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Task Force on Energy, 1976-1979.

Irving Trust Company **A Charter New York Bank**

One Wall Street, New York, N.Y. 10015

Economic Research
& Planning Division

The Economic View from One Wall Street

July, 1977

ENERGY POLICY TRADE-OFFS

The President's energy program is designed to encourage the American people to use less energy in their daily activities. The President hopes to accomplish this by taxing petroleum and high fuel-consuming equipment, and by awarding tax rebates or income tax credits for the adoption of more energy-efficient methods of fuel consumption. For the consumer, it means more expensive gasoline, heating oil, gas, electricity, and low-mileage cars. These higher costs will be offset to some extent by across-the-board tax credits and by specific rebates for those who purchase smaller cars, insulate their homes, or adopt solar heating techniques. A similar set of taxes and credits will apply to the businessman, who will either adopt more energy-efficient means of production or try to pass on his higher energy costs to the consumer.

No one really knows what the program's net effect on the economy or on American lifestyles will be. The Government suggests that the economic impact will ultimately prove pretty much neutral: it is the Administration's hope that higher energy prices will be offset by less energy consumption, thereby keeping total energy costs from rising much more sharply in the future. The Government is guessing that jobs lost in industries hurt by higher energy prices will be found in new or expanded industries providing insulation, energy-efficient equipment, and new energy sources. If, in fact, the Government is right, we will all enjoy a cleaner environment and suffer no significant loss of jobs or real income. But what if the Administration is wrong? What if higher fuel prices do not substantially restrain fuel consumption, but simply lead to higher rates of inflation?

President Carter's energy program is a move in the right direction, but it is only a half step. It puts heavy emphasis on conservation but a low priority on increasing new energy supplies. Some fundamental choices have to be made between an energy policy which stresses conservation--as the President's does--and one which also emphasizes new supply. Those who favor conservation point out the benefits of a cleaner environment and a lower rate of economic growth. Those who favor new supplies emphasize the need for more jobs and for a higher rate of economic growth. Others see the redistribution of the economic pie as the most important element in the energy equation, stressing the need for sharing the burdens of higher energy costs more equitably and for preventing energy producers from making windfall profits from the growing resource scarcity. Still another view suggests that monopoly pricing by the oil-exporting countries represents the principal cause of the energy crisis. And within these groups there are many shades of opinion, making energy one of the most divisive issues in American politics today.

There are valid elements in each of these viewpoints, and the Administration has tried to incorporate many of them into its proposed National Energy Policy. Yet the broad energy policy trade-offs need further explanation and discussion.

(1) Energy and the Economy

Three years have passed since the abrupt increase in the relative price of energy. During this time, the U.S. economy has experienced a sharp recession and a subsequent economic recovery. For that recovery to be sustained, the capacity to supply new goods and services will have to be increased. And that increase will have to take place despite a higher relative cost of energy than in earlier periods when capacity was increased.

The high price of energy today is causing both the cancellation of capital projects that are uneconomical and higher prices for the final outputs of those capital projects that are undertaken. The result is that the high cost of energy becomes--simultaneously--both an inflationary and a recessionary force. If business is to expand capacity there must be a reasonable expectation that the output can be sold at prices high enough to yield an acceptable return on investment. And the capital projects that are being postponed or cancelled are delivering neither the jobs nor the increased productivity needed in an expanding economy.

These energy-related distortions have blunted the conventional tools of economic policy. The twin evils of unemployment and inflation today do not respond readily to conventional monetary and fiscal policies. It would help to supplement them with policies to encourage capital spending--in particular, spending on energy-related projects which would conserve energy or increase energy supply and which would be economically justified. Government economic policy needs to maintain the incentives for profitable private investment in an economy where the distortions of the energy crisis join a growing list of social and environmental costs that business must pay. Without such private investment, the prospects for increasing the employment base of the U.S. economy in a noninflationary manner are bleak indeed.

The relationship between energy and employment is such that it takes more and more energy to supply a job at the level of productivity we have come to expect from the U.S. economy. Increased energy use is a prerequisite to the increased capital intensity of the U.S. employment structure. Increased energy intensity makes for increased labor productivity and consequently for the gains in real income which we call prosperity. Thus our prosperity is based on a high per capita energy consumption; we require large amounts of energy to produce those goods and services which give us a high standard of living.

The historical growth of the economy suggests that the increases in energy consumption and in productive employment are jointly related to the growth of output. Output must grow faster than employment to generate increased productivity and real per capita income gains (prosperity again). But if output does grow materially faster than employment, so will energy use. Despite the dramatic shift in employment away from manufacturing and capital-intensive industries generally, the consumption of energy per productive job has continued to increase as an integral part of the process of capital formation.

There is an often-used rule of thumb that it takes a 3% growth in real output to generate a 1% decline in the unemployment rate. With energy use likely to grow around two-thirds as fast as general economic activity, a corollary rule of thumb would be that it takes a 2% increase in energy use to bring about a 1% decline in the unemployment rate.* We estimate that the unemployment rate in 1977 will average close to 7%. To reduce this rate to 5% by 1980, around 6 million new jobs must be created to employ both those who are currently out of work as well as new entrants to the labor force. This means a growth in employment of 2% per annum between 1977 and 1980 would be consistent with a 6% rate of growth in real GNP. The difference between the growth rate of real GNP (6%) and that of employment (2%) represents growth in output per job, or productivity increases (4%). And these increases depend upon a growing supply of energy. Thus implicit in these employment objectives is a 4% rate of growth in productivity; it is likely that energy use will have to grow commensurately. In other words, if the United States economy is to provide 6 million new, good-paying jobs between now and 1980, energy use will have to grow at the rate of around 4%.

*For a fuller explanation of the energy, GNP, and employment relationships, see "Employment and Energy Independence," Business Economics, September 1976.

We are faced with the dual problems of unemployment and excessive dependence on foreign sources of energy. We have idle manpower resources, and we need a greater domestic supply of energy. Yet we have been unable to weld together an effective employment and energy policy. Solutions will be neither quick nor easy. But the longer we delay, the greater the vulnerability of many American jobs to foreign economic and political pressures. Between now and 1980, it is likely that the U.S. dependence on foreign oil will not decrease from its present high level. The advent of the Alaskan pipeline will only arrest the decline in U.S. oil production, while delays in increased coal production and nuclear power will have to be compensated for through increased oil imports. While we have imposed restrictions on rising domestic energy costs, we must still pay the price internationally. What had been costing us $7 billion to $8 billion annually for imported oil before the 1973 embargo now costs $40 billion. The more time we waste in resolving our domestic energy supply problem, the more oil we will have to import from OPEC--at what will likely be ever-rising prices.

In 1976, the U.S. spent about $38 billion for imported oil--an amount almost equal to our capital investment in domestic production of energy. Compare that to 1962, when the U.S. invested around $10 billion in domestic energy while paying $1.8 billion for oil imports. Within 15 years, our spending on imported oil has grown from an amount equal to less than 20% to almost 100% of our domestic energy investments.

A proportion of those resources devoted to importing oil could be fruitfully invested in increasing the supply of U.S. energy and in creating productive employment. Recent studies have suggested that replacing about 2.0 million barrels per day of U.S. oil imports with an equivalent amount of domestic energy would ultimately generate as many as 800,000 productive new jobs in the U.S., depending upon the particular policies adopted. According to one study, about 25% of those new jobs could come from additional domestic energy production and from the construction of new plant facilities. The balance of new growth in employment would be derived from non-energy sectors, which would produce more goods and services both to support the energy-producing industries and to supply what would become a generally faster-growing economy. Although the policy alternatives to achieve these improved employment opportunities may differ, the overall implication for the economy is the same: idle manpower can be put to work in the implementation of a policy of greater energy self-sufficiency.

(2) Energy and the Environment

Being on the side of a clean environment is as much a cliche as being on the side of Motherhood and Apple Pie. But decisions have to be made about priorities. The extreme environmentalist position questions the need for continued economic growth, arguing that we would all be healthier and happier with a slower pace of economic activity. While this utopian vision of society might appeal to a narrow segment of American public opinion, it is not a viable option in a world of competing claims on limited resources. Intergroup frictions would be exacerbated by a stagnating economy.

The more pertinent question is how to reconcile the widespread concern for a cleaner environment with the need for economic growth. The Carter program suggests that we can use less energy as we produce and consume the goods and services which make for a healthy economy. According to the Administration, the utilization of less energy per unit of output will help to preserve the environment while still maintaining a viable economy.

The tough trade-offs, however, are quantitative. How much can we go in one direction without jeopardizing the goals of the other? There are no simple answers, but a few observations might be helpful.

First, we have imposed many new environmental regulations without recognizing the increased costs of meeting these new standards. Energy costs have risen not only because the resources themselves have become scarce, but also because the techniques for producing and consuming these resources must now meet tougher environmental standards than in the past. At the same time, energy consumers have an understandably negative reaction to paying the higher prices which result from these increased costs. By proposing higher taxes on energy use, the Government is not only sending us a signal that we need to reduce fuel consumption, but also that we have to pay for the cost of maintaining a cleaner environment. Second, it is important to remember that because energy investments require very long lead times before any new production is available, the energy-producing industries need a consistent, long-term set of guidelines which they can be reasonably sure will be applicable at the time a new plant comes on stream. Indecision in Washington concerning the energy-environment trade-off and the constantly changing pattern of regulations have delayed new investment. President Carter's policy statement recognizes this issue and states: "Reasonable certainty and stability in Government policies are needed to enable consumers and producers of energy to make investment decisions."

Finally, nationwide environmental standards may be inappropriate, since it is the local community which must pay for the higher costs of a clean environment and make the decisions concerning the potential loss of jobs and income. Regional differences are significant, and local autonomy in the environment-energy trade-off should be preserved as much as possible.

(3) Energy and Equity

Since the American people became aware of the energy crisis, there has been widespread resentment against the oil industry for allegedly profiting unwarrantedly from the high oil prices imposed by the oil-exporting nations. As a result, sharing the burden of sacrifice equally between oil companies and their customers has become a constant theme of national energy policy. The former Republican Administration followed this theme when it proposed an excess-profits tax and the use of compensating payments to low-income groups as part of its attempt to decontrol U.S. crude oil prices. The present Democratic Administration follows this theme, too; it is keenly aware of the political barriers to allowing the revenues from higher oil prices to flow back to the oil producers. To quote President Carter: "If producers were to receive tomorrow's prices for yesterday's discoveries, there would be an inequitable transfer of income from the American people to the producers, whose profits would be excessive and would bear little relation to actual economic contribution."

The Administration's proposal for dealing with this equity issue, and at the same time for forcing the public to pay the higher international price in the interest of conservation, is to impose a tax on the difference between the present regulated U.S. price and the world price--the "crude oil wellhead tax". The revenues from this tax, which could be as high as $15 billion annually when fully implemented, would be rebated to the public in the form of income tax credits. The Federal Government claims that this approach would recycle these funds through the economy in a more equitable manner than the distribution arrived at through conventional private transactions. Unfortunately, higher taxes will not buy us one additional drop of domestic oil, whereas market prices for oil would inevitably stimulate domestic supply. And the Government's program would not induce very much conservation either, since the final price paid by the consumer would not be much higher than it is now.

It is a simple truth of resource economics that when incremental supplies become scarce those who own existing and less expensive supplies stand to make windfall profits. If these profits are reinvested in additional productive facilities, they serve a useful purpose. To the extent that they are not reinvested, however, many would argue that taxing them away would be appropriate. It would be logical (and easy) to devise a program to encourage reinvestments of these profits in new productive facilities by taxing that portion that is not so reinvested. Instead the Federal Government proposes to preempt any such windfalls and donate them to the consumer through a complicated scheme of wealth redistribution. This is bound to raise substantial controversy, concerned less with energy than with our tax and welfare goals.

(8) International Pressures

President Carter's energy package makes almost no reference to OPEC. Yet the American people are being asked to make sacrifices. Certainly a balanced program should include plans to dilute the price-setting powers of the cartel, so that ultimately market pressures would bring about lower prices. Present sacrifice should have the prospect of future reward.

The Administration contends that the world as a whole is facing a physical shortage of oil as early as 1985. That proposition is open to question. There is an economic shortage in the U.S. because controls hold prices below market clearing levels. The U.S. may have a physical shortage at current controlled price levels; but it is improbable that the world as a whole is facing such a shortage. By the end of 1977, OPEC will have excess capacity of 12 MMB/D, some 25% of world consumption. And that is only in terms of proven resources! According to even the most conservative geologists, ultimately recoverable oil reserves around the world are vastly in excess of what the world will need for several decades. If oil supplies run short in the near future, it will be because of pricing and politics, and because of technical factors such as very long production lead times.

Soaring energy costs today are less the result of impending physical shortage than of OPEC's monopolistic pricing practices. Until the OPEC issue is recognized, dealing with the physical shortage alone may be costly and ineffective.

In his energy program, the President has stressed the goal of reducing U.S. oil imports over the next eight years. Through a mix of energy conservation and new supplies of alternate fuels, the President hopes to gradually reduce our dependence upon OPEC oil supplies. Although the President did not explicitly state that one objective of his energy program might be to dilute the price-setting power of the oil cartel, the goal of reducing U.S. oil imports implicitly leads to the conclusion that the U.S. would like to achieve a greater influence over the setting of international oil prices. Thus, if our contention is correct that it is only the U.S. which has a temporary physical shortage, sufficient oil supplies will continue to be available from other countries. Therefore, we should be able to change the mechanism by which we import our oil today, and thereby at least try to obtain better commercial terms for our oil imports.

It is important for the nation to make every effort to come up with an approach for dealing with OPEC now, not only in terms of oil but also in terms of the petrodollar problem which has the potential for creating worldwide economic stagnation. Today, the international financial and economic forces are so linked with the energy problem that policies for dealing with each separately may not work; they can, in fact, prove counterproductive.

Arnold E. Safer

Irving Trust Company A Charter New York Bank

One Wall Street, New York, N.Y. 10015

The Economic View from One Wall Street

Economic Research
& Planning Division

ENERGY AND ECONOMIC POLICY: CONSTRAINT OR COMPLEMENT*

The economic policy debate today centers around the degree of fiscal stimulus required to "get the economy moving again". The pause in business activity during the second half of 1976 has clearly increased the unemployment rate beyond what most observers consider acceptable. The trade-off with inflation is less clearly defined, and represents the focus of real dispute between two essentially different perceptions of economic behavior. On the one hand, a well-publicized group of Democratic economic advisors has argued forcefully that the economic slowdown was largely caused by a short-fall in the government deficit. That is, the Ford Administration simply did not spend what had been budgeted, thus lowering the aggregate demand for goods and services throughout the economy. Although the federal deficit during 1976 was one of the highest in history, orthodox Keynesian doctrine suggests that insufficient demand stimulus was the cause of the slowdown. By implication, therefore, a higher level of fiscal stimulus would be the remedy. Several key Republican economic advisors have offered an opposing viewpoint. Inflation is the underlying cause of the economic malaise. As the consumers' real income is eroded by abnormally high rates of inflation, spending levels become dampened, especially in the volatile housing and consumer durables markets. The level of prices for consumer nondurables (food, fuel, clothing, etc.) is so high that consumers have all they can do to keep up with these necessities and relatively little is left over to make the large purchases of consumer durable goods. Acceptance of this thesis of an inflation-induced business slowdown suggests another set of policy prescriptions principally focused on a restrictive monetary policy to dampen inflationary expectations. In this view, tax cuts are not looked upon as primarily counter-cyclical tools, but rather should be accompanied by government spending cuts thereby shifting a greater proportion of aggregate demand to the private sector, but at the same time restraining the level of total demand.

Although there is something to be said for both of these approaches, I believe that there have been some fundamental changes in the U.S. economy caused, in large part, by the abrupt change in the relative price of energy. These changes seem to be related to the difficulty of the U.S. economy to respond on the supply side in its historical manner. I submit that one of the principal sets of supply constraints is intimately associated with the Energy Crisis. These constraints are both cyclical and secular, in the sense that they affect not only the course of economic recovery from its recession trough, but also impact the longer term expansion path of economic growth.

*Presented by Dr. Arnold E. Safer, Vice President, Irving Trust Company, at the Atomic Industrial Forum held in Washington, D.C. on January 11, 1977.

I do not refer primarily to a lack of physical supply, but rather to the high price of energy which forces either a cancellation of capital projects because they are uneconomic or requires a higher price for the final output which adds to inflationary pressures. Both of these are prevalent in today's energy-short economy and form an integral part of the so-called long-run capital shortage. The result is that the high cost of energy becomes both an inflationary and recessionary force at the same time. If capital projects are to be carried out in today's economy there must be a reasonable expectation that the output can be sold at prices high enough to yield an acceptable return on investment. To this extent, the abrupt and dramatic increase in oil prices has added an inflationary underpinning to the production of most goods and services in the U.S. economy, and the series of second and third order inflationary effects have not yet been fully digested into the cost-price structure of the economy. At the same time, because of the need by consumers to spend more on energy and less on other goods and services, those postponed or cancelled capital projects are delivering neither the jobs nor the increased productivity which is so necessary for an economic expansion sufficiently rapid to absorb the new entrants into the labor force.

In this view, neither the stimulative fiscal policy of the Keynesians nor the anti-inflationary credit policies of the monetarists will be enough to achieve the goals of lower unemployment and inflation. What is needed is a policy which encourages capital spending, and in particular spending upon energy-related projects. These can take the form of energy conservation or of increased energy supply. In both cases, however, they must be economically justified, and that is where sound public policy must enter. This is a new dimension to government economic policy--how to provide the incentives for profitable private sector investment in an economy where the distortions of the Energy Crisis must be added to a growing list of social and environmental demands. Without this capital investment, however, the prospects for increasing the employment base of the U.S. economy in a non-inflationary manner will become bleak indeed.

Statistical Evidence

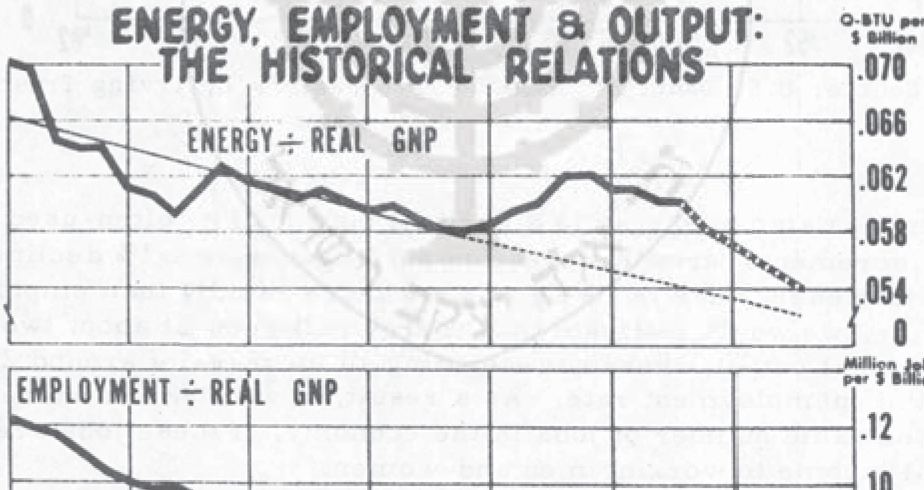
The relationship between energy and employment demonstrates the single overriding fact that it takes more and more energy to supply a job at the level of productivity we have come to expect from the U.S. economy. Energy is an important segment of the increasing capital intensity of the U.S. employment structure. Increased energy intensity makes for increased labor productivity and thus for the gains in real income which we call prosperity. Because we sustain a high per capita energy consumption, we are prosperous. In terms of output, this means we require large amounts of energy to produce those goods and services which give us a high standard of living.

Postwar economic history bears out this important relationship. As the first two charts show, while the amount of energy per dollar of real output steadily declined over the 1947-66 period, the number of jobs required to produce a unit of output declined even faster. As a result, it took more and more energy to sustain the same levels of employment and output. This trend accelerated over the 1967-73 period, as energy use grew by over 30%, while employment increased by only around 15%. With the 1974-75 recession, both the use of energy and the level of employment declined. However, because of the high price of energy relative to other inputs, energy use declined more than employment, so that the energy/labor ratio declined from its peak 1973 level.

In 1976, we estimate that both energy and employment grew by around 3%, so that the ratio held steady. At the same time, real GNP grew by an estimated 6.2%. Due to the forces of cyclical recovery from the depressed levels of 1975, employment grew by more than its long-term trend relation to real GNP growth. Energy, on the other hand, grew by somewhat less than its long-term trend relation to GNP, primarily due to the initial conservation programs brought about by the dramatically higher price of energy. The outlook for 1977 and beyond, however, suggests that cyclical recovery may be giving way to secular expansion.

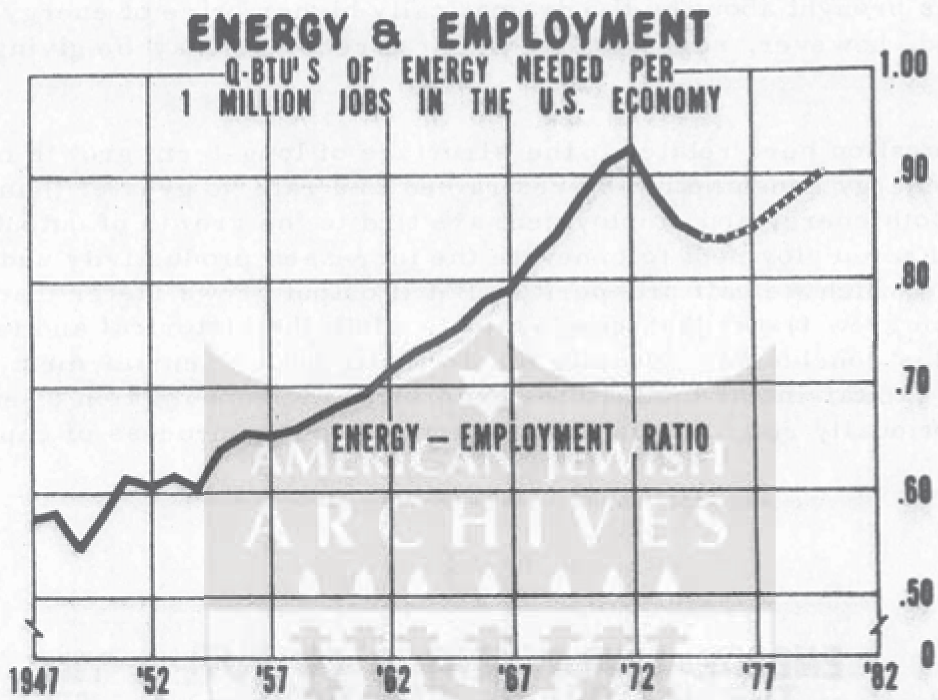
The secular question here relates to the structure of long-term growth in the economy. Can the growth in energy consumption be restrained to a rate no greater than the increase in employment? Both energy and employment are tied to the growth of output. And output must grow faster than employment to generate the increased productivity and the real per capita income gains which we call prosperity. But if output grows faster than employment, energy use will also grow faster than employment. Both the historical and technological evidence point to this conclusion. Despite the dramatic shift in employment away from manufacturing and capital-intense industries generally, the consumption of energy per productive job has continually risen. It is an inherent part of the process of capital formation.

Chart I



Source: U.S. Dept. of Commerce. Projections by Irving Trust.

Chart II



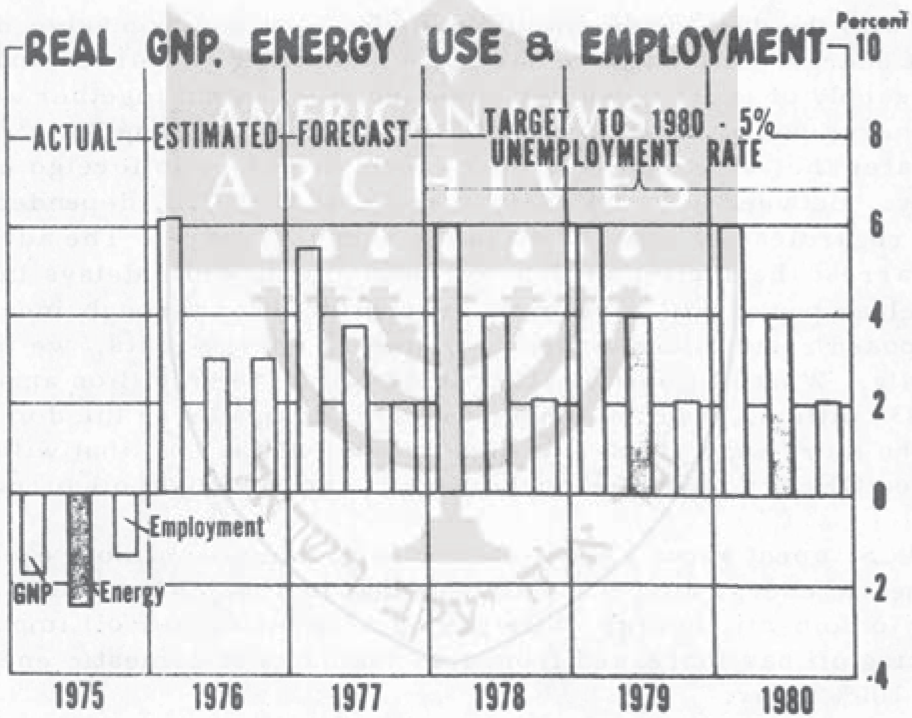
Source: U.S. Dept. of Commerce. Projections by Irving Trust.

These relationships also hold true in a cyclical sense. The often-used rule of thumb that it takes a 3% incremental growth in real output to generate a 1% decline in the unemployment rate implies that energy use is likely to grow more rapidly than employment. As a corollary to that rule, we would estimate that energy will grow at about two-thirds the rate of growth of incremental output, thereby generating an increase of around 2% in energy use per 1% decline in the unemployment rate. As a result, it will take an increasing amount of energy to sustain the same number of jobs in the economy, if these jobs are to generate a higher level of real income to working men and women.

In assessing the outlook for 1977, we would expect to see the ratio of energy to employment increase once again as continued economic expansion stimulates an increased use of energy. According to the chart below, we are forecasting a 5.5% rate of real GNP growth for 1977, coupled with a 3.5%-4.0% increase in energy consumption. This is in contrast to 1976 when energy grew at less than half the rate of real GNP growth. This was primarily due to the implementation of the "easier" conservation programs caused by the initial shock of higher energy prices. For 1977 and beyond, however, tougher and more costly conservation programs will be needed, and these will take a longer time to yield significant new results. At the same time, we are projecting a 2% increase in employment, which will have the effect of once again increasing the energy-employment ratio.

Looking longer run, if we assume that a target of government economic policy is to reduce the unemployment rate to a 4 1/2%-5% range by 1980, it will require around a 2% per annum increase in employment. This employment growth in turn is tied to at least a 6% per year growth in real GNP. If these new jobs are to yield the productivity gains necessary for non-inflationary growth, energy use will likely grow by around 4% per year over the same period. That is, if the U.S. economy is to create 8 million new jobs between 1977 and 1980, based upon an assumed growth of around 6% per annum in real GNP, there must be around a 2% per annum growth in the level of employment. Productivity gains of about 4% per year make up the difference, and for the most part, that productivity gain is intimately linked with an even more energy-intensive employment structure.

Chart III



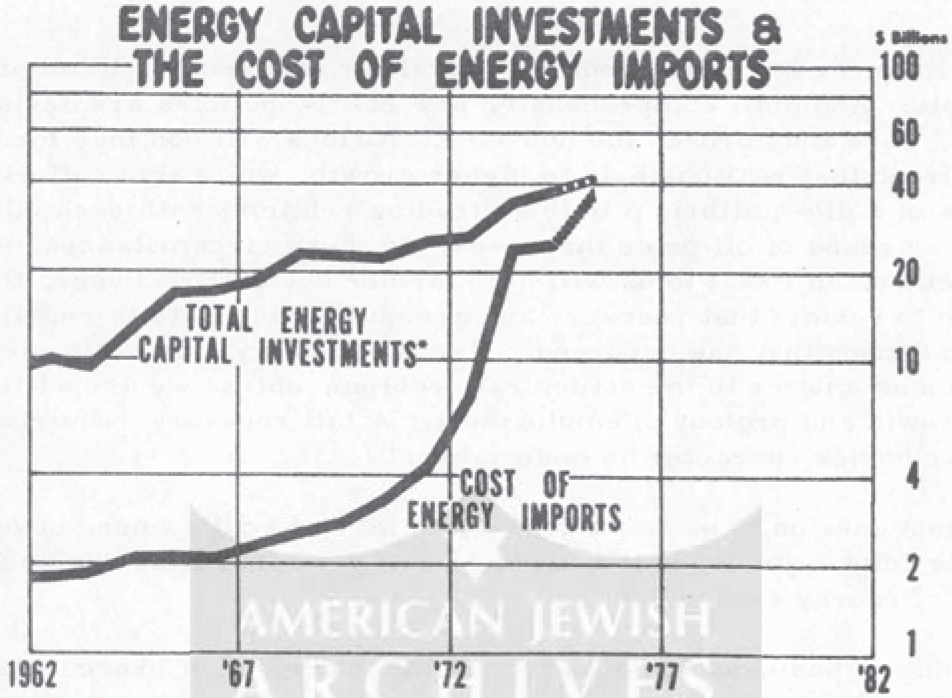
The cyclical response of employment and inflation demonstrates the shorter term constraints imposed upon the U.S. economy by the high cost of energy. There is a growing perception that attempts to further stimulate the economy from the overall demand side, so as to increase the demand for jobs, could lead to a further exacerbation of inflationary pressures and possibly another recession. Whether one accepts this view or not, it is clear that increasing the demand for goods and services through increased stimulation of aggregate economic demand will do little to increase the supply of domestically produced energy. Rapid economic growth over the next few years will likely cause a greater than proportionate increase in the use of energy, as industries will not have had ample time to institute energy-conservation measures nor to install energy-saving capital equipment. With the high cost of energy today, and the likelihood of its cost increasing even further if a more stimulative demand policy were adopted, the energy-related inflationary underpinning of the economy could be severely aggravated. As a result of these considerations, I submit that using an ever-increasing dose of general fiscal stimulus to create more jobs will aggravate the energy crisis and yield only very limited gains in real income. In other words, we can no longer accept the prescription of stimulating demand without paying attention to the economy's supply side. And this is precisely the point of interface between overall macroeconomic policy and the energy problem.

The Costs of Delay

We are faced with the dual problems of unemployment and excessive dependence on foreign sources of energy. Although we have idle manpower resources and the need for a greater domestic supply of energy, we have been unable to weld together an effective employment and energy policy. Solutions will not come easily or quickly. But the longer the delay, the greater the vulnerability of many American jobs to foreign economic and political pressures. Between now and 1980, it is likely that U.S. dependence on foreign oil will increase, regardless of what we do in the next few years. The advent of the Alaskan pipeline will only arrest the decline in U.S. oil production, while delays in increased coal production and nuclear power will have to be compensated for through increased oil imports. While we have imposed restrictions on rising domestic energy costs, we must still pay the price internationally. What had been costing us $7 billion to $8 billion annually for imported oil now costs us $35 billion. And the longer we delay in resolving the domestic energy supply problem, the more we will have to import from OPEC--at what will likely be ever-rising prices, given OPEC's near-monopoly power over the world oil market.

In 1976, the U.S. spent about $38 billion for imported oil--almost equal to our capital investment in domestic energy supply. Compare that to 1962, when the U.S. invested around $10 billion in domestic energy while paying $1.8 billion for oil imports. This means our cost of importing oil has increased from less than 20% of domestic energy investments in 1962 to almost 100% today.

Chart IV



Source: U.S. Dept. of Commerce.
Projections by Irving Trust.
*Includes Utilities and Primary Fuels.

Conclusions

It would seem possible that a proportion of those resources devoted to importing oil could be fruitfully invested in increasing the supply of U.S. energy and in creating productive employment. A recent study by the Economics Department at U.C.L.A. suggests that replacing U.S. oil imports of around 2.0 million barrels per day with an equivalent amount of domestic energy would ultimately generate as much as 800,000 productive new jobs in the U.S., depending upon the particular policies adopted. According to that study, about 25% of these new jobs could come from additional domestic energy production and the construction of new plant facilities. The balance of the growth in employment would be derived from non-energy sectors which would produce more goods and services, both to support the energy-producing industries and to supply what would become a generally faster-growing economy. Although the policy alternatives to achieve these improved employment opportunities may differ, the overall implication for the economy is the same: idle manpower can be put to work in the implementation of a policy of greater energy self-sufficiency.

I would like to quote from a recent speech by Mr. Robert Roosa, a prominent New York banker. He says:

"It is becoming increasingly evident, whatever the original merits of the OPEC case might have been, that the mutation of energy costs which occurred in late 1973 has in fact drastically altered the "production function" of the world economy, apparently imposing a slower or lower gradient for overall growth than might otherwise have been attainable. And until comprehensive new energy policies are devised and implemented, here and abroad, the non-OPEC nations will continue for some years ahead to confront that real obstacle to higher growth, while also suffering the consequences of a disequilibrium in their trading relations with each other--even without another round of oil price increases. In these circumstances, while traditional monetary and fiscal tools will help further cyclical recovery, they may not be enough to sustain that recovery and are quite inadequate to repair the critical structural distortion that has occurred. Nor can conservation strategies by themselves provide an answer to the structural problem, unless we are willing to sacrifice even more growth and prolong unemployment. A full recovery requires that deliberate action of a far bolder character be undertaken."

Mr. Roosa then goes on to outline a long-term plan of action where government and business could participate jointly in the implementation of programs designed to achieve a greater degree of energy self-reliance.

The partnership of business and government has a number of precedents, especially in the postwar economic experience of the U.S. Both the development of atomic energy and the founding of the aerospace industry were joint responses by government and business to critical national problems. The Energy Crisis today demands no less attention than the challenges of World War II or of the Soviet Sputnik crisis. With the bitterness of Vietnam and Watergate behind us, I believe that the political climate will be more amenable to the development of an acceptable national energy program built around a successful partnership of private industry and sound public policy.

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October 13, 1977

Mr. Paul A. Mazur
22 Conklin Place
Dumont, N.J. 07628

Dear Mr. Mazur:

Thank you for your letter of October 8 and your expression of concern regarding energy supplies for the United States. Your counsel in this connection is much appreciated.

While an Energy Task Force has been created, it will deal with political action rather than specific commercial interests. Thus, a meeting with our Task Force would be to no avail..

With repeated thanks for your interest and with every good wish, I am

Sincerely,

Alexander M. Schindler

22 Conklin Place
Dumont, New Jersey 07628
Phone 201-384-4871

October 8, 1977

Rabbi Alexander Schindler
Union of American Hebrew Congregations
838 Fifth Avenue
New York, N.Y. 10021

Dear Rabbi Schindler:

While I watch the progressive erosion of America's good will and support toward Isreal, I recall the now apparent prophetic statement by Dr. Emanuel Rosenblat in 1971 that no president of the United States, no matter how sympathetic toward Isreal, can risk the interest and safety of his country when the "day of decision" arrives that he must choose between the necessity of our oil supply from the Arab cartel and the existence of Israel.

At that time, Dr. Rosenblat was convinced that in order to terminate this inevitable progression, we must find new oil supplies in non-OPEC countries, which are aufficiently large to compete with the flow of oil from the Arab cartel. He also had incontrovertible facts that no amount of money and effort spent on domestic oil exploration and production could satisfy the United States requirements.

He demonstrated that there are unexplored giant basins in Africa and South America with great resource potential for oil and specifically pointed out that the Etosha basin in South West Africa might yield enough oil to solve our energy problems. Our exploration in the Etosha basin is far enough advanced, that intensive effort can bring about quick results. We have not had an opportunity to demonstrate how that can be done.

I have seen announcements that you have formed an Energy Task Force which will study and recommend methods for increasing the energy supplies for the United States.

We wish to have an opportunity to meet with members of the Task Force.

Sincerely yours,

Paul A Mazur

Paul A. Mazur

PAM:f

Thank you for your counsel
Task force on Energy concerned
with political action + cannot
get involved with
specific commercial
interests

June 23, 1977

Mr. Emanuel Rosenblat
175 Lorraine Avenue
Mount Vernon, N.Y.

Dear Mr. Rosenblat:

My travel schedule has been exceedingly heavy and thus I trust you will forgive the delay in responding to your letter of June -.

It was thoughtful of you to share with me your concerns and I want to assure you that I share them. I am trying my utmost to get the message across and the enclosed item from the Jewish Week will give you an indication of the things I have been saying in regard to energy.

With kindest greetings, I am

Sincerely,

Alexander M. Schindler

Encl.

Emanuel Rosenblat

175 LORRAINE AVENUE
MOUNT VERNON, N. Y.

(914) 668-1618

COUNSELLOR AT LAW

Tell him I agree with him — Send him a copy of my Jewish Week Stmt. Tell him I'm doing everything I can. ~~[illegible]~~ to alert Jew[illegible]

June 9, 1977

Rabbi Alexander M. Shindler, President
Union of American Hebrew Congregations
838 Fifth Avenue
New York, New York

Dear Rabbi Schindler:

1. In the spring of 1976, I brought to your personal attention the impending politico-economic crises hanging over the head of the American people because of the dwindling U.S. oil supply and the ever increasing demand for oil. I indicated to you the potential for danger to the existence of the state of Israel inherent in the U.S. dependence on imports to fill this gap.

2. On the 20th of April, 1977, President Carter told the American people while the whole world listened how serious the situation had become. He painted a gloomy picture for the future. Now everyone who heard knows for the first time the extent of the U.S. dependence on imported oil--mainly Arab oil.

3. In 1970 when U.S. imports were only 3.4 million barrels a day, its dependence on Arab oil was 5.8%. At the time of the Arab embargo, one of crisis for the U.S. and Israel, 11.5% of the 6 million barrels a day imported, came from the Arab Block. By the end of 1976, of the approximately 8 million barrels a day of imports, dependence on Arab oil reached 31.5% of the total. At the time of the President's speech, it appeared that approximately 50% of the imports were from the Arab Block. The imports for that first quarter of 1977 had already averaged almost 9-½ million barrels a day. Now U.S. production is less than 8 million barrels a day.

4. It should be obvious then, that the very military safety and economic security of the United States is keyed to this ever increasing dependence on Arab oil. It appears to me that our Jewish leaders have not made it explicitly clear to American Jewry just how inextricably intertwined the fate of the continued existence of the State of Israel depends on the whim of this Arab Block supplying this much needed oil.

5. You no doubt recall that in 1976 when President Ford permitted Egypt to receive C 130 cargo planes, you felt a crack appearing in the solid wall of support for Israel. Now Secretary Vance in 1977 had to be reminded by the Senate that his memo PRM 12 failed to include Israel when he listed the countries who would receive access to co-production agreements. President Carter is now recommending acceptance by Israel of a P.L.O. State on the West Bank of the Jordan and perhaps the Gaza strip as well in exchange for recognition of Israel as a state. Sovereignty by its very definition cannot be negotiable.

6. While its true that on May 19th, 1977 President Carter reaffirmed that the U.S. will honor its historic responsibilities to assure the security of the State of Israel in his final decision, nevertheless the memo itself was not altered from its original content that only Nato, Australia, New Zealand and Japan would be exempt from general restrictions on exports. Who will read the handwriting on the wall for American Jewry?

7. It's folly for American Jewry to expect an American President or an American Congress to openly jeopardize the military security and economic health of the United States just to honor its historic responsibility to assure Israel's right to exist. Since April 20, with the President's revelation of our great emergency, imports for the comparable period reached new highs, domestic supply new lows and demand for oil reached new records. But life goes on undisturbed because the cancer in the situation is that the U.S. Public and its representatives have come to accept without contest this overwhelming dependence on Arab oil.

8. When the safety of our country is at stake there will be no choice. All other considerations will have to be put aside. As Americans we must and will support that decision. But as Jews we must bend our every effort and thought to eliminate that dependence which could force that inevitable choice.

Sincerely,

Dr. Emanuel Rosenblat

cc: General Julius Klein

May 24, 1977

Mr. Jeffrey H. Newman
42 Perry Street
New York, New York

Dear Mr. Newman:

Many thanks for your letter of May 10. I am grateful to you for sharing with me your concerns and comments on energy and the program of the Carter Administration.

As I am really not an expert on this subject, I am taking the liberty of sharing your letter with appropriate persons in Washington.

With kindest greetings, I am

Sincerely,

Alexander M. Schindler

42 Perry Street
New York, N.Y.
May 10, 1977

Rabbi Alexander Schindler
Chairman of the Conference of
Presidents of Major American
Jewish Organizations
515 Park Avenue
New York, N.Y. 10022

Dear Rabbi Schindler:

In the April 24 issue of The Jewish Weekly Richard Yaffe quoted you as calling on American Jewish support for President Carter's energy program to make America independent of Arab oil and blackmail. You stated, wisely, that you didn't know whether Schlesinger was right in claiming that the program would save 5 million barrels of oil a day, but that even 50% success would constitute a dramatic reversal of the present dangerous trend, with all its unpleasant economic and political consequences.

In view of the opposition the Carter plan is running into, not only from certain interests but from many taxpayers, it would be the essence of wisdom to bear in mind possible alternatives. Accordingly I submit to you as worthy of looking into a program which, in my opinion, holds promise of reversing the dollar drain and emancipating this country from foreign oil domination even more effectively.

The magnitutde of the problem can be realized by estimating that, with some $46 billions accumulated yearly by the handful of Arab oil-producing nations, within ten years they will have half a trillion dollars to purchase arms and to invest in the West, with eventual control of major corporations and concommitant political power. For American Jewry this propsect is a cause of deep anxiety. Yet, I submit, the response to this challenge has been unworthy of our intelligence and business acumen. We have been told to keep a low profile, but it seems more like our head buried in the sand. Far from cautious expressions of gratitude for the small blessings emanating from the Administration, we need to combine our scientific, technical and industrial know-how and come up with effective energy proposals of our own that a grateful nation would accept and expedite.

Let us take the Carter objective of reducing gasoline consumption by 10% through taxing gasoline and big cars punitively. The approach is indirect. Suppose instead there were an additive which could replace 10% of gasoline in cars without affecting performance adversely. That additive exists and it is in use today in many parts of the earth. It has two forms: methyl and ethyl alcohol. Recent tests at M.I.T. showed that that admixture resulted in a fuel that gave more mileage and less pollution. (Confer Dr, Tom Reed, Lincoln Laboratory, M.I.T.) No special motor adjustments were required.

What is even more intriguing, methanol, as it is called, can be made from solid waste, thus helping municipalities solve their critical garbage disposal problems at the same time. A similar alcohol can be manufactured from wood waste, crop waste, in fact anyhting organic. In Nebraska the alcohol is made from grain crop waste and when added to gasoline, the resulting mixture is called "gasohol" and is sold in the state. A third exciting characteristic of its manufacture is that the process can be shifted to making methane gas, where, we are told, another shortage is developing.

If all this is true, why then is it not being manufactured in great quantity and added to gasoline at the pump? There must be serious objections or it would have been developed by now. The only way I can answer this is to inform you that Dr. Tom Reed's experimental tests with some 200 faculty members at M.I.T. were interrupted in the middle, at the same time that M.I.T. received half a million dollars from Exxon. Also that legislation setting up a million dollar methanol program for California suddenly ran into opposition. Scott Carpenter, the astronaut, who was to head it up, attributed the sudden loss of interest to pressure by Standard Oil of California. (In Brazil the government was smarter. They got one of the big oil companies, Shell, to make the ethyl alcohol for them! Eventually they will have to replace dwindling gasoline with some other fuel, and they know it, but they are in no hurry until they've made the most out of oil. But why should we let them determine when?)

If the Carter administration mandated a methanol/gasoline fuel for all government vehicles, that would immediately create a market, and perhaps that is all that the country would need to start the ball rolling. State and local governments could follow suit, mandating the admixture on all pumps. Large scale manufacture would bring the cost down considerably, municipalities could find it a source of income. And there is no need to stop at a 10% mixture. Washington could call on the auto companies to adjust auto motors to take 15% and over of the fuel. If the German and Swedish governments can work with Volkswagen abd Volvo to develop a methanol program, why can't we?

I will not go into other aspects of the Administration's energy program except to say that there are similar deficiencies, except for the important conservation principle, and not enough insistence on speedy development of clean and renewable sources of energy. The important thing to emphasize here is that we can reduce gasoline consumption without a punitive tax, simply by replacing part of it with a substitute. And we can do it rapidly and predictably. The only problem is, who will mount the necessary drive?

If you want to discuss the matter further, please telephone me at 243-5730.

Sincerely yours,

Jeffrey H. Newman

National Jewish Community Relations Advisory Council

55 West 42nd Street, New York, N. Y. 10036 (212) 564-3450

May 9, 1977

Rabbi Alexander M. Schindler, Chairman
Conference of Presidents of Major
American Jewish Organizations
515 Park Avenue
New York, New York 10022

Dear Alex:

I know that you, both as Chairman of the Presidents Conference and as President of the UAHC, a member agency of the NJCRAC, will find of interest the text of the section on energy to be included in the Joint Program Plan for 1977-78 when it is published June 1. This section as well as the balance of the Joint Program Plan was adopted by the Executive Committee of the NJCRAC at its meeting on May 1.

The draft, submitted to the Executive Committee, was recommended by an NJCRAC Task Force on Energy which was mandated by the NJCRAC Plenum last January in Miami Beach, after a Plenary Session on energy which was addressed by Senator Henry Jackson. The Task Force is comprised of representatives of each of our nine national agencies, including staff members of these agencies who have developed special expertise in the area of energy as a result of their own agencies undertaking special consideration of this problem, and community representatives, including distinguished experts in the field of energy who bring various perspectives to our discussion. Because of the importance of this issue, I am happy to say that Jordan Band, a past Chairman of the NJCRAC, has agreed to chair this Task Force on Energy, which will be linked to the NJCRAC Commission on Equal Opportunity and Urban Affairs.

The immediate charge upon the committee is to utilize this statement as a criteria for a process by which we will attempt to evaluate the proposals of Carter and others in regard to the energy crisis, which we describe as perhaps America's most critical problem in the years ahead. You will also note that the main thrust of the approach is in terms of identifying this as a critical American issue, which, if left unresolved, would face this country with catastrophic social, economic and political consequences and threaten the independence of American foreign policy. By design, it avoids giving emphasis either to the potential threat inherent in the energy issue to Israel's special relationship with the United States or to the possibility of anti-Semitism growing out of this issue. It is, for this reason, that the Task Force operates within the framework of the Commission on Equal Opportunity, rather than the NJCRAC Israel Task Force. In short, the agencies, both national and local, feel very strongly that this is an issue that must be dealt with as a domestic matter rather than within the framework of the Middle East.

I am confident that you share this assessment and analysis. Thus, we would hope, as we have previously stated at meetings of the Presidents Conference and in discussions with you, that the Presidents Conference will not involve itself in this area. I hope you agree that the matter is in competent hands, and we look forward to the same cooperative process in the NJCRAC that resulted in the significant achievement in regard to anti-boycott legislation. Furthermore, I believe that you concur with the judgment expressed by Joe Glaser's committee that the Presidents Conference will in no way compete, and I might add duplicate, the established functions of constituent organizations. I hope that I am correct in this assumption in regard to the vital question of energy.

Warmest regards.

Cordially,

Theodore R. Mann
Chairman

TRM:ZC

CC: Jordan C. Band
Albert D. Chernin
Yehuda Hellman
Rabbi Israel Miller
Albert Vorspan

ABRAHAM N. FRANZBLAU, PH.D., M.D., L.H.D., (F.A.P.A.)
1 GRACIE TERRACE, NEW YORK, N. Y. 10028
TRAFALGAR 9-7678

May 1, 1977

Dear Alex,

I read your interview by Yaffe on the Energy Crisis, etc., in the "Jewish World" and wish to congratulate you. It is the kind of "in depth" exploration that leaves little to chance, misquotation or mis-interpretation, and you come off just great! I hope everyone reads and takes note.

My congratulations are, perhaps justifiably, mingled with a bit of pride in you.

Rose sends her best.

Cordially,

Abe

A

Rabbi Alexander M. Schindler

Dear Abe

How thoughtful of you to write! You were my teacher And so you must shoulder both the pride + embarrassment of me, you

Warm good wishes,

Alex

WILLKIE FARR & GALLAGHER
(SYKES, GALLOWAY & DIKEMAN)
1 CHASE MANHATTAN PLAZA
NEW YORK, N. Y. 10005
212-248-1000
CABLE "CONVEYANCE NEW YORK"
TELEX: 233780 (RCA)
12-7679 (WU)

MIDTOWN OFFICE
277 PARK AVENUE
NEW YORK, N. Y. 10017

SYKES, GALLOWAY & DIKEMAN OFFICE
120 BROADWAY
NEW YORK, N. Y. 10005

EUROPEAN OFFICE
16, AVENUE PIERRE 1ER DE SERBIE
75116 PARIS, FRANCE
TELEPHONE 723-5156
CABLE "CONVEYANCE PARIS"
TELEX: 842-620080

April 26, 1977

Rabbi Alexander M. Schindler
President
Union of American
Hebrew Congregations
838 Fifth Avenue
New York, New York 10021

Research Project on Energy and Economic Policy

Dear Alex:

Thanks for your note. I look forward to meeting with you and Yehuda Hellman again soon to advance our plans.

Sincerely,

Ken

Kenneth J. Bialkin

KJB/mr

file

April 20, 1977

Mr. Kenneth J. Bialkin
1 Chase Manhattan Plaza
New York, New York

Dear Ken:

It was nice meeting you. I am grateful to you for taking the time to meet with me.

I expect to be in Washington on Monday and am trying to arrange a meeting with Dr. Hordes. Of course, I will be in touch with you soon after I have had a chance to chat with Hordes.

With repeated thanks and warmest regards, I am

Sincerely,

Alexander M. Schindler

April 6, 1977

Mr. Walter P. Stern
Capital Research Co., Inc.
299 Park Avenue
New York, N.Y. 10017

Dear Wally:

I have your note of March 29th and want you to know that I am in the process of exploring possibilities for aid in connection with the Research Project on Energy and Economic Policy. I'll be in touch with you in a week or so, hopefully with some positive word.

By the way, there was no enclosure with your letter. I would like to see the detailed list of activities and would be grateful if a copy could be mailed to me.

With kindest personal regards, I am

Sincerely,

Alexander M. Schindler

bcc: Mr. Laurence Tisch

CAPITAL RESEARCH COMPANY

INCORPORATED

LOS ANGELES · NEW YORK · GENEVA

299 PARK AVENUE
NEW YORK, N.Y. 10017

March 29, 1977

WALTER P. STERN
Senior Vice President

Rabbi Alexander Schindler
President, Union of American Hebrew Congregations
838 Fifth Avenue
New York, NY 10021

Dear Rabbi Schindler:

Several people have suggested that I keep in touch with you on our anti-boycott activities and other activities of the Research Project on Energy and Economic Policy. I am enclosing a brief sheet which details some activities that we hope to go into. I have about half the money raised for a $50,000 budget this year. I wonder if you might have any ideas on where else to go?

Kindest regards.

Sincerely,

Wally

WPS:L

Tell him am ~~[illegible]~~ exploring some possibilities now. Will be in touch with him in week or so.

Send copy of Wally letter to Larry Tisch, F.Y.I.

Thank Larry for [illegible] with me. Tell him I have set up big session with lawyer friend of his on re strategy. [illegible]

April 6, 1977

Mr. Laurence Tisch
666 Fifth Avenue
New York, N.Y. 10019

Dear Larry:

It was good seeing you yesterday. I am grateful to you for taking time from a busy schedule to meet with me and I much appreciate your counsel.

I am seeking to arrange an appointment with Mr. Bialkin and I want to thank you for the introduction.

With warmest personal regards, I am

Sincerely,

Alexander M. Schindler

Encl.

Steven L. Spiegel
9701 Wilshire Blvd., Suite 700
Beverly Hills, California 90212
(213) 273-8697

March 17th, 1977
Ref: 77/102

Rabbi Alexander Schindler
Conference of Presidents of the
Major Jewish American Organizations
Chairman
515 Park Ave.
New York, N.Y.

Dear Rabbi Schindler:

I am responding to your note of March 3rd. I am glad to hear that our energy papers have been helpful. I enclose a recent catalogue of all the material which we have produced. If you are interested in receiving any others, please feel free to request them and we will be happy to send them immediately.

I hope that we can continue to be of assistance and I thank you for your kind note.

Sincerely yours,
Steven Spiegel
Steven L. Spiegel

SLS:rr

Encl.

LIST OF COMPLETED PAPERS AND OTHER MATERIAL

* 1. David Aviv - Energy Independence Feasibility in the Next 10 Years.

2. Sheldon Bierman - A Preliminary Review of the Relationship among Banks and Petroleum Companies.

* 3. Seth Carus - Arab Arms Acquisition since 1973.

* 4. Alan Dowty - The Question of Palestinian Representation: Options for US Policy.

* 5. Alan Dowty - Memorandum - US Policy and the Palestinians.

* 6. Samuel Fishman - The Meaning of Normalization.

7. Robert Freedman - Jimmy Carter, Zbigniew Brzezinski, and the Future of US Policy in the Middle East.

8. Fred Gottheil - An Economic Analysis of the Relations Between Israel's Balance of Payments Problem and US Economic Assistance.

* 9. Morton Halperin - A Policy for the Arab-Israeli Dispute.

* 10. Rita Hauser - The Palestinian Refugees: A Realistic Solution.

* 11. Rita Hauser - A US Guaranteed Peace in the Middle East.

12. Jess Hordes - The Energy Crisis.

13. Jess Hordes - The Arab Boycott.

14. James Kurth - Statement before the Senate Committee on Foreign Relations.

* 15. Jordan Paust - The Israeli Response to Terrorism.

* Formal Papers

* 16. Nat Pelcovits - Israel at the UN: Challenge at the 31st General Assembly.

* 17. Robert Pindyck - Low Prices or Self-Sufficiency: The Conflicting Goals of National Energy Policy.

* 18. Itamar Rabinovich - The Lebanese Crisis: An Interim Assessment of its Significance and Prospects.

19. Eugene Rostow - The Safety of the Republic.

20. Eugene Rostow - Statement before the Subcommittee on Foreign Assistance of the Committee on Foreign Relations.

* 21. Arnold Safer - Recommendations for US Energy Policy: The International Aspects.

22. Fred Singer - Domestic Resources Can Satisfy the Energy Needs of the US.

23. Fred Singer - Statement on Energy Security and the World Price of Oil.

* 24. Steven Spiegel - The Arab-Israeli Dispute: A Plan of Action.

25. Steven Spiegel - Statement before the Subcommittee on Near Eastern and South Asian Affairs of the Senate Committee on Foreign Relations.

* 26. Steven Spiegel - The Effectiveness of Jewish Efforts to Influence the American Foreign Policy-Making Process.

* 27. Raymond Tanter - The Palestinian Issue: Current Trends, Prior Policies, and Future Options.

* 28. Abraham Wagner - The Future of Step by Step.

29. Sheldon Bierman - Commentary on Aviv's Paper.

30. Sheldon Bierman - Commentary on Safer's Paper.

31. Arnold Safer - Employment and Energy Independence (Irving Trust Report).

32. Arnold Safer - Outlook for World Oil: Prices and Petrodollars (Irving Trust Report).

33. Arnold Safer - International Commodity Issues (Irving Trust Report).

34. Arnold Safer - The Emotional Side of Divestiture (Irving Trust Report).

* 35. Robert Freedman - The Soviet Union and US Peace-Making Efforts in the Middle East.

* 36. Harold Waller - Energy Choices for the Next Administration.

* 37. Asher Arian - Israeli Domestic Politics and the Negotiating Process.

* 38. Max Singer - Are the Arabs Willing to Make Peace with Israel?

* 39. Burton Leiser - Responses to Terrorism.

* 40. Uri Raanan - Soviet Union in the Middle East.

* 41. Donna Divine - The Meaning of War: Lebanon, 1975-1976.

* 42. Sheldon Bierman - An Antitrust Approach to Oil Problems

* 43. Edward Luttwak - American Arms to Egypt: The Nato Connection.

* 44. Noel Kaplowitz - American Foreign Policy in the Middle East: Requirements for Constructive Conflict Resolution.

45. Marvin Feuerwerger - Congress and Israel: A Look to the Future.

46. Alan Dowty - Testimony before the Senate Committee on Foreign Relations.

* 47. Arnold Safer - World Oil: Challenges and Opportunities.

48. Max Singer - Memo on Oil.

49. Arnold Safer - Energy and Economic Policy: Constraint or Complement.

* 50. Steven Rosen - The Dilemma of the Occupied Territories: Implications for US Policy.

51. Fred Singer - A National Energy Policy - At Last?

52. Fred Singer - Who is afraid of OPEC?

53. Eli Bergman - The American Jewish Population Erosion - Causes and Consequences.

* 54. Shlomo Aronson - Israel's Domestic Politics and the Future of Middle East Negotiations.

* 55. Max Singer - Modifying the US Approach to Middle East Peace.

* 56. Zvi Gitelman - Jews in the USSR: Prospects and Policies.

* 57. Edward Luttwak - The Sale of American Weapons and Military a Services to Saudi Arabia: The Need for a Re-assessment.

* 58. Robert Freedman - The Soviet Government and the Issue of Aid to Soviet Jewish "Drop-Outs": A Moral and Political Analysis.

59. Arnold Safer - Oil and the International Economy.

60. Fred Singer - The Limits of Arab Oil Power.

* 61. Shlomo Aronson - Israel's Nuclear Options.

* 62. Max Singer - Pursuing Peace in the Middle East: The Idea of Quasi-Settlement.

* 63. Alan Dowty - International Guarantees: Historical experience and Prognosis for the Middle East.

* 64. Alan Dowty - International Guarantees and the Arab-Israeli Conflict

* 65. Edward Luttwak - US Arms Sales to Jordan: The Delicate Threshold.

* 66. Alouph Hareven - The Scope of Human Contacts between Israel and her Arab Neighbours.

* 67. Marvin Feuerwerger - The American National Interest and Assistance to Israel.

68. Arnold Safer - The Energy Crunch and American Diplomacy.

69. Mark Heller - The Fallacy of Imposed Peace.

* 70. Yair Evron & Anne Cahn - The Politics of Arms Transfers: US Arms Sales to Egypt.

March 3, 1977

Mr. Steven L. Spiegel
9701 Wilshire Blvd.
Suite 700
Beverly Hills, Ca. 90212

Dear Steve:

I am grateful to you for the continuing flow of papers on energy and other vital matters. Thank you for sharing these. I have just been appointed to serve on the Alliance for Energy and the materials from your office will be most helpful.

With warmest regards, I am

Sincerely,

Alexander M. Schindler

With the Compliments of

Steven L. Spiegel

We would greatly appreciate your comments on this/these paper/s as well as on other papers you have received and not yet commented on.

Thank you !

"Oil and the International Economy"

address by: Dr. Arnold E. Safer
Vice-President, Economics
Irving Trust Company

to: National Committee On
American Foreign Policy

at: the Carnegie Endowment for
International Peace
New York City

January 27, 1977

Introduction

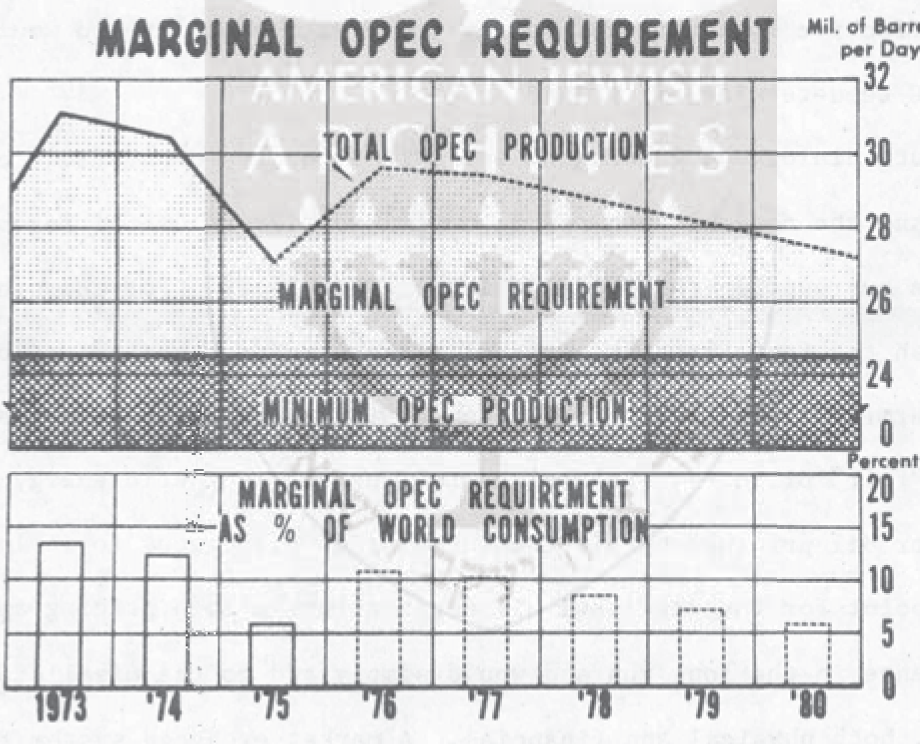
The world has not really adapted to the increased price of international oil improved by the cartel of oil-producing nations. The mounting international debt of many developing countries and of some industrialized nations is one important symptom of the disruptive nature of high oil prices. As long as large OPEC surpluses continue, there will be an ever-increasing burden of deficits in the oil-importing nations which must be financed through the international monetary system. Chronic international payments deficits can set off a vicious devaluation-inflation cycle, which in turn brings about high unemployment or increased protectionism--key symptoms of the failure of the economic adjustment process. Lest the seriousness of this problem be too lightly dismissed, it is important to remember that most economic historians feel that the failure of the international economic and financial system was a principal element in the Great Depression of the 1930s. Measures taken in the 1930s to defend against these deficits emphasized exchange controls and protectionist trade policies which contributed to a sharp contraction in world trade, an end to economic prosperity, and the ultimate rise of a destructive economic nationalism.

The world has learned much about economic cooperation since the 1930s, and economic history shows that many of the aspirations of individual OPEC nations cannot be achieved except at considerable expense to the rest of the world. The strategy of achieving economic development by imposing high oil prices upon the rest of the world contains certain risks to OPEC as well as to the oil-consuming nations, both developed and developing. The world recession of 1974-75 was in large part the result of the oil price shock; the slow recovery of the world's economies may be another. But it is precisely this slow economic recovery, with its limitations on increasing social goals, that may very well cause the gradual erosion of the strength of the cartel itself. It is important for both Western policymakers and the governments of OPEC to understand the nature of this process.

This economic process depends critically upon three sets of economic forces. First, the state of the oil market and the resulting pressures on oil prices. Second, by the populous OPEC nations, it could be reduced to production levels by 1980 which even it might find intolerably low. As another alternative, if Saudi Arabian production in 1980 were held near current levels, other OPEC members would be forced to cut oil production below levels which would permit the planned implementation of economic development programs already in progress.*

U.S. international oil policy should recognize the likelihood of this natural friction within OPEC. The period ahead offers the opportunity to limit the cartel's power over the world oil market and to reach a more healthy accommodation with the legitimate aspirations of its member governments.

Chart II



Source: Historical Data by American Petroleum Institute,
Projections by Irving Trust Co.

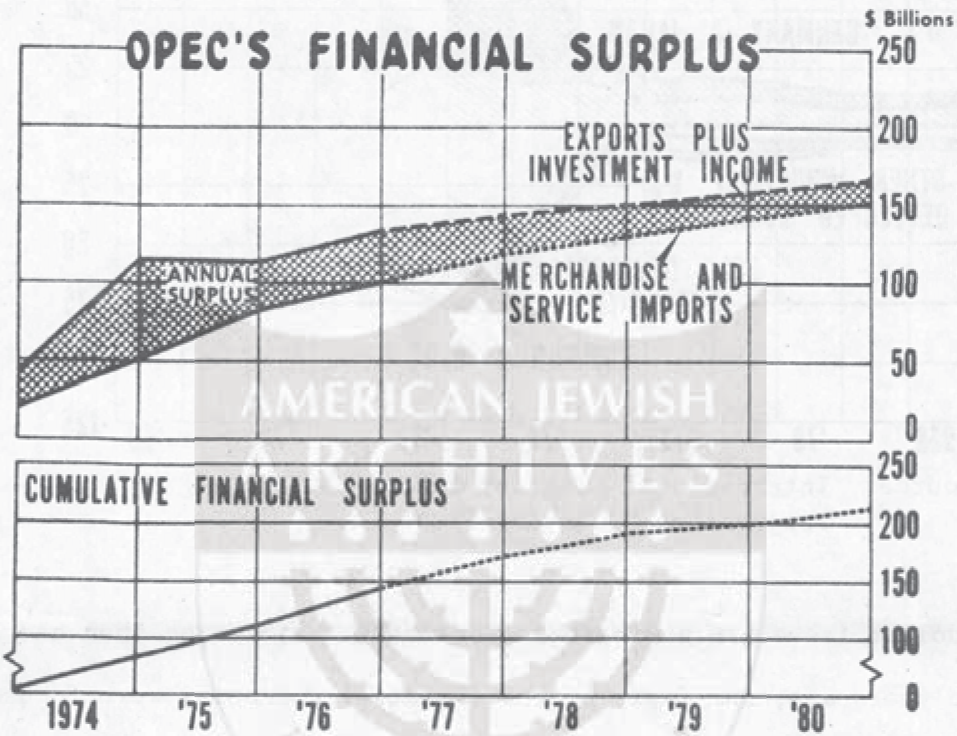
In a prior study we argued that over the 1975-80 period OPEC's minimum production level required to sustain its member countries' respective development objectives was in the

*See Table I in the appendix for a description of possible 1980 OPEC supply scenarios. Also, see "World Oil: Challenges and Opportunities," View From One Wall Street, Irving Trust Company, New York, N.Y., Dec. 20, 1976

Petrodollars

The second potential source of economic instability derives from the issue of petrodollars--of a very large potential overhang of OPEC-owned financial claims on the consuming countries.

Chart III



Source: International Financial Statistics,
Projections by Irving Trust Co.

As Chart III shows, prior to 1974 the OPEC financial surplus came to around $16 billion, largely concentrated in Saudi Arabia and Kuwait. By the end of 1976, we estimate this figure to have risen to around $145 billion, with Saudi Arabia alone accounting for roughly two-thirds of this total. By 1980, this petrodollar surplus will likely be over $200 billion.*

In effect, virtually the entire surplus will be concentrated in the small population OPEC members, principally the Arab states of the Persian Gulf. At the same time, some of the large population OPEC members could very likely go into current account deficit over the next few years.

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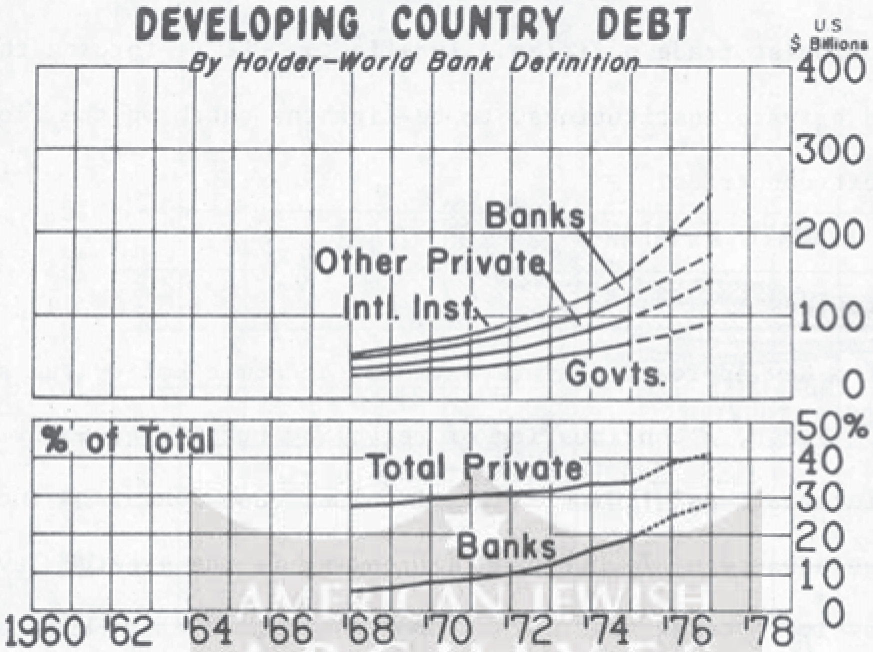
*See Table II in the appendix for the detailed assumptions behind this forecast.

Chart V



Source: World Bank.

Chart V shows that by the end of 1976, the cumulative outstanding developing country debt is estimated to have exceeded $250 billion (ca. $200 billion for the non-OPEC LDC's) with approximately $70 billion owed to commercial banks. For the past three years, this group of countries has required over $40 billion annually in external financing, with roughly $30 billion stemming from current account deficits. Prospects for 1977 appear to be about the same, with another $40 billion or so added to the total.

This annual flow of resources to the developing nations totals about 1% of the non-communist world's GNP. While in and of itself this figure may not be excessive, there has been a concentration of this flow in the form of increased loans from private Western banks to the developing countries, estimated to be almost 30% of total developing country debt at the 1976. The six largest U.S. banks at the end of 1975 had nearly $12 billion of non-guaranteed loans outstanding to 15 less developed countries, representing about 5% of the combined assets of these banks. While this may not be an inordinate level of risk at present, a further expansion of private sector lending to the developing countries could pose problems for the future.

time, will increase its imports of raw materials from the LDC's, thereby generating a strong second order effect upon exports of the deficit countries.

This two-pronged approach of restraint in the deficit countries and stimulus in the surplus countries may help to gradually restore a measure of equilibrium to the international payments mechanism. The petrodollar recycling is basically a credit flow, a series of loans to carry the deficit countries through their period of adjustment. That, however, could be the "fly in the ointment", because there may be nothing temporary about the growing deficits of the weaker countries, as long as OPEC continues to run these very large balance of payments surpluses, stemming from the high and still rising price of oil. There is reason to believe that increased stimulus in the stronger countries will not lead to an improvement in the weaker countries. What could happen is an increased world deficit vis-a-vis OPEC, as stronger economic growth worldwide in both the surplus and deficit countries generates a sharply increased demand for oil. As the U.S., for example, stimulates its economy, it may lead to some increase in the demand for goods and services in the deficit countries, but also to an increase in the demand for Japanese goods. At the same time, both Japan and the U.S. will increase their oil imports. As the LDC's increase their raw material exports to both the U.S. and Japan, they could in fact end up with even higher deficits as their economies will require both more oil and more industrial goods, both at even higher prices. In other words, the proposal assumes a fairly constant OPEC surplus to be redistributed among oil consuming countries. Unless there is a greater effort at energy conservation, the increased tempo of economic activity and world inflation could generate an even larger OPEC surplus and leave all oil consuming countries with an even larger petrodollar deficit.

Another problem with the proposed course of international economic policy involves the value of the dollar in foreign exchange markets. If the U.S. promotes an increased balance of payments deficit, the international value of the dollar could weaken, in the absence of offsetting capital flows. The cost of U.S. imports would rise, as it will take more dollars to purchase foreign goods from other countries. The result would be increased inflationary pressures in the domestic U.S. economy. This effect could become even more pronounced if the Germans and the Japanese do not go along with the U.S. in trying to reduce their payments surpluses. If the yen and the mark were to strengthen substantially vis-a-vis the dollar, the element in this economic readjustment, which I believe is almost as vital as the stronger military capability which many observers now perceive as necessary. From both the economic and political points of view, our leadership of the Free World is being challenged because our relative domestic strength has been eroded. And unless we repair that damage over the next few years, much of the international economic dialogue will only add to the confusion of an already skeptical public.

The opinions expressed are the author's and do not necessarily represent those of the Irving Trust Company.

Appendix

Table 2

OPEC CURRENT ACCOUNT AND FINANCIAL SURPLUS

	1974	1975	1976	1977	1978	1979	1980
	(actual)		(est.)	----------(forecast)-------			
Oil Production (bil. bbls.)	11.1	9.9	10.8	10.7	10.4	10.2	10.0
Domestic Use (bil. bbls.)	.5	.6	.6	.7	.8	.9	1.0
Oil Exports (bil. bbls.)	10.6	9.3	10.2	10.0	9.6	9.3	9.0
Oil Prices ($1 bbl.) (1)	9.45	10.20	11.15	12.04	12.64	13.27	13.93
Value of Oil Exports ($ bil.)	100.1	94.9	113.7	120.0	121.3	123.4	125.4
Other Exports ($ bil.)	11.0	12.0	13.0	15.0	18.0	21.0	23.0
Total Exports ($ bil.) (2)	111	107	127	135	139	144	148
Merch. Imports ($ bil.)	36	59	70	82	90	100	110
Service Imports ($ bil.) (3)	15	23	30	36	40	41	42
Investment Income ($ bil.)	4	6	7	9	11	15	18
Current Account Balance($ bil.)	64	31	34	26	20	18	14
Cumulative Financial Surplus ($bil.) (5)	80	111	145	171	191	199	213

(1) Government Take, Average OPEC
(2) Rounded to nearest billion
(3) Including Transfers
(5) Year-End, 1973: $16 billion

Table 2 translates our forecast of OPEC oil production into OPEC oil revenues. We have assumed an increase of 8% in oil prices in 1977 and a 5% per year growth thereafter to 1980. As a result of the expected decline in OPEC volume, therefore, OPEC oil revenues are projected to grow only marginally through the remainder of the decade. With a continued rise in merchandise and service imports, albeit not as rapidly as had been expected, OPEC is likely to experience a decrease in its annual current account surplus through 1980. The cumulative financial surplus, therefore, is expected to peak at around $200 billion in the 1979-80 period.

THE LIMITS OF ARAB OIL POWER

Introduction

The proper conduct of foreign policy has always depended on superior intelligence concerning the intentions and capabilities--not only of unfriendly powers but also of allies. For the United States, which in the past has been reasonably independent of imported natural resources, the supply of oil has assumed crucial importance. For this reason we need a careful assessment of Arab oil power, and indeed of the power of all oil-producing nations. Unfortunately, so much fiction has been added to the facts, that the crystal ball has become quite cloudy. It is essential to have a correct perception of what oil power consists of, what can and cannot be done by oil-producing nations, so that we will neither be pressured or blackmailed, nor become overconfident and arrive suddenly at a situation which can jeopardize national security. The purpose of this essay is to make a modest contribution towards illuminating such misconceptions as: (1) OPEC can raise the price of oil without impunity; or (2) the Arabs can declare an embargo and cut off oil to the United States; or (3) the Arabs can stop the recycling of petrodollars, ruin our banking system, leave us with a huge trade deficit, cause unemployment, inflation, etc. etc. There are some grains of truth in all these statements, but they are very small grains: mostly, they are incorrect assessments of Arab oil power. If we believe in and act in accordance with such assessments, we will pay a heavy price, both in dollars and in political coinage.

S. Fred Singer, Professor, University of Virginia. Partly based on studies performed for the U. S. Treasury under Order Number ES-318.

according to some formula. The success of OPEC would then depend on each country sticking to the assigned cutback, and not cheating by selling oil under the table at a lower price. Once price cutting starts, the other countries would of course follow suit, and the effect of the price increase would be more than eliminated. In fact, the cartel would be seriously weakened politically as well.

Perhaps OPEC knows all this, because they do not operate as a cartel, but rather as a modified monopoly. What happens is that a very few countries, those with large reserves but with small populations and therefore little need for cash, form the core of the cartel: Saudi Arabia and the Emirates of the Arabian peninsula, including Kuwait, Bahrein, Abu Dhabi, as well as (sometimes) Libya. The cartel core, mainly Saudi Arabia, has so far been willing to abosrb all of the production cutbacks.* The core countries might be willing to absorb the additional 2 1/2 mbd cutback by reducing production. Naturally, when they do this, they will lose a great deal of current income, although they will retain more oil in the ground. But there is a time value to money, and it therefore pays for them not to reduce their current income by too much. Also, their needs for financial resources have risen considerably in the last three years because of an ambitious development program and an even more ambitious program of buying modern arms.

How much of a cutback might they be willing to accept? A straw in the wind is the recent Saudi-ARAMCO agreement which sets a minimum level to Saudi production of 6 mbd, compared to a June

*For example, in June 1976 Kuwait had 46% of its production shut in, but Iran only 6%. The average for all of OPEC was 21%.

Limits to Oil Embargoes

Now that we have demonstrated that there are rather tight limits to the world price of oil, it should be obvious also that the price cannot be raised, let us say just to the United States. But what about cutting off the supply of oil to the United States? The so-called embargo which was attempted by some of the Arab countries during the winter of 1973- 74 did not succeed in cutting off oil to the US. Its chief effect was to accelerate the OPEC price increase, perhaps by a few months, over what it might have been in the normal course of events.

It is interesting to study the psychology of such an embargo. Long before the October 1973 war in the Middle East, embargoes were prominently discussed by the mass media. During the summer of 1973 NBC even ran a three-part special which promoted the idea and featured the glowering visage of King Faisal. Yet at the very same time, the Saudi oil minister, when interviewed by the Lebanese journal Al Hawadess, was quite explicit and honest in stating that an embargo against the United States made no sense, since it would only hurt other countries. Nevertheless, the public press and television continued with its campaign that an embargo could and would be placed against us. The Arabs apparently decided that if we conceived an embargo to be possible and feared it, then they would institute one and take advantage of this fear.

When the embargo finally took place, it turned out that the shortages that developed were mainly due to the poor allocation by the federal government of gasoline and other oil products.

of our total energy supply. But in the future we will also have available a strategic stockpile of oil of around 150 million barrels minimum, as specified by law. This is equivalent to a 60-days supply of Arab oil. When superimposed on a general 30-day supply reserve for all oil, this gives us therefore a reserve of about 6 months against an Arab embargo.

If under these circumstances the Arabs decide to embargo the United States, they could take two different courses of action . One would be not to change their production rate, but rather insist that their oil does not go to the United States. This case is fairly simple to handle: if their oil goes to other countries, it will be excess to their supply and the other countries will then be able to make available oil from non-Arab sources to the United States. It might take a while to readjust shipping schedules, and there could be short disruptions, but the strategic stockpile would handle this problem very nicely. Of course, this analysis assumes the Arabs do not produce the largest fraction of world oil. This situation is likely to hold until the year 2000, after which Saudi Arabia may be one of the few countries left with enough oil to support a major export program. Then again, Saudi Arabia may not be around by the year 2000, so that our concern is strictly academic.

A more likely course of action for Saudi Arabia would be to declare an embargo against the United States, and then cut its production by an amount corresponding to US imports. But even under those circumstances, it would still not be possible to keep oil away from the United States. The available oil would flow to

But an embargo is unlikely for other reasons as well. There has been developing a growing interdependence between the Arab countries, chiefly Saudi Arabia, and between the United States. Much of the Arab money is invested in the United States. The build-up of the infrastructure and of the armed forces depends on shipments of supplies from the US, on the provision of technical personnel, spare parts, and so on. Most important, Saudi Arabia has no real protector in the world except for the United States. One cannot conceive of any country that would go to the aid of Saudi Arabia if they were attacked from the outside, or infiltrated by Communists and subjected to subversion and even takeover.

Of course, all this analysis assumes that Saudi Arabia will act rationally. It assumes also that irrational elements, such as terrorists, will not gain the upper hand. But the futility of giving in to terrorists is so well known that little more needs to be said on this point.

<u>Limits to Financial Power</u>

One of the most misunderstood problems is the recycling of petrodollars. At one time it was feared that the Arabs would shift their deposits from bank to bank and thereby create havoc within the Western banking system. This fear has now disappeared. Instead people seem to be afraid that the oil-importing nations as a group will build up large trade deficits with respect to OPEC. Actually, nothing could be more desirable because this would mean that the money would be put out of circulation. They would give us oil and we would give them paper. We should not be afraid of that remote possibility but welcome it.

Finally, the Arabs use much of their money to buy goods. If they stopped buying from the United States and switched to Europe and Japan, then undoubtedly we would lose much business. But such a switch is not very likely. Commercial relations are now set up with engineering firms and with suppliers, which are difficult to break. Making new arrangements will cost a great deal of money and will cause great delays. Once started with a particular supplier, it becomes quite expensive to break the relationship and establish a different one. This holds even more true for arms shipments. On the margin, however, some business could certainly be lost by the US, and would be gained by Europe and Japan. But their more favorable trade balance in turn would mean that they would buy more from the United States than they are buying now. While one cannot guarantee exact equality, to a rough order of approximation, the money flows and trade flows may not change even if the Arabs declare a trade embargo on the United States. For the same reason also, the United States can afford to fight the Arab boycott against American firms which trade with Israel. In most cases American goods are so desirable that the boycott office ignores its principles and simply goes ahead and trades anyway. Individual firms, particularly smaller firms, may get hurt, but the United States business community as a whole would be hardly affected. But of course, for everyone who loses, somebody will gain. However, it is usually the ones who lose who create the political pressure on the Congress and on the State Department.

Otherwise there is probably not much we should do about the OPEC cartel. There is not much point in negotiating, cajoling, or threatening them. Counter-boycotts and counter-embargoes will not work, and price agreements are probably counterproductive. Nor should much be expected from the remedies that have been variously proposed, such as breaking up the oil companies, substituting the U. S. government as the sole importer, and similar schemes. They will not help as long as the cartel core is willing to reduce its production in order to maintain a high world price.

Our real answer is to stop talking about breaking up OPEC and work instead on the really tough political problem of straightening out our domestic energy policy. The principal tasks are to deregulate at least the price of new natural gas and to deregulate the price of oil. The latter is currently held at three different levels, a controlled price for old oil, a higher controlled price for new oil, and an uncontrolled price from stripper wells. This pricing scheme is providing the wrong signals and incentives to oil producers as well as to oil consumers. For example, as a result of the 3-tier price system a program had been set up to equalize the price of oil to domestic refiners some of whom import high-priced uncontrolled oil. In essence, the program subsidizes the price of oil to the consumer, and subsidizes also the import of oil from the OPEC cartel, all of which is completely counterproductive to our aim to weaken the cartel price. Clearly, it is difficult to ask the consumer, be he an industry or a household, to conserve oil when at the same time the government is subsidizing the price. While admittedly difficult, it should be possible to work out a conservatively estimated as being worth over 2 trillion dollars--and they present a tempting target to assorted radicals and ambitious militarists, from both inside and outside of Arabia.

In this situation, the presence of the Arab-Israel conflict cuts both ways. It certainly provides an irritant towards better relations between Islamic nations and the United States, Israel's chief supporter. But the mere existence of a strong Israel has also exerted a stabilizing influence in the past--and perhaps even more so in the future. Even before the huge rise in oil prices in 1973, President Nasser of Egypt had launched a military operation in Yemen, certainly with the aim of eventually taking over the oil wells of the Arabian peninsula. This scheme was aborted by the Israeli victory of 1967. The presence of Israel has also prevented a take-over of Jordan by Syria in 1970 and a linkup between Egypt and Syria, which could have placed a Soviet ally in a position to block European access and U. S. access to the Arabian peninsula. At the present time, things are in a fluid state, subject to a peace agreement between Israel and its neighbors. For the time being at least, the Sin ai peninsula is in friendly hands and accessible to the United States, in case it should become necessary to supply direct aid and assistance to Saudi Arabia from the Mediterranean. But this situation may not long prevail if Egypt regains the Sinai and were to again become a Soviet client state.

The large arms purchases by Saudi Arabia may be as destabilizing as they are stabilizing, in that they may encourage internal subversion by dissident elements or by ambitious military men who would like to take over the reins of power. It is estimated that the indigenous Saudi population is only 4 million people, and that will be multi-millionaires with fortunes stashed away abroad. When the final coup comes, we should offer them the possibility to emigrate to the United States and become citizens. At that time they would become subject to the same kinds of tax laws as other U. S. citizens, which would allow us to repatriate at least some of the money now being paid out for oil. Of course, it may never come to this. There are some specific steps which could and should be taken now, which would serve to protect the existing regime in Saudi Arabia and make it, and the United States, more secure. But even the possibility of this scenario should provide a strong incentive for the Arabs to make concessions to the United States, rather than the other way around.

With the Compliments of

Steven L. Spiegel

We would greatly appreciate your comments on this/these paper/s as well as on other papers you have received and not yet commented on.

Thank you !

THE CASE FOR HASTENING THE BUILD-UP OF A STRATEGIC OIL STOCKPILE

Eugene Bardach
Graduate School of Public Policy
University of California, Berkeley

It is now three and one-half years since the Arab oil-producing countries embargoed petroleum exports to the United States. The Federal Energy Administration (FEA) has estimated that this embargo cost the economy \$10-\$20 billion. Since we are now considerably more dependent on foreign oil imports than we were during the 1973-74 embargo, a major supply disruption would be even more costly. Yet we do not now have even one barrel of oil set aside in a stockpile that would buffer the economy against such a catastrophic disruption.[1]

It took Congress over a year and a half from the inception of the 1973 embargo to pass the Energy Policy and Conservation Act, which authorized the FEA to establish a Strategic Petroleum Reserve (SPR) containing a 90-day supply (about 500 million barrels) of crude oil and petroleum products by 1982. Intermediate milestones designated by the legislation were 150 million barrels by December 1978 (the so-called Early Storage Reserve) and 325 million barrels by December 1980. The FEA was also mandated to acquire the first ten percent (50 million barrels) by June 1977. In December 1976 the FEA published its SPR plan, in which it stated that the June 1977 goal would not be met "because of technical requirements, environmental hazards and high costs."[2] As for reaching

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[1]Industry inventories normally are large enough to substitute for 120 days' worth of oil imports, but, these inventories should be counted only as a buffer against normal commercial disruptions, not abnormal political ones.

[2]Federal Energy Administration, "The Strategic Petroleum Reserve Plan in Brief," p. 3.

the rest of the milestones on time, the FEA report promises little. Although capacity for Early Storage of 240 million barrels "will be developed," the FEA only "will endeavor" to fill this capacity to 150 million barrels by December 1978. Similarly, the agency "will endeavor" to complete the storage program on a schedule "essentially consistent" with the 1975 Act. In view of the fact that the 1977 milestone will be missed, and that the FEA was six months late publishing its SPR Plan, the promise to "endeavor" is not reassuring.

On the brighter side, President Carter and his advisers appear concerned not only to adhere to the original schedule but to accelerate it. The President's revisions in the Ford budget call for 250 million barrels to be stored by December 1978 and 500 million barrels by December 1980. The political magnitude of this decision can be calibrated by noting the difference in the relevant budget estimates for fiscal 1978: $1.7 billion in the Ford budget and $3 billion in the Carter budget. In addition, according to the Wall Street Journal, "sources said that Mr. Carter is considering, and probably will propose in his national energy policy this spring, enlarging the total stockpile program. Officials said that doubling the envisaged stockpile to one billion barrels of oil is being seriously considered."

No one quarrels with the concept of a strategic oil stockpile to deter a future embargo and to reduce its economic impact should deterrence fail. But a stockpile is expensive. Critics seem to think it is another one of those luxurious and unaffordable concepts like "equality" or "justice" or "strategic nuclear superiority." The FEA estimates the cost of construction and land acquisition for the stockpile at $1.38 to $1.65 per barrel, and this is the cheap part. To fill it with oil will cost anywhere from $11 to $14 per barrel, bringing total outlays for a 500-million-barrel SPR to over

$7.5 billion. Doubling the size of Reserve would presumably bring the total to nearly $15 billion.

Of course, budgetary outlays are in a very important sense misleading. Oil in the Reserve does not evaporate. It sits around until one day, perhaps many years in the future, we no longer fear an embargo. At that time, the oil is sold off and the initial outlays are, in effect, recouped. If the sale price turns out to be lower than the acquisition price, the government sustains a capital loss; conversely, if the sale price is higher, the government receives a capital gain. In the meanwhile the only predictable and certain costs are the costs of construction and land acquisition ($1.50 per barrel, say) and the interest foregone on the initial capital outlay. If the interest rate is ten percent, and the purchase price $14 per barrel, the annual storage cost is only $1.40 per barrel plus amortization of the initial setup costs of $1.50, roughly $.20. Calculating the stockpile costs in this way implies, therefore, an annual expenditure of about $1.6 billion for a billion-barrel reserve. This is a lot less than the alarming figure of $15 billion. But the $1.6 billion expenditure does continue year after year, as long as we hold the stockpile.

It seems certain that President Carter's plan to accelerate the storage schedule and to double the eventual stockpile size will be resisted in some quarters as too expensive. A February 1977 report by the General Accounting Office on the SPR program, entitled "Issues Needing Attention in Developing the Strategic Petroleum Reserve," focussed mainly on financial issues and ignored all those issues pertaining to schedule slippages. It also questioned the need for a 500-million-barrel government reserve <u>in addition to</u> normal industry inventories. Although the GAO report raises legitimate questions, its emphasis on cost-cutting probably portends trouble for the Carter plan in Congress. In the following section I shall argue that, while the costs of a 180-day reserve are not small, they are almost certainly worth paying.

First, we shall do some simple calculations to show that the benefits far exceed the costs. Next, we shall examine some alternative means of attaining these benefits and show that none of them is likely to be a complete substitute for a stockpile, though any of them could, and should, affect our conception of the optimal size of a strategic oil stockpile.

The Benefits of a Stockpile

The benefit of a stockpile can be construed as the economic damage that would be averted in the case of an embargo, with this sum discounted by the improbability of such an embargo occurring. Thus, if an embargo of six months' duration were expected to cause, say, $64 billion damage, we would have to discount its chances of occurrence to less than five percent per year before we would conclude that a six-month stockpile was not worth its cost of $1.6 billion per year. If the risks of such an embargo are greater than five percent per year, the stockpile is worth it. Of course, varying the parameters in a hypothetical embargo would not affect the logical validity of this procedure. For instance, if an embargo lasted a year, the total economic damage might be, say, $200 billion. Drawing down a six-month (billion barrel) strategic stockpile at a rate that stretched it out over the entire year might reduce this loss to $100 billion. In that case, one would have to believe that such an event was more than 98% improbable to make a six-month stockpile look like a bad bargain.

What sort of damage estimates are realistic? Such estimates are bound to be crude. However, the FEA has an elaborate computer simulation model that gives us some numbers to conjure with.

The economic cost to the GNP from a six-month embargo in 1977 would be \$42 billion. In 1980 it would be \$55 billion (in 1977 prices) if the world price of crude oil were to drop to \$8/barrel, and \$16 billion if prices remained just over \$12/barrel. If the price of oil drops to \$8/barrel, the cost in 1985 would be approximately \$170 billion.[3] And, of course, if the embargo is longer than six months, the cost would be higher.

No matter how fuzzy the estimates of potential damage by embargoes of different durations, it is easier to make these estimates than to assess the probability of an embargo (of whatever duration). It is hard to imagine an Arab oil embargo triggered by anything but another Arab-Israeli war. A selective embargo of one nation--the United States, for instance--is not feasible because the oil exporters simply cannot monitor the transshipment of oil, nor prevent it if they could monitor it. Hence, "an embargo" can only mean a general embargo against all importing nations in the OECD bloc (and Japan), and this drastic action is plausible only if there is another Arab-Israeli war. Yet, in the event of such a war, I think the odds strongly favor a general embargo, whether or not the U.S. intervenes to help Israel as in 1973. All that is needed to trigger the embargo is Arab military defeat, political stalemate, or psychological humiliation. Since another Arab-Israeli war in the next ten years, say, is very probable if not virtually certain, a betting man would surely wager on another embargo. Indeed, one plausible scenario would have the Arab nations locked in a political stalemate with Israel over the next two or three years and then starting a war they know they will lose as a pretext for imposing another oil embargo. If oil is their strong suit, why should they not create opportunities to lead to it?

In the absence of counter-measures, therefore, a general oil embargo is predictable in the next decade. Against the threat of an oil embargo no counter-measure could be better adapted than a strategic reserve.

[3] Thomas H. Tietenberg, Energy Planning and Policy, Lexington, Mass.: D. C. Heath, 1976, p. 124. Table 9-1. Tietenberg presents his estimates in 1975 dollars. I have increased his figures by approximately ten percent to convert

It pits oil against oil, barrel for barrel. In fact, it is such an excellent defensive weapon, at a mere $1.6 billion per year we can hardly afford not to buy it.

The Cost-Effectiveness of a Stockpile

Now this conclusion would not necessarily hold up if there were some less costly weapon that were equally effective, e.g., increased domestic supply, imports from more secure sources, or conservation. We can also take certain during-the-embargo emergency measures like fuel-switching (oil to coal in power generation, particularly), stand-by fuel production, and mandatory car-pooling.

It seems doubtful that accelerated domestic supply, conservation, and stand-by measures can reduce our vulnerability to an embargo very much in the next decade or so, however. The underlying difficulty is that the demand for oil is very brisk during prosperous times, and conventional domestic sources are declining. Within the past year imported crude oil and refined products exceeded domestic supply for the first time. Indeed, imports rose about 25 percent.

Some of these measures, moreover, have costs of their own. Domestic supply inevitably means increased environmental degradation, though of course people can disagree on how much and on its significance. Conservation can mean money-saving steps like home insulation, in which case these measures are desirable. If, however, "conservation" also means unpopular modifications in style of living or levels of consumption, it is not costless, and we might be better off paying for whatever size stockpile permits us to import whatever volume of oil we really want. In this context, I use "might" advisedly. It is hard to know the truth of the matter. Perhaps the best way to find out is to finance the strategic reserve through a tax on imports. In that way consumers of imported oil would actually end up paying for most of the stockpile; and if they did not want to pay so much, they would always have the option of importing less or none at all.[4]

Of course, reducing our import-vulnerability is only one means of reducing the expectable damage from oil embargoes. Another way is to blunt the will of the Arab oil exporters to resort to an embargo even in the event of another war with Israel. To a degree, this has occurred already. The importing nations are the sheiks' partners in a profitable trade, the valued suppliers of their technology and foodstuffs, the guardians of their financial assets, and the guarantors of oil-related debt accumulating in the poor countries. As Sheik Yamani so often reminds us, the Arab oil exporters have a large stake in Western economic well-being. Nevertheless, we must wonder if any or all of these prudential and utilitarian considerations would weigh very heavily in the face of deep political frustration and psychological humiliation. For the sake of Islamic glory and honor would not the sheiks be willing to sacrifice a few billion dollars? Anyone who doubts it should remember that the United States spent far more, in lives, treasure, and spirit, in the vain pursuit of "peace with honor" in Vietnam.

Still in the air, too, is the threat of military intervention in case of imminent "strangulation" of the West, as former Secretary Kissinger put it. The more seriously the Arabs take this threat, the less likely an embargo, and the lower the size of our required stockpile. Herein lurks an irony, however. Because the Arab counter-threat to an invasion is the threat to disrupt oil flows by sabotaging the oil fields and loading docks, a credible invasion threat must be backed by a large stockpile to hedge against such

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[4]Another nice feature of a tax on imports is that, to the extent it is shifted backward onto producers rather than forward onto consumers, the parties who are at the root of our problem are paying for its solution.

a disruption. More precisely, the stockpile must be large enough to tide us over the period while Western petroleum engineers and construction crews repair the damage, a job that would take some six months according to plausible calculations.

The Political Dimensions of a Stockpile

Because a stockpile--whether or not accompanied by a military threat--is such an excellent deterrent to an embargo, if we have a large one we can be virtually assured that it will never have to be used. More accurately, it will never have to be used as a defensive economic weapon. However, it could have plenty of uses as an offensive political weapon. We could feel a lot freer to assist Israel militarily and politically. We could try to force the price of OPEC oil back down to some tolerable level or, better still, break up the cartel. We could also exert pressure on our allies to create more adequate oil stockpiles of their own. And, finally, the very act of acquiring the stockpile is a signal to all other nations that we are determined not to give in to blackmail or to retreat from our historical responsibilities in world affairs.

Unfortunately, the political debate over whether to enlarge the stockpile and to accelerate its acquisition has the potential to signal fecklessness as well as determination. The GAO report, viewed in this context, is harmful--not, of course, for what it says but for what it fails to say. One can only hope that cost-conscious critics of the SPR program, and of President Carter's likely proposal to expand it, will not be too audible. Foreign leaders will no doubt follow the course of the forthcoming debate with care, for it will probably reflect fairly accurately the present state of elite opinion on the future American role in foreign affairs.

MARCH 21, 1977

DO NOT QUOTE OR CITE!

WHAT'S IN IT FOR US?

AMERICA'S NATIONAL INTEREST IN ISRAEL

by

Aaron Wildavsky

COMMENTS WELCOME

WHAT'S IN IT FOR US?

AMERICA'S NATIONAL INTEREST IN ISRAEL*

For friends of Israel, America has a self-evident national interest in giving it support: Israel is worthy because, well it is worthy--beautiful, benevolent, and brave. There is no need to demonstrate whether or why Israel fits into America's national interest since it is assumed by those friends that natural affinity binds the two nations together. For some others, however who are not necessarily enemies, just not firmly friends of Israel, the perspective is different. Sentiment, claim those voices,is no substitute for substance. Israel is outnumbered in the Middle East. It is poor while its neighbors grow rich. It is ringed, if not enveloped, by hostile forces. Israel lacks oil because it is badly located. America would profit materially by being on the good side of the Arabs; it has nothing to gain from Israel. America's interest in Israel, they say, is idealistic -- the kind of interest that cannot survive without a material base. Thus, to borrow a phrase from Trotsky, Israel's opponents consign it to the dung-heap of history.

Supporters take Israel's importance to America's national interest for granted, while its detractors insist that the United States cannot afford to back a losing cause. One side thinks it unnecessary to give reasons, while the other believes no good reasons exist. One side acts as if ideal interests (liberty, dignity) were their own justification, while the other insists that without a material base ("How many divisions has the Pope?" as Stalin was reported to have asked) America can have no national interest in Israel.

Is there an American national interest in Israel? Failure to provide answers may be positive--American interest is self-evident, thus

* I am indebted to Robert Crowe for research assistance.

accounting for automatic military aid. Or, answers may not be given because there are none; this may explain a by-now familiar phenomenon during crises: effusive expression of support for Israel followed by hesitation and doubt -- as if the original act were impulsive rather than grounded in firm principle, based, perhaps, on political expediency rather than on national interest. It is long past time, then, for the question of America's national interest in Israel to be raised to a conscious level. Is there such an interest? If so, what kind of interest? Under what conditions is which type of support justified?

Interests

Interests are not wishes, lists of things it would be nice to do. Interests are not made up of disembodied ideals or objectives. Nor can interests be material instruments without aims, such as defending ourselves with (mis)guided missiles without knowing or caring about their impact. Material instruments and ideal objectives combine to create interests through actions: We learn what we ought to prefer by finding out what we can get; we discover what we can do by learning what we cannot. Conquering Canada may be feasible but runs counter to our ideals. Liberating Eastern Europe or freeing Tibet may be ideals but we lack the material resources to accomplish them. To act on interests involves negotiating between what is desirable and what is doable. Ideal and material interests (or, objectives and resources), then, stand together by combining what is possible with what is desirable. Or, put it another way: Interests can be defined as programs of action which join resources (as means) to objectives (as ends). Our interests are embedded in our actions. When we ask about America's national interest in Israel, therefore, we ask whether there are courses of action which make it worthwhile for the United States to support Israel.

Speaking of nations calls to mind the word "national" that precedes interests. By national I mean a widely shared interest, one that is either recognized by a majority or that can be argued to benefit most citizens. Is there, in these terms, an American national interest in Israel?

Criteria for American National Interest in Israel

To become operative, interests must be embodied in actions. In order to choose among actions, we need criteria to let us identify policies that serve American interests and to rule out those that do not. Now criteria may be plausible or helpful, but not necessarily correct or true. In action, interests embody values -- and values are not neutral. No particular set can be absolutely right or wrong, therefore, since criteria, like interests themselves, necessarily are subjective. We are looking for criteria that will be helpful -- few enough to be manageable; focused, so they are useful in distinguishing among alternatives; and congruent with American values, in order to command general support. I propose three to help us decide what kind of policies best serve America: (1) America's interest in its own self-worth (legitimacy); (2) its interest in having allies (solidarity); and (3) its interest in being able to choose its own future interests (autonomy). First I will discuss these; later I will use them, in the context of peace proposals, to help us choose policies that are in America's national interest.

The first criterion, legitimacy, suggests that any reason for rejecting Israel must not apply equally well to the United States. If Israel is judged unreliable because governments there change, it should be remembered that the United States also, as a democratic regime, practices alternation in office. If Israel is deemed unworthy because its founders displaced native inhabitants, how much greater must have been our offenses in regard to Indians and Mexicans. For we Americans to disown Israel on this account must be to delegitimatize ourselves.

Consider America's sense of its own self-worth. Opposition to Israel would involve rejection not only of our past pledges of support, but also of the deep symbolic connections that exist between the two nations. I do not refer only to the ties of American Jews and Israelis. No, I refer explicitly to sentiments, ideals, and values common to all. America would be casting aside the birthplace of Judaism and Christianity. It would be rejecting a country whose immigrant origins and political practices are close to its own. If it were accepted, furthermore, that no nation whose founders were born elsewhere could be judged as legitimate, there would be even less rationale for putting America's legitimacy above that of Israel, whose people have been in Palestine from the beginning of recorded history.

The second criterion, solidarity, implies that arguments against Israel must not be such as to apply equally well to most of America's allies, for then we would not be talking about America's lack of interest in Israel in particular, but about why the United States did not need (or should not want) allies in general. For example, opponents of Israel claim that Israel does not possess substantial military forces; would this not rule out Japan and Canada? Or, the argument is made that there are no contiguous borders between the United States and Israel; with the exceptions of Mexico and Canada, what allies would that leave us?

What would happen if the United States, deciding it had no interest in Israel's survival, let it be known that it would not intervene (or hinder the Soviet Union from intervening) in the next Middle East war? What would America be saying to its other allies? Which of them would feel safe if the same principles used for abandoning Israel were applied to them? If democracy and a common cultural heritage were not enough, what would it take to stay on America's most-favored-nation list? Greece and Italy, for instance, have little going for them other than cultural affinity and awkward attempts at democratic politics. The United States gives them more than it gets in economic support; and their reliability, in terms of political cleavages, is suspect. Britain is better off politically but not economically. Small fry, like Belgium and the Netherlands, acceptable on those grounds, are not rich enough to be worth protecting on that ground alone. How about Canada, Japan, and Norway? Serious questions can be raised about each. Norway has oil but can hardly defend itself; Japan is rich but far away, hence difficult to defend; and Canada is close but suffering from internal political conflict.

Nevertheless, even if a few nations did merit American support, would they, alone and exposed, think it worth carrying on? In the absence of recent experience it is easy to underestimate the demoralization of being left with few culturally compatible nations in one's world. In such circumstances, might not Americans themselves begin to question the worth of their own existence? The choice of cultural isolation is not one America should want to make. The moral of the story is all too clear: if the United States tries hard enough, it can find ample reasons to reject any ally as unworthy or indefensible -- and end up alone.

The third criterion is autonomy, the ability of the United States, to decide in future circumstances whether and how far to intervene in a Middle East conflict. Whatever the rationale for adopting a "trip-wire" situation in Europe, created by the presence there of American troops, such an automatic reaction system would not be a good idea in the more volatile Middle East. The number of conflicts, after all, is likely to be large and their direction (who is fighting against whom) and duration (who will be involved for how long) hard to predict. Even with the willingness to get involved, the United States would prefer to choose the form (military, diplomatic, economic) and the forum (the United Nations, a Geneva conference, bilateral negotiations) before commiting itself to specific actions. Who argues otherwise? Almost everyone who suggests that the United States impose and/or guarantee a settlement stipulating in advance what it would do if or (more likely) when the agreements broke down.

Few argue that legitimacy, solidarity, and autonomy are unimportant as generalized national interests. It remains to be seen what happens when they are measured against the specific mix of military and economic interests with which the United States must also be concerned.

Military Interests

Because the United States need not (and should not) control countries in the Middle East, its defense interest lies in denying rule of the entire area to the Soviet Union or Iran or any other nation. The best way to do this is to reinforce existing tendencies toward national independence, economic growth, and social cohesion in the region. America does not want to weaken anyone, whether Israel or its neighbors. On the contrary, the stronger and more independent each nation is, the less vulnerable it will be and the less likely to combine with some against others.

If national interest in the Middle East were determined solely by military factors,-- a principle with which I disagree -- the United States would do well to back the side that can defend itself with American weapons but without American troops. If the Soviet Union intervened, it could not do so simply by sending weapons; in fact, the regimes it supports, as history shows, lack the internal cohesion necessary to sustain military effort should the tide turn against them. The Soviet Union risks losing arms every time it sends them. Whenever its allies or proteges are defeated, the USSR must face the difficult choice between letting them go down or risking the use of its own soldiers far away from home. By contrast, the United States, as it were, can meet the situation by remote control. Turn the matter around: What would American public reaction be if our government had to send soldiers in support of undemocratic, unstable, and untrustworthy states whose support could not be guaranteed even after they were saved?

Some people, perhaps too friendly to Israel for its own good, view Israel as strategically important, thus constituting ipso facto a vital American national interest. This position in part is just loose talk: the Middle East somehow is strategic in that it lies between East and West -- next door to Africa, near the Indian Ocean, and along the Mediterranean -- thus leaving open a path to the sea and thence to Southern Europe. What is left is tough talk: Israel becomes a strategic interest by providing the United States with bases for its troops and nuclear weapons. With friends like this, however, Israel would need few enemies, saving itself, so to speak, only to become an occupied country. Thus, much of the reason for its very existence -- the struggle for cultural identity and independent national life -- would be lost in its defense.

As for America, only in desperation would it wish to use Israel as a military base. The United States would have to be unable to refuel its planes or berth its ships or keep its weapons anywhere in Europe and the Mediterranean, or would have to believe that it is so severely threatened that it must have forward bases to defend itself. Israel would have to remain the only friendly patch of ground in a hostile world. In this eventuality -- Israel becoming an American base -- an attack on Israel would be equivalent to an attack on America. By this act, the United States would permanently antagonize all other Middle Eastern countries. The thrust of American foreign policy is to avoid such situations, not to bring them about.

Of course, if Israel proved indefensible, America might see it go down -- with regret, but go down nevertheless. No one is saying that, were support for Israel included within America's national interest, this interest must be manifested militarily by sending troops. But Israel is defensible in all the ways that matter -- externally, internally, and morally. It is true, to be sure, that in actual quantity of material resources, Israel is outnumbered and outweighed. But its capacity to mobilize and direct the resources it does possess is far superior to its neighbors; otherwise, Israel would have long since departed the international scene.

The future military importance of one country to another is determined, not by the resources that exist in some passive sense (like a lump of clay), but by those resources that the country is (a) willing and (b) able to employ with (c) consistency over periods of time. The combined wealth and manpower of the Middle East is much greater than that of Israel. But Israel neutralizes this advantage because its government can mobilize far more of its national resources. As all Israelis know, their government is a good tax collector; it is also a superb conscriptor of men and women. When one takes a dynamic rather than a static view of national resources, Israel is more desirable as an ally.

Suppose we compare Israel with its Middle Eastern neighbors as potential American allies by trying a gruesome but instructive mental experiment. What would be the effect (in these countries) of losing the national leader, the top ten, and the next hundred leaders, or the top thousand, and ten thousand, public officials? In Egypt, Syria, Jordan, Libya and Iran, for instance, the assassination of the national leader might drastically alter the nation's politics. No one knows what would happen after a Quadafi, a Sadat, a Hussein, an Asad, or a Shah left the scene. Even if one person were not crucial, the removal of ten or one hundred at the top might well topple an entire political regime. Only in Israel can we confidently expect that any government which took office, even after all leading public officials had been removed, would be identical -- in political structure and in public policy -- to its predecessor. That consistency, that close communication between elite and mass (or rather the lack of sharp distinction), that consensus on fundamentals among virtually all political factions, is the true meaning of stability. Dictatorships are good at appearing stable while democracies are better at hiding stability beneath surface intrigues. Endless cabinet re-shuffles and coalition re-formations distract attention from basic agreement on fundamentals. Only when the surface calm of a dictatorship is shattered does it become clear that so few people make the difference between continuity and chaos.

Nothing, as we know, comes for free; there is not only no free lunch, there is also no ally, stable and steadfast though it may be, that is incapable of resisting influence from abroad. A common objection to alliance with Israel, after all, is that its difficult, often recalcitrant leaders make necessary numerous compromises. How could it be otherwise? The very closeness of the relationship between the leaders and the led stems from its democratic character. Such a relationship is based on consent, not coercion: and we know it will last even if the current set of leaders is replaced.

Economic Interests

Let us look at economic interests. A quantitative estimate of Israel's economic worth may be had from the latest (fall of 1976) OPEC conference. Those we may designate as commercial nations, because they want to maximize their oil income, wanted a 15 percent price increase. Saudi Arabia offered 5 percent for six months on the condition that the United States follow a favorable policy in the Middle East. Can we not say, then, that the existence of Israel is worth approximately 10 percent of the OPEC oil bill in America ($3.4 billion), a sum exceeding the $2 billion plus that the United States now gives. Even in pure economic terms, Arab need for American assistance in regard to Israel may be worth more than it costs to supply Israel.

I do not say this to argue that America can gain economically from Israel, but only to point out that economic loss is not automatic. In fact, economic interests cut both ways. Obviously the Arab oil-producing nations are much richer than Israel. They are more important now to America than ever before because of their impact on its economy. Whether this impact would be lessened by friendlier foreign relations, or by actions designed to drive down the price of oil, is not self-evident. More important, even if the flow and price of oil are paramount, America needs a strong and friendly Israel so that oil producers interested in gaining concessions from Israel will have a need for America to intercede for them. America needs Israel in order to be able to bargain with Arab oil producers. Even if peace should suddenly break out, doubtful though desirous as that might be, oil producers would still have to worry about Israel for a good twenty years or as long as oil is likely to be a problem.

But what about the threat of an oil embargo? It is a double-edged sword, of greater potential threat to those who use it than to those against whom it is aimed. Embargo is far better as threat than as practice, for it would simultaneously divide OPEC (the Arab and non-Arab members) and unify its opponents. The unifying force in OPEC is the common interest of its members in making far more money together than they could singly, and thus in competition with each other. Based on past practice, there is little reason to believe that non-Arab members -- Iran, Venezuela, Indonesia, Nigeria -- would join an embargo. By receiving supplies through these producers, as well as by using stockpiles, we could blunt the force of any embargo. In the meantime, as the desperation of western industrial nations grows, they would become more willing to consider joint action against major Arab oil producers. Their people, in the face of evident physical shortages, could be more easily mobilized. The question is whether such nations would be more inclined to abandon Israel or to combine to hold out against rising oil pressure.

Those who submit to open "oilmail" may influence others to take advantage of this weakness. When Saudi Arabia made its case for imposing a five percent oil price increase (one percent equaling a mere billion dollars), it also wanted the United States to make commercial concessions on various other valuable international commodities. An important precedent always implicit in "oilmail" has now been made public: Oil prices as well as oil embargo can be used for additional political and economic purposes. Once the target of "oilmail" is not limited to U.S. policy with regard to Israel, it becomes a general purpose weapon that can be used to achieve a variety of objectives. If America does not support Israel in the face of "oilmail," then it had better ask which of its other interests are worth more than Israel; those which are not, then, would be subject to the same threat: If the United States does (or fails to do) X or Y the price of oil will rise to Z. "We wouldn't stand for it," you say. Who ever would have thought that tiny, feudal, and despotic regimes could be pressuring the United States in public?

Who, indeed, would have thought that the original oil embargo could have thrown our western allies into such panic, leading them not only to deny military passage to the United States but also to a futile effort to protect themselves by making special arrangements with the Arab oil producers. Yet, if in their desperation they had succeeded in undermining Israel, which of them would have felt confident of securing support if they were directly implicated in the next international crisis? That first impulse did not necessarily represent their lasting interest.

Would the end of Israel have meant the beginning of new and better relationships between the western world and Middle-Eastern governments? (More likely, not long after initial congratulations, the United States and its allies would discover that their relationships with Middle Eastern governments were deteriorating because fundamental differences among them, long submerged by the irritant of Israel, had resurfaced.) Israel is largely responsible for whatever unity exists in the Arab world, and even for creating an Arab need for America. If this need and this unity went, followed by war among and within feudal and radical regimes, America might long for the bad old days. Peace in the Middle East with Israel would be good for America, but a peace without Israel would be no peace at all.

Cultural Interests

To have interests implies willingness (up to a point) to sacrifice something for them. Unless there are things one is prepared to give up, interests are only unfocused desires. Asked to lay it on the line, how much would Americans be willing to sacrifice for what interests?

Without ranking priorities my list would include religious liberty, political freedom, economic opportunity, and such other practices as ethnic pluralism, and freedom to travel and choose goods, which define our way of life. Put the matter the other way: Who among us would want to defend an America which lacked these aspects of what is loosely called culture? Indeed, it is this cultural complex that we call the American way of life. If its legitimacy were undermined -- if political liberty were a farce, if ethnic pluralism were a delusion, if advancement depended wholly on political favoritism -- America would collapse from within long before it was threatened from without. America's first national interest, therefore, is to solidify its own sense of self-worth.

Translated into international terms, America's primary interest is to foster an environment hospitable to its culture. "Fortress America" might be a military goal, but it could never be the cultural one, for that requires a number of nations sharing sites where Western culture is (and historically has been) practiced. Foremost among these, because of the critical part they played in creating our culture, are Jerusalem, home of Judaism and Christianity, and Athens and Rome, originators of our secular civilization.

I presume to remind us of the child's ABC's of Western culture because the cultural importance of these places is not matched in this era by their economic or military significance. Greece and Italy hardly could defend themselves against external attack. They have little to offer economically, and their loans, likely to be succeeded by larger loans, are unlikely to be repaid to the United States and other Western creditors. Much the same, I might add, could be said of Britain, which is not without cultural-historic value among ourselves and other English-speaking states.

Need I say that Americans would be devastated if London, Rome, Athens, or Jerusalem fell into hostile hands? Deprived of cultural ties and affectionate memories, we could hardly help but wonder if our days were numbered, and whether cultures like ours were doomed to disappear. Let us just say the decline of the West would not be good for American morale.

Presumably it is this cultural interest that is called "ideal" as opposed to "material." Why things worth fighting for should be separated from what it takes to fight for them is beyond me. Would the capacity to use force not be affected by the strength (or lack of it) of the belief in self-worth that underlies the will to defend oneself?

I must add immediately that morality need not become a synonym for moralism; defense of cultural values need not imply aggression against the beliefs of others. There is no reason to say (and many reasons to guard against saying) that America is more-moral-than-thou or has a mission to convert the world. What America does have is an interest in protecting its own values, values that require reinforcement from other compatible cultures.

Culture alone, considered as pure preference, is not enough without the means for its realization. As Jung says, "The man who promises everything is sure to fulfill nothing, and everyone who promises too much is in danger of using evil means in order to carry out his promises, and is already on the road to perdition." Interests may become delusions if they are incapable of being realized in actions. America's cultural interest in Israel must be supportable. How, then, might it be managed?

Procedural Rules for Expressing American National Interests

Goals for America, we now see, lie in preserving a compatible culture in Israel as well as in the western world, enhancing the viability of the states which surround Israel, and reducing the probability of any being drawn into war. To secure these aims the United States needs not only a formula for an immediate settlement but also rules to enhance the prospect of permanent peace. These rules should be designed to provide the parties at conflict with incentives not only to settle, but also to monitor agreements reached so that the need for American intervention is reduced.

The first rule is that crime (read, moving armed forces across boundaries) should not pay. This means both that the United States will help negate gains won by aggression and that it will not intervene to prevent losses sustained by the aggressor. The superpowers must not provide insurance policies against the risks of aggressive war. So long as the parties believe they can attack each other with impunity (if they win, they win, but if they lose, they are rendered able to try again) violence will grow. However promising any settlement that the United States might help negotiate, inevitably it will break down if one side can significantly better its position by force.

The rule on force is essential, but it cannot stand alone, for then those who gain by the status quo could prevail by doing nothing. Thus our second rule is one of reciprocity: Each side gets as much as it gives; for each degree of peace conceded by Egypt, Syria, Jordan and their allies, Israel must make a corresponding territorial concession. The most is given for normalization of relations -- trade, travel, diplomatic relations, etc. -- and the least, but still something, for nonbelligerency. The more Israel and its neighbors yield to each other, the more they should expect to get.

Our third rule is to leave room for error. How things begin happening may determine what takes place later on. Concretely, this rule means that implementation of any agreement should be phased over considerable periods of time. If an overall settlement means that each element is tightly linked to each other, the malfunction of a single part can destroy the entire edifice. By building up agreements part-by-part, all parts will not have to be assembled anew if only one fails to function. Breakdowns thus can take place without imperiling an entire structure of agreements and without resulting in the movement of armies immediately next to Israel's heartland or in the need for a U.S. presence in local disputes. Placing American troops between belligerents would trap the United States in a web of events from which it might be difficult to disentangle itself. The rule on room for error is designed to let repairs take place without directly involving the United States. Otherwise, America eventually would become the adjudicator of all disputes, with the responsibility and hence the danger that this implies.

The United States should be as much concerned about repairing breakdowns as about initial agreement. That agreements may have to be concluded simultaneously does not mean that all have to collapse at the same time. If assaults took place across the Lebanese border, for example, the United States would not wish this relapse to be followed by fighting along the Egyptian, Jordanian, and Syrian borders as well. Such a "peace" might soon seem worse than an old-fashioned war.

The fourth rule, that all agreements should be self-policing, is aimed in part at avoiding unwanted American involvement. Specifically it means that joint Israeli-Egyptian-Syrian-Jordanese patrols are to be made responsible for various regulatory tasks such as maintaining demilitarized zones. For one thing, these exercises will provide practice in living together. For another, joint involvement means that the parties must at least try to repair breakdowns before calling for outside help.

The fifth and final rule is to involve others. The Soviet Union should be included in (not kept out of) negotiations so that it shares responsibility for the results. Since there can be no viable agreement without the USSR, its participation is essential for its consent. More valuable than its signature on treaty paper, however, would be Soviet forbearance in not taking advantage of breakdowns by supporting local repairs. Credit for a settlement should be shared to avoid discredit for a dissolution of all that has gone before.

Are there no limits to this American national interest in Israel? In other parts of the world there are limits to American action. If Canada were invaded, the United States presumably would intervene. But in some situations -- if internal discord rendered Canada militarily indefensible, or its alleged oppression against its French-speaking countrymen rendered it morally culpable, or it was trying to involve the United States in an unwanted war -- the United States might well take no action. No commitment is (or should be) total. Therefore America's desire for a speedy settlement in the Middle East should not lead to its being sucked in unawares. To go on dreaming that every problem can be solved -- an old American illusion -- could prove especially unfortunate in the Middle East. A settlement in the Middle East is in America's interest only if it initiates and sustains a process through which contending parties maintain the incentive to solve their own disputes.

The Process is the Purpose

It may not be in America's interest to seek comprehensive, once-and-for-all solution to the Israeli-Arab dispute. Why? Because the process of negotiating a single solution could lead to overexposure and over-commitment. Overexposure is inevitable because the United States would have to negotiate each and every point in public. Over-commitment comes from overexposure: Since American prestige would then be visibly attached to a settlement, the party over whom the U.S. has most leverage (and of whom it is asking the greatest sacrifice -- no doubt Israel, but possibly the Palestinians as well) will ask for guarantees. Thus the United States will find itself saddled with treaty commitments requiring it to move in if Israel is invaded or to coerce Israel if it reneges. By promising Arab Palestinians a state of their own, the United States (and what is worse, its soldiers) would be in the middle of the Middle East, directly involved in the numerous violations of the settlement that are bound to occur when an imposed rather than a mutually (un)satisfactory solution is negotiated.

It is not in America's interest to get credit for an agreement that will lead to direct (and quite possibly armed) U.S. involvement every time something goes wrong. Alternatively, it would be morally debilitating to America and its allies to look the other way when obvious violations of the peace accords take place -- either because there are so many violations it is difficult to justify intervention in each and every situation, or, because this is deemed too dangerous. It is not wise for the United States (alone or in concert with others) to have to decide what is or is not a violation, let alone to find it necessary to rectify those that take place. The greater the extent to which the parties police their own agreements, the better for the United States.

How can conflict be limited and structured so that its creative elements are retained and its destructive tendencies minimized? By making it worthwhile for the parties directly involved in the dispute to reach and police their own agreements. And how might this be done? By reinforcing the rules of force, reciprocity, error, self-policing, and implication that enhance mutual accomodation.

Here lies the American dilemma in the Middle East; autonomy is ultimately at odds with solidarity. To support solidarity it is necessary to let others know in advance that the United States will not allow Israel to be destroyed. To preserve autonomy, the United States should not commit itself to specific actions in advance. I have tried to reconcile these interests by suggesting a general commitment to the preservation of Israel manifested by processes that preserve as much discretion as circumstances will allow. Should America's interest in its own legitimacy prove decisive in maintaining its commitment, as I have argued, letting others know will provide a restraining influence on all concerned. If the United States will not accept the worst, it should seek to restrain others from attempting it. Let's look at the record, as Al Smith used to say: America has intervened before. America, under different Presidents and parties, has pledged itself to preserve Israel; both parties' national platforms include these pledges. President Carter has reinforced them. So has Congress. Of course, there is risk even in a general commitment; but so is there risk in its absence and, worst of all, in vacillation, for that tempts the worst impulses without having decided one will not thwart them. There is no easy way out -- one single decisive act to assure permanent peace -- but only the steadfast application of rules that cannot eliminate but can reduce risk.

If there is risk in over-commitment there is equal danger in the other direction: Because it has managed so well in the past, because its deeds of "derring-do" are only too well-known, Israel's capacity to go on confronting adverse conditions may be overestimated. How long can its people live with the constant awareness that they may be invaded and over-run with few friends to help them? How long can they cope with a super-heated, overinflated economy in which it is unwise to save, and with which it is impossible to keep up? Morale good enough to sustain a single heroic effort may be dissipated by too many small sacrifices. The result could be sudden collapse, followed by a precipitous rescue effort -- much more dangerous for them (and us) than continuous support. If Israel is worth preserving, the United States should stick to rules that will make it less necessary to take risks when it is very late or very dangerous.

The Promised Land: America and Israel

I have argued that the United States should wish Israel to survive because this is in our interest. Yet if the justification for Israel is so obvious, why is it so often challenged abroad? Why indeed?

We are brought face to face with a controversial and emotional topic, perhaps the largest obstacle to peaceful relations between Israel and its neighbors: Does Israel have a moral right to survive? In America, to be sure, the question is always raised the other way round: as ex-Senator Fulbright said, "It is in our interest for Israel to survive because we wish Israel to survive,"* suggesting that Israel's survival is morally right but materially wrong.

Can there be a concept of national interest that does not include concern for a nation's cultural heritage, its liberties, and its religious and moral character? The answer is "no" because even the narrowest definition -- national interest as vital to the physical survival of the country -- includes a moral preference for the survival of the nation's way of life. If this were not so, if existence alone were the aim of national policy, then either pure passivity or unlimited aggression would be adequate. On one hand, armies could be abolished and the nation laid open to all comers; alternatively, all efforts could concentrate on national defense even if morality, liberty, and culture fell by the way. But no one, presumably, argues that survival should be America's only interest, or that either pure passivity or all-out aggression is the best way to achieve it. No, the argument is always that the things we care about most are compatible with survival. Like the lady in the lifeboat who refuses to choose which of her children to save, Americans try to make all basic values compatible with surviving to enjoy them. The question here is whether they go along with support for Israel.

*J. William Fulbright, "United States Interests in the Middle East," (Middle East International, December 1975), p. 6.

If Israel truly is all that we know it to be -- politically free, morally humane, an expression of the best in Western civilization -- why does it have so many enemies? This apparent anomaly must be faced. On the surface, obvious answers suggest themselves. Arabs regard Israelis as intruders and dispossessers, Europeans see them as an inconvenience in making arrangements with Arabs, for the sins of Europe during the holocaust have been transferred to the Middle East. The Soviet Union sees an opportunity to gain a foothold by exploiting enmity against a nation based on a different political system. African and Asian nations see Israel opposed to their "third world" compatriots. At a deeper level, however, we must all recognize that Israel is an anomaly in the world that has taken shape since the Second World War.

A respected student of Middle Eastern affairs, Professor George Lenczowski, observes that Israel is the only major exception to the "movement of liberation and anti-colonialism promoted on a world-wide basis by the United Nations and practiced by the major Western powers."* Lenczowski says that Israel is a state established

> ...by immigrant alien colonists in the teeth of native opposition.... Israel and its supporters in the United States have often argued that opposition to Jewish settlement in Palestine is artificially spurred by self-seeking Arab politicians and that the ordinary Arabs of Palestine stand to gain from Jewish immigration by being exposed to better agricultural techniques, greater employment opportunities, and improved health standards.... These assertions might have been correct, and yet the world today has repudiated them, recognizing instead the right to independence as a higher value.**

It does no good to say that the United States and the Soviet Union have been far more expansionist in their time, or that Israel has paid for its land

* George Lenczowski, "United States Interests in the Middle East," (American Enterprise Institute for Public Policy Research, October 1968) p. 110

** Lenczowski, p. 110.

whereas others have simply seized what they wanted, or even that Arab Palestinians would have a state if Israel had not been attacked in 1948. True but irrelevant. If self-determination circa 1945 is the standard, Israel wasn't there and the Arabs (though not of course the Palestinians, whose sense of national identity was created by the conflict with Israel) were. The basic argument against Israel is not strategic or material but moral and cultural. Israel is accused of violating moral principles and it is attacked because it represents a different kind of culture -- Western culture in a non-Western area of the world.

America's national interest in Israel rests on this: any moral argument which condemns Israel applies equally to America itself and any cultural argument against Israel applies to all of Western civilization. In Israel we Americans are brought face to face with our own origins. When we ask whether we have an interest in Israel we are really asking about ourselves.

America's highest national interest is preservation of what gives it its own sense of self-worth. If the idea of America became illegitimate to Americans, nothing else would much matter, for our people would have lost both their ability to identify interests and their will to support them. Well and good, one might say, but where does Israel fit in? In the past, our forbears used to refer to America as their Zion, their promised land. In the present, it is hard to find a single objection to Israel (other than its small size) that does not apply equally to America. Israel alone raises questions of the legitimacy of immigration, the value of religion, the desirability of democracy, and the viability of western culture. To ask if Israel deserves support is to ask the same question about America.

By acting as if there were no American national interest in Israel, the United States would simultaneously be rejecting its own identity. America has a national interest in Israel precisely because no other nation invokes at one and the same time so many basic American values. What's in it for us? -- Our own purposes, values, self-worth, and any other reasons we have for believing in ourselves.

ENERGY POLICY RECOMMENDATIONS
SUMMARY VIEWS

Dr. A.E. Safer
Vice President - Economics
Irving Trust Company
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The principal objectives of government energy policy, within the limits of the immediate technical and political constraints, appear to me as follows:

a) Achieve the greatest possible self-reliance from unreliable and monopoly priced foreign oil sources.

b) Prevent energy shortages from causing increasing economic dislocations.

There are really two separate sets of issues associated with the Energy Crisis. The first is an international problem, affecting U.S. foreign political and economic policies. These problems relate to OPEC control of world oil supplies which represents a fundamental change in the world power structure. The second is a domestic economic problem which is related to a changing set of social values among Establishment decision makers in the United States. Present energy policies have so confused these two sets of issues that neither of the objectives are being met, and we are in fact further away from them than we were in 1973. In particular, increasing constraints on domestic energy production have caused an even greater necessity to import oil from OPEC.

International Policies

a) Break the preferred access of the international oil companies so that OPEC governments will have to compete for world oil markets. An immediate step in this direction would be the introduction of a variable oil import quota administered by the U.S. government.

b) Subsidize the cost of U.S. oil imports, to reduce the price of foreign oil to the American consumer. I would recommend a subsidy of $3/bbl. to reduce the present average delivered cost from $14 to $11.

c) This subsidy should take the form of a Treasury note paid directly from the U.S. government to a particular OPEC government, in return for selling the oil to the U.S. company for $3 less per barrel. This would also alleviate some of the balance of payments burden on the U.S. economy.

Domestic Policies

I. Oil

a) Remove all price controls from the U.S. oil market. The average price of domestic oil would rise from a current level of around $8.50/bbl. to $11, which would be the ceiling imposed by the import subsidy. Thus foreign and domestic oil would sell at the same price in the U.S. and the cost to the American consumer would remain the same as it is today.

b) Impose a windfall profits tax on the domestic producers, with a credit for reinvestment in domestic exploration and production. If there is no increase in domestic drilling, the Treasury would get back the cost of the import subsidy. If the oil companies increase their U.S. drilling, the Treasury would get back less revenue from the tax, but the prospect of more domestic oil.

c) Impose a gradually rising gasoline tax, with ample time for people to adjust. Increased mileage efficiency standards are already in place, but may need to be speeded up. Revenues from the gasoline tax should be used for mass transit and for fuel stamps to low income groups.

II Natural Gas

a) Immediately deregulate new natural gas production, and gradually phase out price controls on existing gas supplies.

b) Encourage state regulatory bodies to impose incremental gas pricing to industrial users, phasing out "roll-in" pricing. Utilize federal subsidies to the states to promote this process.

c) Begin a major program of coal gasification to provide a long term supplement to conventional natural gas.

d) Discourage imports of liquified natural gas from high priced, insecure foreign sources.

e) Work with the Canadians to speed up the Artic gas pipeline.

III Coal

a) Provide financial incentives to the electric utilities to employ stack gas desulfurization techniques ("scrubbers") in combination with the immediately available high sulfur Eastern coals.

b) Do not support horizontal divestiture; it's another scapegoat issue which will leave the coal industry with even less capital, technology, and management than it now has.

c) Western low sulfur coals (as well as shale oil) have formidable water, environmental, and transportation problems. These will be much more difficult to overcome than (a) above.

d) Support the new strip mining bill, simply to get some consistent law on the books.

IV Nuclear and Electricity

a) The anti-nuclear position borders on the irrational; it stems from fear of the unknown. Unless the U.S. meets its minimum goal of 130,000 megawatts of nuclear pwer by 1985, hope of reasonable energy self-reliance by 1985 is futile. Don't confuse the breeder reactor which is still in the research stage with the currently operational light water reactors.

b) There is ample uranium in the U.S. to meet our needs well beyond the year 2000. There should be an investigation into the current methods of uranium pricing.

c) Encourage state regulatory bodies to impose incremental pricing for electricity, and eliminate the current quantity discounts, especially for industrial users.

d) There is ample capital available for power plant construction, provided that the electric utilities can earn a return on investment acceptable to private investors.

V Conservation and Economic Growth

Energy and economic growth are tied together. A more efficient use of energy means sacrificing some growth in real personal income while the capital investments for new energy conservation technology are implemented. Rising energy prices will continue to shift consumer spending to energy and other necessities whose production costs have risen due to rising energy costs. This means less spending on other less necessary items. As a result, if general economic policy pushes too hard for a more rapid rate of real economic growth, severe inflationary pressures will resume, and another economic recession will follow. Steady and slower growth is necessary until the economy can make the adjustments to these higher energy costs. Pushing too hard for a reduction in unemployment through higher government deficits will make the energy conservation job that much tougher.

Between now and 1985, the economy will grow at a slower rate than during the past decade. The more rapidly it grows now, the greater the likelihood of a recession later. As a result, we will have to tolerate a higher level of unemployment for a few more years until the growth of the labor force slows substantially in the early 1980's.

Israel's Economy and the Role of External Funds

Howard Pack*

* Professor of Economics, Swarthmore College

I Introduction

Any analysis of the foreign aid requirements of Israel should be derived from an understanding of the country's economic structure and the role of capital inflows within this larger picture. Thus, I will first outline some of the major features of Israel's economy and briefly examine its past performance. Only after this history is established can the discussion of foreign aid proceed within a coherent, logical framework rather than as a series of arbitrary statements.

Israel is among a number of countries whose economic growth is conditioned by the twin facts of a highly skilled population and a relatively poor natural resource base. That this combination is consistent with sustained economic growth (defined as rising income per capita) can be seen, most dramatically, in the case of Japan. Countries possessing this endowment of factors of production will normally import a variety of natural resources and semi-finished inputs, process them, and export sufficient quantities to pay for these imports. Given the relative abundance of skilled labor in Israel, and the fairly high (by international standards) wages of unskilled labor, the composition of output must be disproportionally weighted towards products in which skilled labor is an important component. Israel's exports, particularly newer ones such as medical instruments, indeed embody considerable quantities of skilled labor. The composition of production is increasingly shifting toward high skill industrial products and agricultural exports such as vegetables grown in the off-season using advanced technology and sent by air to Europe.

Israel's need to engage in international trade is not solely conditioned by its resource base. Even well-endowed small countries such as Norway , trade extensively. Any small country is simply unlikely to possess a sufficiently wide resource base to preclude the need for external purchases and sales. Moreover, as is well known, the possibility of international trade offers considerable scope for a country to increase its real income through specialization in those activities in which it has competitive advantage. Finally, it should be emphasized that Israel's population is sufficiently large to permit a wide range of efficient economic activity, provided that the opportunity for trade exists. Its population of three and a half million is similar to that of Norway, and not much smaller than that of Denmark.

It would not be necessary to emphasize the economic viability of Israel were it not for the oft-repeated assertion to the contrary, beginning with a number of British commissions to Palestine in the 1930s. Such statements, when they do not simply represent convenient political stances, evince a fundamental lack of understanding of the dynamics of economic growth, particularly the possibility of overcoming a lack of natural resources by international trade. If natural resource endowments were all that mattered in determining economic success, the positions of Japan and Zaire would be reversed in terms of their respective standards of living.

Two other economic characteristics of Israel have also drawn considerable attention in the press and popular discussion, and evoked pessimism, namely, the chronic balance of payments deficit (in the sense of current imports of goods and services exceeding exports) and the high tax levels. Each of these will be analyzed after a capsule economic history without which their dimension and function cannot be placed in perspective.

II <u>A Brief History</u>

Since obtaining independence in May of 1948, Israel's economy has evolved through three distinct periods: 1948-51, 1952-66, and 1967 to the present. Although further useful subdivisions are possible, they would be mainly of interest to the specialist.

<u>1948-51</u>

The years 1948-51 were ones of mass immigration; from May, 1948 through December, 1951, the population more than doubled from 650,000 to 1,404,000. About 90 percent of this extraordinary increase was attributable to immigration; the immigrants comprised roughly equal numbers of Europeans, mainly from the displaced persons camps, and those from the Arab countries of the middle-east.

Not surprisingly, during these three years only limited per capita growth occurred, both human and physical resources being devoted primarily to the successful absorption of the destitute immigrants. Of course, even the maintainance of per capita income required a large increase in total income given the magnitude of population growth.

1952-66

From 1952 to 1966 intense efforts at economic development were undertaken. Though substantial immigration continued, it was at a lower level than in the preceding years and required a smaller percentage of the economy's labor and material resources to permit successful absorption (defined as the provision of some minimum acceptable standard of living and the generation of employment for the breadwinner). In the early years of the period Israel's per capita income was low, ($600 in 1955), comparable to that of some of the more developed Latin American countries (Argentina and Venezuela), and below that of the better-off Western European countries. As in almost all developing countries, the initial governmentally directed program to foster growth in per capita income took the form of replacing imported products, both agricultural and industrial, by domestically produced goods. Government loans and investment preferences were accorded to those companies whose products allowed a reduction in the import of specific products. This effort, designed to raise domestic production and reduce outlays on imported products, was the earliest manifestation in economic policy of the need to reduce the excess of imports over exports which had characterized the country since Independence. The effort was fairly successful in terms of reducing the country's ratio of imports to gross national product, the latter declining from 31 percent in the early 1950s to about 27 percent in 1960.

By the late 'fifties almost all economically feasible import replacement had occurred in both agriculture and industry; indeed, it may have gone a bit further than desirable. A sustained growth in exports was thus needed to narrow the continued excess of imports over exports, and a variety of policies were introduced by the government to encourage such growth. They were notably successful; between 1958 and 1966 commodity exports rose from $139 million to $475 million,* a growth rate of 16.6 percent per annum, and the share of exports in GNP rose considerably. Because of excessive pressure on productive capacity and the continued import surplus, a slowdown was induced by restrictive monetary and fiscal policy in late 1965 and continued almost up to the June, 1967 war.

<u>1967-75</u>

Between 1967 and 1975 Israel experienced continued rapid growth, though with more fits and starts than in previous years. Although exports continued to increase at a high rate, large internal consumption demand for commodities led to a slower rise

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* There was no change in the export price index during these years so that the growth in dollar volume corresponded to the real growth.

than could have been obtained from the growing productive capacity and knowledge about export markets. Simultaneously, a rapid growth in imports, primarily attributable to defense needs, led to an increased ratio of the import surplus to GNP. It should be noted that even when exports grow at a more rapid rate than imports, this is not sufficient to decrease the import surplus. For example, assume imports of $4000 per year and exports of $2000. If exports grow by 20 percent over the next year and imports by 15 percent, the import surplus will nevertheless grow from $2000 (4000-2000) to $2200 (4600-2400). Thus, despite the more rapid growth of exports in this period, the import surplus increased.

The following tabulates some of the growth rates used in the above summary.

Rates of Growth

	1952-66	1967-75
Gross National Product (constant prices)	9.8	8.4
Population	3.8	3.0
Gross National Product (per capita)	6.0	5.4
Exports of Commodities (constant prices)	17.4	13.6
Imports of: Civilian Commodities (constant prices)	7.5	4.8
Imports of: Defense Commodities (constant prices)	unavailable	14.6

III Analysis of the Import Surplus

The major economic problem that has confronted Israel's economic policy makers since independence has been the continuing excess of imports over exports. The elimination of this deficit requires a decrease in the domestic use of the economy's output and the export of those products thus becoming available. Thus, one of the three local uses, private consumption, government expenditures, or investment must be reduced and the manpower and equipment formerly devoted to producing them redirected to the production of exports. Such a reallocation can be brought about by increased levels of taxation (to reduce consumer spending), a decrease in the level of service provision by the government, and by higher interest rates or taxes to discourage investment. If present levels of investment are to be retained to ensure continued expansion, policies to discourage investment cannot be adopted and the burden of adjustment must fall on private and public consumption.

From 1952 to 1966 the Israeli economy was in fact moving in the above direction. Public and private consumption declined in relative importance and the share of exports in national output was growing. As a result, the ratio of the import surplus to gross national product declined continuously, from 20 percent in 1952 to about 13 percent in 1966, reflecting both the substitution of domestic production for imports and a rapid increase in exports. Toward the end of this period it would have been possible, with not very drastic increases in tax rates, to have engineered the requisite decrease in private consumption, though to be sure such an increase would not have been greeted with joy. Tax increases rarely are.

The financing of the total pre-1967 import surplus primarily took the form of transfers which did not have to be repaid, usually termed unilateral transfers. By far the largest share of these came from the world Jewish community and the West German government, the latter in the form of both personal restitution payments and government-to-government reparations payments. Total U.S. aid from 1948 to 1966 constituted $815 million or 12.4 percent of total capital inflows of $6.56 billion. About two-thirds of the U.S. aid was in the form of low interest loans, the rest being grants in aid. The latter were discontinued in 1963 and had been relatively small since 1954. Thus, before 1967, U.S. aid, while generous, had by no means been decisive in financing the import surplus.

A major function of the import surplus (and its mirror image, financial inflows) before 1967, especially in the 1950's, was the easing of the burden of absorbing large scale immigration. Without this external aid, taxes would have had to increase, and consumption decrease, despite the relatively low standard of living of most of the population, many of whom were themselves recent immigrants. Similarly, some of the burden of the disproportionally large military outlays was mitigated by the availability of external funds.* Nevertheless, the inflow of funds was greater than the combined requirements of immigrant absorption and defense and contributed importantly to the financing of productive investment. If external finance had not been available, the same level of investment would have required lower public and/or private consumption. Had this in fact been necessary, it is likely that Israel's government, like those of other countries, would have generated the necessary investment funding from domestic resources by active measures to reduce consumption and growth would not have been precluded; the availability of aid mainly allowed consumption to be greater during these years than it would otherwise have been.

Thus, before the 1967 war, Israel had been dependent, to a quantitatively limited degree, on the influx of foreign funds. There had been fairly successful effort to reduce the size of the import surplus, although further politically unpopular measures still remained if the gap was to be completely closed. The June, 1967 war, and even more, the October, 1973 war, altered this picture in quite fundamental ways. The import surplus which had constituted 13 percent of GNP in 1966 grew to 24 percent by 1970 and 41 percent in 1975. Part of this deterioration reflected the continued growth in private consumption, but most was attributable to the greatly augmented inflow of expensive, modern

* Israel's defense expenditures in 1953-54 amounted to 7.7 percent of gross national product, as compared with 3.7 for Sweden, 1.9 for India and .5 in Ceylon.

military hardware, as well as the intensive use of domestic productive capacity, especially labor, in military rather than civilian pursuits. Whereas in the 1952-66 period, the import surplus covered substantially more than the combined costs of immigrant absorption and defense, by 1975 the huge surplus, $4 billion, was only slightly larger than total military expenditures (foreign and domestic).

Put another way, if, in 1975, Israel's defense budget, IL 26,470 million could have been eliminated and the manpower and materiél thus absorbed completely redirected to the production of exports, (see p. 14), the import surplus would have declined from $4 billion to $557 million. Allowing for some "normal" defense expenditures, say the same percentage as the NATO countries, might have added $275 million for a total of $832 million. Moreover, the calculation understates the potential increase in exports for a number of reasons.[1]

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1 For example, the calculation of the civilian output foregone because of military expenditures assumes that the wages in the military accurately reflect civilian productivity, whereas it is likely that military pay is considerably below civilian productivity. Similarly, the non-wage income normally generated simultaneously with wage income in the civilian sector has no counterpart in the military. Non-wage income in the private sector is roughly half that of wage income. The calculation also excludes many civilian expenditures, such as roads, whose size is partly affected by defense concerns. Finally, it should be noted that the imports required to produce exports do not appear to be significantly different from the import content of military expenditures, thus justifying the implicit assumption that total imports remain constant.

Table 1

	Millions of Israeli Pounds	Percent of Total Uses
1. Private Consumption	45,372	34
2. Government Expenditures	34,727	26
2a. of which defense	(26,470)	(20)
3. Investment	25,398	19
4. Exports	27,175	21
5. Total Uses (1+2+3+4)	132,672	100
6. -Imports	57,808	44
6a. of which defense	(11,983)	(9)
7. Gross National Product (5-6)	74,864	56
8. Import Surplus (4-5)	30,633	
9. Domestic Defense Expenditures (2a-6a)	14,487	

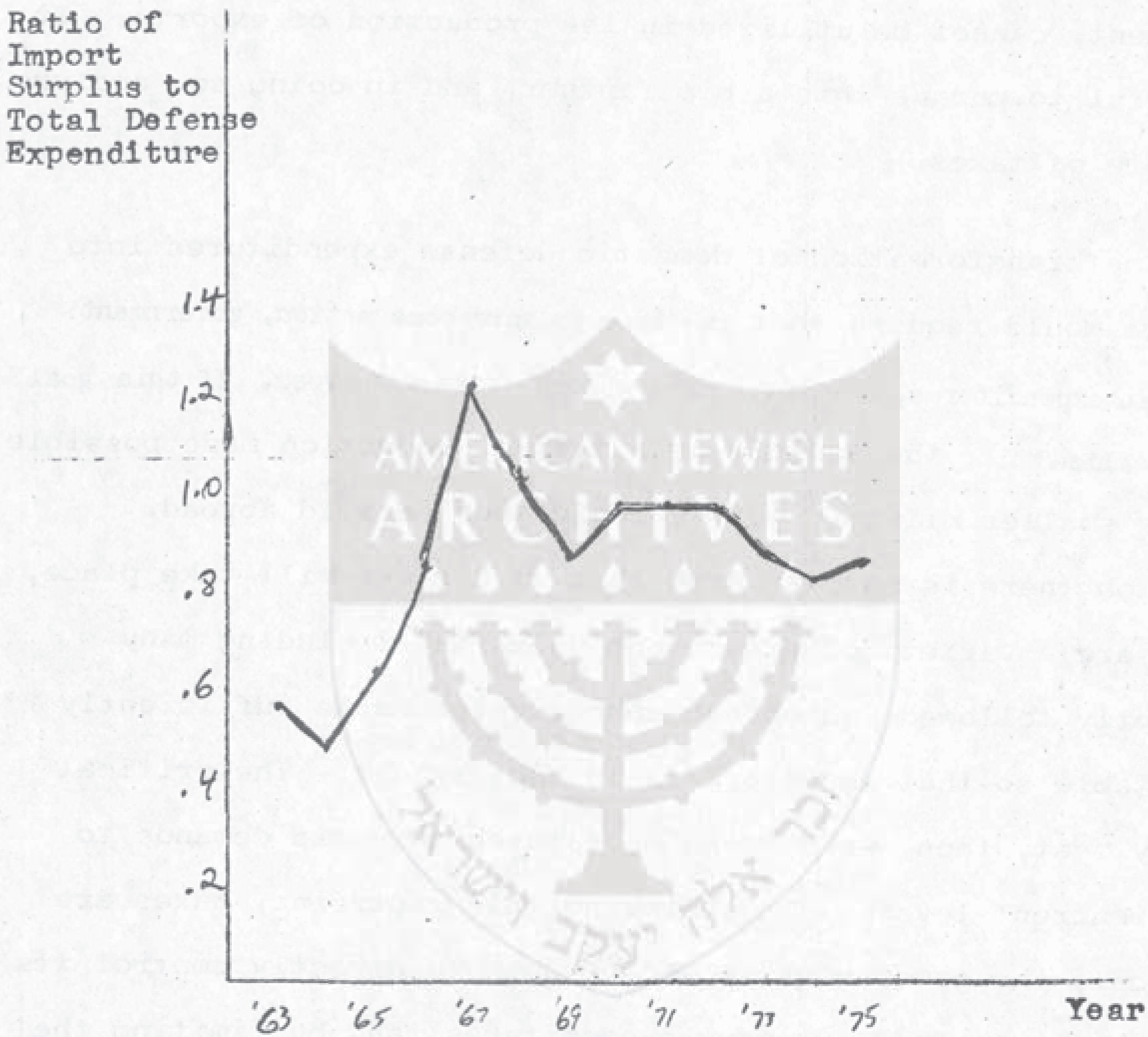
In 1975 the import surplus was IL 30.6 million. Of this direct defense imports were IL 12 million and domestic expenditures on defense amounted to IL 14.5 million. Thus, the import surplus was only slightly larger than total military expenditures of IL 26.5 million. In tabular form these calculations can be summarized as follows:

Import Surplus		I£ 30,633
Imported Defense Goods	I£ 11,983	
Domestic Defense Expenditures	14,487	
Total Defense Related Expenditures		26,470
Import Surplus not Attributable to Defense		I£ 4,163
Millions of Dollars at Exchange Rate of I£ 7.47 per dollar		557

Although the preceding concentrates on 1975, the conclusions are relevant for the entire period since 1967. Until 1967 the import surplus exceeded the combined expenses of defense and immigrant absorption and thus paid for a substantial fraction of Israel's investment. In the years preceding 1967 the ratio of defense outlays, domestic and foreign, to the import surplus was typically 2/3 or less. Since 1967 this ratio has in many years been close to 1, in the most recent years averaging about 85 percent (see Figure 1). In light of the probable underestimate of true defense costs, it is likely that since 1967 almost the entire surplus, (remembering foregone exports), year by year, has been devoted to defense.

In 1975 defense domestic and foreign outlays amounted to 86% of the import surplus. The remainder constitutes the maximum amount by which the civilian economy was living beyond its means, that is, the quantity by which private consumption, government non-defense spending or investment would have had to decline if the non-military related import surplus were eliminated. This amounts to less than 10 percent of private consumption.

Figure 1


Ratio of Import Surplus to Total Defense Expenditure
1.4
1.2
1.0
.8
.6
.4
.2
'63
'65
'67
'69
'71
'73
'75
Year

Thus, the import surplus of the last decade is largely due to defense outlays, foreign and domestic. Although the latter do not directly lead to foreign exchange outlays, they do so indirectly insofar as the local resources devoted to defense, namely, manpower and equipment, cannot be utilized in the production of exports. It is useful to pursue this a bit further, and in doing so, analyze the role of taxes.

The transformation of domestic defense expenditures into exports would require that neither private consumption, government civilian expenditures, nor investment absorb these resources. If this goal were realized . the additional civilian production made possible by the smaller military outlay could then be sold abroad. Although there is no guarantee that such sales will take place, there are a variety of government policies, including many currently followed, which can make foreign sales sufficiently profitable so that exports will in fact result. The critical policy feat, then, would be constraining domestic demands to their current levels. In achieving this restraint, taxes are critical; the government should be able to directly control its own demands for non-military expenditures, and by limiting the extent of bank lending, be able to limit business investment. To prevent the growth of private consumption, however, requires that taxes on households be maintained at their current levels so that spendable income does not grow. The role of taxes, then, is to restrain the growth in private consumption and thus permit new agricultural and industrial production to be sold abroad rather than consumed locally.*

The preceding may be viewed from a slightly different perspective. Again consider the economy in 1975. If 1975 tax levels had been maintained, and military expenditures eliminated, the government would have shown a surplus (I£ 8 billion) rather than a very substantial deficit (I£ 22 billion). This change in surplus would have been equivalent to the increase in exports (I£ 30 billion) and thus to the decline in the import surplus. The surplus thus accumulated by the public sector could then have been used to finance domestic investment, perhaps by auctioning off the accumulated funds. The surplus, along with private sector saving, would have been sufficient to finance most of local investment, leaving a very small gap to be filled by an inflow of foreign funds.

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* In 1975, total government receipts (taxes and fees) constituted 42 percent of gross national product, roughly the same ratio as that characterizing most of the West European countries. Thus, at the aggregate level the taxes imposed on Israelis were not excessive, at least in contrast with other countries. On the other hand some individuals undoubtedly faced very high marginal rates of personal income tax (i.e., the rate of tax on the last pound earned). This reflects the very narrow income base to which existing rates were applied and hence the need for high rates if substantial collections were to be obtained. Until the recent tax reforms such important income components as the cost of living adjustments were tax free. With the recent reform of the tax system and the much more inclusive tax base, marginal tax rates have been substantially reduced.

We briefly consider the growth in private consumption during 1967 to 1975 as it accounted for a part, though minor, of the continuing excess of imports over exports. During this period the government was unable to restrain, as much as needed, the growth of consumption by traditional tax devices, as the powerful trade unions fought successfully for pre-tax income levels which would permit a growing after-tax standard of living. Israel is thus one of many countries confronting such a dilemma. Western democratic societies, having learned a great deal about providing high levels of employment and limiting hardship for those at the bottom of the income distribution, have yet to develop satisfactory mechanisms for resolving disputes about income shares or limiting the demands for rapid growth in consumption standards. If Israel's balance of payments difficulties were simply like those of England, France, Holland, or Italy, they would be of intellectual interest, but not of great concern to those interested in foreign aid. Until an adequate incomes policy was devised, the import surplus would have to be covered by traditional sources including unilaterial transfers, direct investment, and, increasingly, long-term commercial credit and/or loans from international institutions such as the IMF. The inherent limit in the growth of such funding would inevitably force an adjustment in internal policies; the International Monetary Fund would be a much tougher legislator of domestic economic rules than the interlinked directorate of the Histadrut and the labor parties' alignment.

But unlike the other countries just mentioned, Israel's current account difficulty is not simply a reflection of conflicting domestic demands for private consumption goods. While a reduction in domestic consumption would have resulted in a smaller import surplus and thus an economy less dependent on foreign capital inflows, most of the problem lies in the high level of defense spending. Almost all of the current account deficit is attributable to defense outlays.

IV Financing the Import Surplus

Throughout Israel's history most of each year's import surplus has been paid for by unilateral transfers. Thus, borrowing from both private and official sources was relatively limited. The use of loans in the pre-1967 period was not an issue of concern insofar as they helped to create domestic production capacity whose output could ultimately be directed towards exports. As long as a sufficient quantity of exports could be obtained from the augmented capacity to allow amortization of the loan and payment of interest charges, the use of loan finance was a sensible method for (partially) financing economic development. Indeed, external loans had played an important role in the development of the U.S., Australia, and many other countries. Although outstanding loans continued to increase throughout the years until 1967, they rose at a considerably slower rate than export earnings. As neither the average maturity of the debt (which determines the repayment of principal) nor interest rates increased, the ratio of debt service to export earnings continuously decreased - an increasingly small share of each dollar of export earnings had to be set aside for debt service.

Since 1967 outstanding foreign debt has grown very rapidly. However, the continued rapid expansion of exports has forestalled a rise in the debt service ratio. While a growing foreign debt is never relished, it has, until now, not been difficult to finance its servicing. Insofar as the debt being currently contracted is not being utilized to finance increased productive capacity, the continued growth of exports to cover any further growth in debt service cannot be taken for granted.

It is useful, finally, to briefly consider the financing of the import surplus in 1975, the last year for which complete statistics are available. These financial flows are the mirror image of the excess of imports over exports discussed above: they provide the means of payment for the "real" surplus.

Table 2

Financing of Import Surplus - 1975
Millions of Dollars

Import Surplus		4037
Financing:		
Long Term		
U.S. Government Grants	665	
long term loans	1190	1855
Unilateral Transfers- private		732
West German Restitution Payments		359
Long Term loans other than U.S.		234
Foreign Investment		81
Total Long Term Capital Inflows		3261
Short Term Loans and Changes in Foreign Exchange Reserves		776
		4037

Unilateral transfers ($732 million) from private sources and the West German government ($359 million) more than covered that fraction of the import surplus which was not defense related. Thus, the other sources of both long and short term financing would not be needed were military outlays, both in foreign exchange and domestic, eliminated or reduced to some normal level consonant with Israel's development. Indeed, the total U.S. aid package of $1.855 billion, was roughly equal to the direct imports of defense items $1.846 billion.

V. The Question of American Aid

The preceding has set out the dimensions and causes of Israel's current imbalance in its foreign accounts. No prescriptions are derivable about the proper level of further U.S. official aid. This involves explicit political judgments about the moral value to the U.S. of helping to maintain liberal democratic societies with a demonstrable interest in their own self preservation. Currently, we implicitly spend a large share of our defense budget on strategic deterrence to protect the democracies of western Europe, Japan, and Oceania.

If we assume that a similar consideration provides the basis for a continuing flow of official U.S. aid to Israel, what should be its level and composition (grant versus loan)? There are no rigorously derivable guidelines and subjective evaluations are necessary. Given the large outlays on military hardware, and the obvious fact that these do not generate future export capacity to allow repayment, it would seem reasonable to tie the U. S. official aid level to direct dollar outlays on equipment. Such aid would still leave domestic military expenditures to be covered by non-U.S. government sources. These domestic costs will probably increase as a share of total defense expenditures insofar as some of the recent large scale procurement programs are likely to decrease in size, while the number of man-years needed to provide a sufficient numerical strength in the Israeli armed forces will not decline. Thus, the importance of non- U.S. aid in the financing of the import surplus is likely to increase over-time; if, as expected, such aid, will increasingly consist of loans rather than transfers, it will impose a growing service burden on future generations, though this could be financed with sufficient slowing in the growth of private consumption. Clearly, the larger is the U.S. loan component in any given aid package, the greater will be the future service burden. While there is no critical percentage of loans, which, if exceeded, would prove unserviceable, there is probably some maximum rate of export growth achievable, and if debt service requires more than this, severe problems may result. Thus, a reasonable division of any U.S. aid package, as between loans and grants, will require, at that point, precise analyses of prospective export growth, the existing committed service burden, and perhaps other details. These are likely to change from year to year and precise guidelines, before the fact, are not likely to prove fruitful.

If defense outlays could be reduced to more "normal" levels, say those preceding 1967, official U.S. aid would certainly not be needed nor would commercial and institutional lending. Israel could then resume sustained, long run growth, unhampered by the need for period slowdown occasioned by the need to finance defense related imports. But such an economic idyll depends on resolution of more fundamental questions.

Note on sources of data

All of the data on Israel have been obtained from various issues of the Statistical Abstract of Israel and the Annual Report of the Bank of Israel. More detailed analyses of many of the issues considered in the paper can be found in Don Patinkin, The Israel Economy: the First Decade, (Jerusalem, Falk Project for Economic Research in Israel,1960) and Howard Pack, Structural Change and Economic Policy in Israel, (New Haven, Yale University Press,1971)