the most of its allotted resources, we expect that the IDF will sustain spending for important procurement programs and operational requirements while continuing to stretch out and reduce selected low-priority procurement programs, to eliminate marginal maintenance and training, and to trim research and development projects. Defense Minister Rabin, who last year lobbied successfully to keep the defense budget intact, demanded a nominal increase of about $30 million for the defense budget for the fiscal year that began 1 April, according to the US Embassy. Although the Knesset has not approved a military supplement, Rabin is supported by most political leaders, who agree that Israel's security depends on a strong deterrent force. [redacted] 25X1 25X1 25X1

The IDF's intention to acquire more modern and sophisticated armaments almost certainly ensures that military spending will contribute to the heavy burden defense imposes on the Israeli economy. In addition to the production of new tanks and the purchase of fighter aircraft, the Israelis are planning to enhance the helicopter fleet and to modernize the navy. Such advanced and high-technology weapon systems will be increasingly expensive to operate and maintain. [redacted] 25X1 25X1

Funds saved from the cancellation of the Lavi will not ease the defense burden by freeing money for use in the civilian sector. The IDF intends to use the money originally allocated for the Lavi in other priority weapon programs, including the purchase of additional US F-16s. Savings also will go toward the procurement of AH-64 Apache attack helicopters that the

[redacted] 25X1 25X1

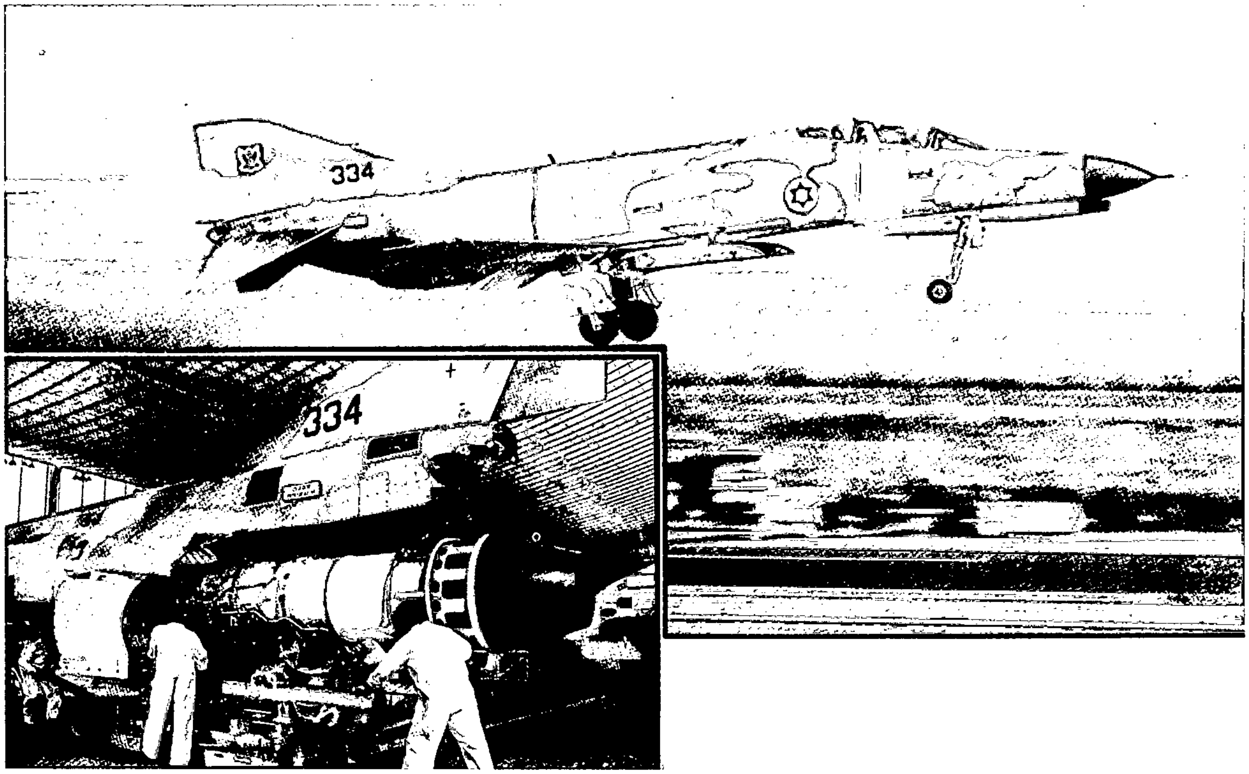

Figure 8. Israel is looking to sophisticated—and more expensive—aircraft, such as the Phantom 2000, to upgrade its military capability. [redacted] 25X1

IDF could not afford because of the excessive cost of the Lavi. In addition, the Ministry of Defense is using funds originally allocated for the Lavi to employ laid-off workers in other aerospace projects or elsewhere in the defense industry. [redacted]

Although Israel will attempt to sell surplus weapon systems overseas to earn additional foreign exchange, we believe Israeli arms exports will stabilize in the years ahead partly because of increased competition from other producers and weaker world demand. Israel most likely will focus on traditional markets in Latin America for its Kfir fighters and excess A-4 [redacted] could have as many as 100 Kfirs available for sale in 1988. The Israelis will look to China and the United States—its leading arms export markets—for sales of other military equipment. [redacted] 25X1

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Tel Aviv will find it politically difficult to reduce budget spending in the civilian sector enough to compensate for domestic military spending that is budgeted at about $3.1 billion in fiscal 1989. The new Knesset-approved budget calls for civilian expenditures of about $27 billion—a 38-percent increase over fiscal 1988. With a national election scheduled for this November, Israeli legislators apparently are unwilling to reduce allocations for politically sensitive

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[redacted] 25X1

Table 4
Israel:
Major Arms Customers, 1980-87

	Major Sales
Argentina	Mirage III aircraft
Chile	Super Sherman M4A1 tanks
Colombia	Kfir fighter aircraft (proposed)
Ecuador	Kfir C2 fighter aircraft
West Germany	Tank ammunition
Iran	Artillery, ammunition, aircraft, and spare parts
South Africa	Patrol boats, howitzer technology, and remotely piloted vehicles
China	Python III air-to-air missile, avionics, and tank upgrade kits
Venezuela	Probably Mapats antitank guided missiles
United States	Popeye guided munition

areas such as health and education, as well as outlays for an assortment of special interest programs. Other spending categories—including salaries and entitlements—are virtually locked in. For example, 80 percent of the education budget is earmarked for wages, and another 10 percent is a fixed contribution to the municipalities, according to an Embassy source.

Although domestic military spending provides jobs and income in the near term, it will have a debilitating effect on economic growth in the long run, in our judgment. Military spending—both for direct purchases and debt servicing—will continue to siphon off resources that could be used for civilian investment. Moreover, recent legislation prohibits the government from turning to the Bank of Israel for money creation or new loans to finance budget deficits. Because other financial institutions are required to give preference to government lending requirements, this prohibition will make it more difficult for other investors to obtain funds in the capital markets. This combination will contribute to a slowdown in real investment, which is the key to future growth. Our econometric model of the Israeli economy projects the growth in real investment will fall from 5.8 percent in 1987 to

Israel: Economic Impact of Unrest in the West Bank and Gaza

The Palestinian uprisings that began last December in the West Bank and Gaza are affecting Israel's economy. The Ministry of Economics and Planning estimates that through February the disturbances set Israel back roughly $320 million in direct military expenses and indirect costs such as lost output and sales. The almost certain continuation of the unrest could reduce annual gross domestic product growth by at least 1.5 percent in 1988. 25X1

The violence has forced higher spending for Israeli military and police activities in the occupied territories. The Israel Defense Force demanded last February a $30 million increase in the defense budget to support the doubling of troop strength in the West Bank and Gaza. The uprisings also have cut into civil administration tax revenues. The US Embassy reports a drastic decline in receipts from the value-added tax as well as other business and consumption taxes. 25X1 25X1

Military curfews and civilian strikes have created temporary labor shortages in Israel in sectors such as agriculture and construction that employ Palestinians. The Israeli Employment Service calculated that only about 60 percent of the approximately 109,000 Palestinians who hold jobs in Israel reported for work last February. Expanded military reserve duty also has reduced the number of Israeli workers available to the economy. 25X1 25X1

The uprisings have disrupted Israeli commerce with the West Bank and Gaza. Retail sales among Israeli merchants in Jerusalem have dropped noticeably, according to the US Embassy. The Embassy also reports that a recent surge in bad checks constitutes part of some $40 million that West Bank and Gazan merchants owe Israeli businesses. After a record month last January, tourism bookings—which account for more than 22 percent of Israel's foreign exchange earnings from services—are off significantly, and cancellations are running about 20 percent. 25X1

3.7 percent in 1988. We anticipate a further decline in investment growth to less than 2 percent by 1989.

We believe that economic growth will not be rapid enough to offset the effects of increased military spending for at least the remainder of the decade. Serious structural problems—in particular, high inflation, inefficient capital markets, and a heavy tax burden—will persist. We foresee scant growth in investment. As a result, we expect real gross domestic product growth will be less than 3 percent into the 1990s, or not much above the average of 2.5 percent during the early stages of the stabilization program in 1985 and 1986. If the gross domestic product growth rate were to reach the planned range of 3 to 4 percent, the US Embassy reports—and we agree—that it probably would be insufficient to reduce the defense burden much below the current level.

Moreover, Tel Aviv is unlikely to sustain the momentum of its structural adjustment programs—in particular, tax reform and restructuring the capital market—that are preconditions for sustained economic growth. The Embassy reports that the pace of economic reform has slowed. Israelis believe they have sacrificed enough and do not want to see a further decline in their standard of living, according to public opinion polls. With the approach of the national election, we believe neither Labor nor Likud will risk alienating its constituencies by pressing for additional reforms.

Continued US assistance, in our judgment, will be the critical factor that determines Israel's ability to import the military hardware needed for its modernization program without bankrupting the economy. Israel has no realistic alternative source for arms imports. In the event of reduced US assistance, Tel Aviv might turn to West European suppliers for sophisticated weapons. Because of cash-flow problems of their own, however, many of these countries would be unwilling to provide the financing Israel would need to purchase weapons packages. Moreover, several of these countries probably would be reluctant to sell to Israel for fear of antagonizing Arab states that might retaliate with trade boycotts. On the plus side,

Figure 9
Israel - Syria: Real GDP Growth, 1980-90

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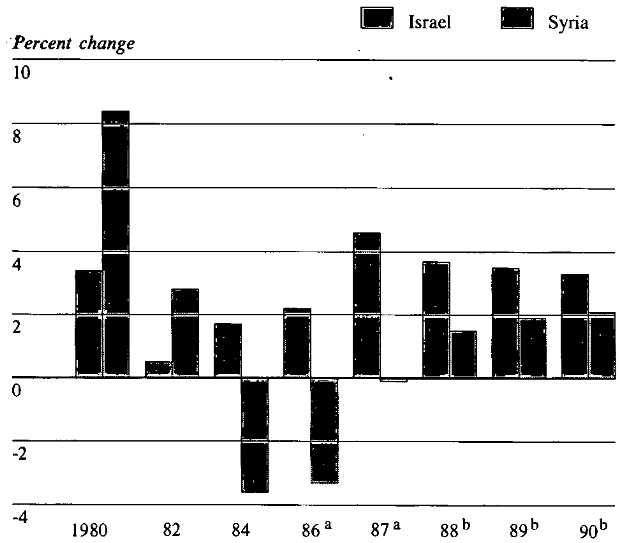

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[a] Estimate.
[b] Projection.

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new US military assistance will impose no additional defense burden on Israel's economy because it will all be grant aid tied solely to arms purchases. 25X1

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Israel still faces the prospect of growing repayments on previous US military-related loans well into the 1990s. Scheduled annual debt service on US foreign military sales loans will range between $1.0 billion and $1.2 billion from 1988 until 1997, according to Ministry of Finance data provided to the US Embassy. From 1990 to 1993 debt repayments will exceed the current level of US economic support funds of $1.2 billion. As a result, Israel has almost no chance of using the funds for productive civilian purposes in the years ahead. If Tel Aviv continues using this funding to repay military debts, it will be able to meet its total debt obligations without serious problems.

Otherwise, Israel faces the prospect of sharp cuts in foreign spending unless it can obtain some form of debt relief. [redacted]

Past borrowing needed to maintain high levels of military and civilian spending will leave Israel the task of servicing a sizable share of its domestic debt before 1990. By March 1989 the government must repay over $5 billion due on routine debt redemption, according to the US Embassy. Available data on payments schedules for several categories of domestic debt indicate that Tel Aviv must repay over half the approximately $22 billion owed on these obligations before 1991. Not included in published figures are additional payments owed on bank investment and savings portfolios on deposit with the Ministry of Finance. Accounting for almost one-third of the total domestic debt as of March 1986, such portfolios are the government's largest single source of debt financing. Without larger cuts in either military or civilian spending, the government will have to borrow more in the years ahead—a prospect that will encourage inflation. [redacted]

Syria. Despite Assad's quest for military parity with Israel, we expect that economic realities will keep Syria's military buildup at a near standstill through the end of this decade and force additional reductions. Syria cannot afford to increase military spending without a significant boost in outside support from Moscow or the moderate Arab states. Even if the current level of aid is sustained, military spending is likely to decline because of the competing demands of a surging food bill and needed investments in agriculture and electrical power generation. [redacted]

We expect Damascus will improve economic performance by 1990, but not enough to allow a renewed rise in military spending. Growing popular frustration over economic hardships probably will weaken Damascus's resolve to reduce the civilian budget further, and costly, although reduced, subsidies for consumer items and public enterprises will remain intact. Syria's rate of investment and economic growth will continue to depend on the availability of foreign resources and, without a substantial boost from foreign benefactors, should be sluggish through the end of the decade. Consequently, we are projecting growth of real gross domestic product to average less than 2 percent, an improvement over the past four years but still weak. [redacted] 25X1 25X1

Syria's foreign payments outlook, even excluding military transactions, remains troubled. The projected increase in oil production in 1988 and beyond will almost eliminate Syria's need for crude oil imports, but cost recovery payments to foreign oil companies will partly offset the financial gains from new oil. We project Syria's civilian current account deficit to decline in 1988, but foreign reserves will remain low. Beyond 1988 payment obligations to foreign oil companies, if met, and probable increases in food imports are likely to bounce the current account deficit back to current levels. Continued high arms imports from the USSR and other suppliers will aggravate foreign payments deficits. [redacted] 25X1

Securing firm aid commitments from the Arabs will remain near the top of Syrian priorities at least through 1990. Baghdad payments officially end in late 1988, but we believe that current donors—Saudi Arabia, and possibly the United Arab Emirates and Kuwait—will continue providing some assistance beyond 1988 on a bilateral basis. The key variables are the Arab donors' perception of Syria's role as Israel's principal military rival, donors' concern over possible Syrian retaliation for an aid cutoff, Syrian efforts to reduce tensions between Iran and the Gulf states, and Assad's willingness to moderate his hard line toward Iraq and the Palestine Liberation Organization (PLO). Damascus's stubbornness on these issues could derail Arab aid after 1988, forcing a sharp contraction in Syrian military and civilian imports. [redacted] 25X1 25X1 25X1

We believe the Syrian-Soviet relationship will remain stable, and military and economic ties may grow stronger. Despite Damascus's poor payment record and Assad's political differences with Soviet leader Mikhail Gorbachev, Moscow and its East European allies appear willing to continue underwriting Syria's military and economic development efforts, especially

Consequences of Increased Syrian Oil Output

Damascus is looking to the oil sector to extract the country from its economic morass, but increased oil production alone will not erase Syria's deep-seated economic weaknesses. Syria has expanded crude oil production by over 50 percent since 1985 and is producing about 250,000 barrels per day (b/d). The higher oil output includes about 100,000 b/d of low-sulfur light crude that is well suited for blending with heavy crude from Syria's older fields. The principal benefit from higher oil production will be reduced oil and product import requirements and possibly a rise in exports. We calculate that Syria will generate an oil trade surplus at least through 1990 and will improve its current account. Cost recovery and profit payments to Syria's foreign partners in the oil sector initially will absorb almost half the new oil wealth. Despite the benefits of new oil production, we expect Syria's foreign payments situation will remain severe and constrain military spending.

where there is a perceived payback. We believe mutual Syrian and Soviet needs for strategic cooperation will override Syria's debt problem, and Damascus may grow more reliant on Soviet economic support to compensate for the deterioration in commercial relations with the West. Evidence of the strong ties is the large jump in Soviet arms deliveries to Syria following Assad's visit to Moscow in April 1987 and the Soviets' apparent agreement to reschedule Syria's debt.

Syria has little latitude to diversify its arms inventory. Syria's relations with the West and its economy are too fragile to permit a dramatic shift away from Moscow. The Soviets seem to recognize Syrian vulnerabilities and will try to gain leverage over Damascus through manipulation of arms deliveries and promises of debt relief. We suspect that Damascus may accept greater Soviet influence over arms procurement and order-of-battle decisions, but we doubt that financial pressures alone will produce increased Syrian cooperation with Moscow on regional issues, such as reunification of the PLO and Iraqi-Syrian rapprochement, that Damascus perceives as contrary to its interests. 25X1

Coda: Impact on the Military Balance

Israel will maintain its qualitative military superiority over Syria and could defeat the Syrian forces in a conflict within the next five years, in our judgment. Recognizing the military must adapt to the realities of Israel's limited resources, IDF doctrine is slowly moving toward a smaller force structure while placing greater emphasis on high-technology weapon systems to preserve the IDF's qualitative edge. The military, for example, will concentrate increasingly on precision-guided munitions and develop systems that reduce the risk of casualties, according to the US Embassy. We cannot rule out an expanded role for chemical-biological weapons, given Syria's buildup in this area. 25X1

The temporary shrinkage in the Israeli defense budget—now reversed—will not reduce the IDF's capability to repel a potential Syrian attack, in our view. The Israeli air force and armor units remain the best in the Middle East and are more than a match for potential Arab foes, according to US Embassy reporting and our analysis. Israeli military training, leadership, and intelligence—as well as command and control—are far superior to that of Syria's armed forces. 25X1

Despite the small size of its active-duty units, Israel would achieve a decisive victory over Syria should war break out during the next several years, in our judgment. Innovative uses of resources and flexibility will give the IDF a decided tactical advantage on the battlefield of the future. Although most of Israel's armor units are manned at only about 5 percent of their authorized strength during peacetime, the IDF can muster its 400,000-member ready reserve in about 24 to 48 hours in the event of an imminent threat. Moreover, the military has a well-developed logistic and maintenance system to support the IDF in sustained combat. 25X1

The military implications of Syrian efforts to cut waste and improve efficiency will be far reaching. Reorganization of units may help improve combat readiness of the remaining ground forces, but overall capabilities are almost certain to decline because of inadequate field training and equipment maintenance and a slower introduction of new technology and equipment. Development of Syria's other forces—air, air defense, and naval—will continue at roughly the same pace as in recent years—too slowly and unevenly to challenge Israel's wide qualitative edge.

Syria's willingness to sacrifice critical personnel expenditures rather than major weapon systems imports will increase its key military weakness—the quality of its manpower. Damascus has concentrated on buying advanced weapon systems while ignoring its more important deficiencies in leadership, training, and morale. Severe manpower shortages in the technical fields probably will become worse by 1990, and Damascus may have to resume involuntary extensions of duty tours. The role and influence of Soviet advisers and technicians probably will increase as technical manpower problems worsen. In addition, we expect Moscow to increase its involvement in Syria's financial management and weapons procurement strategy and try to recoup losses where possible. 25X1

Finally, and perhaps most important, Damascus will continue to expand its chemical and biological warfare capability as a cost-effective deterrent against 25X1
Israel that Assad hopes will partly compensate for its lagging conventional capabilities and will strengthen its strategic deterrence against Tel Aviv. 25X1

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