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EBS/84/258

CONFIDENTIAL

December 11, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Israel - Exchange Arrangements and Exchange System

The attached paper on recent changes in the exchange arrangements and exchange system of Israel is circulated for the information of the Executive Directors.

If Executive Directors have technical or factual questions relating to this paper, they should contact Mr. R. P. Hicks, ext. (5)7187.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

ISRAEL

Exchange Arrangements and Exchange System

Prepared by the European Department and the
Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by L. A. Whittome and Eduard H. Brau

December 10, 1984

In the attached communication, the Israel authorities have informed the Fund of certain economic policy measures recently introduced, including modifications to Israel's exchange system. According to the communication, these measures are aimed at preserving foreign exchange reserves and reducing inflationary pressures. Foremost among the steps taken is an agreement between the Government and the employers' and employees' organizations on a freeze for three months from November 5, 1984 on prices of all goods and services, wages and salaries (excluding agreed cost of living adjustments), profits, and taxes. In conjunction with the agreement, although not forming a part of it, guidelines have been established with respect to monetary and exchange rate policies. In addition, modifications were announced in the trade and payments system which provide for an extension, from November 1, 1984 until August 1, 1985, of certain restrictions introduced on July 25, 1984 relating to imports and the repayment of foreign loans.

After receiving the attached communication, the staff obtained details of a new imported services tax law effective from November 13, 1984 for a one-year period. This law supercedes a previous arrangement (introduced on July 25, 1984 for a three-month period) whereby applicability of the 15 percent value-added tax was extended to include imported services. The new law provides for a tax of 15 percent on imported services and will be collected when the purchase of foreign exchange is made.

The foregoing measures need to be viewed against a background of various other steps recently announced, and reported in EBS/84/162 (8/3/84) and EBS/84/212 (10/12/84). Further details with respect to the most recent measures are as follows:

1. In conjunction with the price and wage freeze, arrangements regarding the cost of living adjustment to wages have been modified. The underlying arrangement, in force since May 1984, provides for compensation of 80 percent of the cost of living increase if the latter should amount

to between 12 percent and 25 percent in any one month, or 90 percent if a higher cost of living increase should be recorded. According to the recently agreed modification, the cost of living adjustment to wages in November 1984 is limited to two-thirds of these amounts. For December 1984, a similar procedure is to apply so long as the standard formula (of 80 percent or 90 percent compensation) provides for a cost of living adjustment no higher than 15 percent; if such is not the case, the government will enter into negotiations with the employees' organization to determine the extent of the adjustment. For January 1985, the standard formula for the cost of living adjustment will apply without qualification. As part of the agreement, the Government has stated that--with effect from February 1985--wage earners would be compensated for the erosion of their incomes by a 5 percent reduction in the amount of income tax to be paid; persons whose income is below the tax threshold are to be compensated in a manner yet to be decided.

2. With respect to guidelines for monetary policy, the attached communication indicates that the growth of shekel credit is to be severely restricted, while no expansion in foreign currency credits will be allowed. Interest rate policy will be aimed at securing real positive rates, with a real rate of 1 percent per month set as an objective. As indicated in the communication, real interest rates--which have been significantly positive in recent periods--were lowered by about 5.5 percentage points at the time of the announcement.

3. For exchange rate policy, the guidelines reaffirm the present policy of maintaining Israel's competitiveness by regular depreciations of the shekel to reflect inflationary differentials.

4. Measures relating to the exchange system involve an extension from November 1, 1984 to August 1, 1985 of certain of the arrangements introduced on July 25, 1984, and outlined in EBS/84/162. In particular:

a. Foreign exchange for payments for imports will continue to be permitted only against certain documents (bills of lading and letters of credit), or for repayment of suppliers' credits.

b. Imports of investment goods and motor vehicles will continue to be permitted only against foreign credit covering at least 75 percent of the f.o.b. value of the imported item, and provided that the average maturity of such credit is not less than 30 months. With the extension of this regulation, there has however been some easing of its coverage in that motor vehicles are now defined as only those for noncommercial use, while certain other investment goods have been exempted from the obligation to receive suppliers' credit as a condition for import.

c. The provision of foreign exchange for voluntary prepayment of foreign obligations by residents continues to be suspended.

The measure described above in paragraph 4, section b., involves the extension of an exchange restriction previously notified to the Executive Board (EBS/84/162) and unapproved. The law with respect to a tax on imported services--which replaces the value-added tax system in certain respects--involves a multiple currency practice subject to approval under Article VIII, Section 3.

The various economic policy steps recently taken, particularly the freeze on prices, wages and profits, are seen by the authorities as offering a temporary respite from inflation while more basic measures are put in place. The staff continues to believe, as indicated in EBS/84/212, that a comprehensive set of fundamental policy measures is essential if Israel's severe economic problems are to be addressed. Article IV consultation discussions will be held with Israel in early 1985. In the meantime, no action by the Executive Board is proposed.

Attachment

NOVEMBER 13, 1984

TO: INTERNATIONAL MONETARY FUND, WASHINGTON, D.C.

ATTN: MR. J.J. POLAK, EXECUTIVE DIRECTOR

DEAR MR. POLAK,

TO REDUCE INFLATIONARY PRESSURES AND PRESERVE FOREIGN RESERVES, THE FOLLOWING STEPS WERE TAKEN BY THE GOVERNMENT DURING THE LAST TWO WEEKS:

1. ON NOVEMBER 5, AN AGREEMENT WAS SIGNED BY THE GOVERNMENT, HISTADRUT AND PRIVATE SECTOR EMPLOYERS, THE MAIN POINTS OF WHICH ARE AS FOLLOWS:

A. A FREEZE WAS IMPOSED ON THE PRICES OF ALL GOODS AND SERVICES, AS WELL AS WAGES AND SALARIES, PROFITS AND TAXES, FOR A PERIOD OF THREE MONTHS.

B. PAYMENT OF COST-OF-LIVING ADJUSTMENT FOR THE FIRST MONTH OF THE AGREEMENT (NOVEMBER) WILL AMOUNT TO TWO THIRDS OF THE ADJUSTMENT AS ORDINARILY CALCULATED. THIS MEANS THAT WAGE-EARNERS WILL FOREGO ONE THIRD OF THE ADJUSTMENT WHILE EMPLOYERS WILL ABSORB THE REMAINING TWO THIRDS.

C. THE SAME PROCEDURE WILL APPLY TO THE SECOND MONTH OF THE AGREEMENT (DECEMBER) ASSUMING THAT THAT MONTH'S ADJUSTMENT AS ORDINARILY CALCULATED WILL NOT EXCEED 15 PERCENT.

D. FOR A PERIOD OF THREE MONTHS, STARTING FEBRUARY 1985, WAGE EARNERS WILL BE COMPENSATED FOR THE EROSION OF INCOME BY A 5 PERCENT REDUCTION IN INCOME TAX. THOSE WHOSE INCOME IS BELOW THE TAX THRESHOLD WILL ALSO BE COMPENSATED IN A MANNER TO BE DECIDED.

2. THE RATE OF INTEREST AND THE RATE OF EXCHANGE ARE NOT PART OF THE AGREEMENT. HOWEVER, GUIDELINES IN THESE TWO AREAS WILL BE AS FOLLOWS:

A. THE REAL RATE OF INTEREST SHOULD BE POSITIVE. (WHEN THE AGREEMENT CAME INTO FORCE, INTEREST RATES WERE REDUCED BY ABOUT 5.5 PERCENTAGE POINTS.) AS THE AIMS OF THE AGREEMENT ARE PROGRESSIVELY ACHIEVED, THE REAL RATE OF INTEREST WILL BE DECREASED UNTIL IT REACHES 1 PERCENT PER MONTH.

B. THE GROWTH OF SHEKEL CREDIT WILL BE SEVERELY RESTRICTED WHILE FOREIGN CURRENCY CREDIT WILL NOT BE ALLOWED TO EXPAND AT ALL.

C. THE PRESENT EXCHANGE RATE POLICY, WHICH IS INTENDED TO PRESERVE THE REAL RATE OF EXCHANGE, WILL CONTINUE.

3. THE TEMPORARY AMENDMENTS TO THE EXCHANGE CONTROL REGULATIONS INTRODUCED ON JULY 25, 1984 (AMENDMENTS (3)-(5) IN OUR TELEX OF JULY 26, 1984) HAVE BEEN EXTENDED UNTIL AUGUST 1, 1985. HOWEVER, THE REGULATION REGARDING IMPORT CREDIT (AMENDMENT (4) OF THAT TELEX) HAS BEEN CHANGED TO INCLUDE ONLY MOTOR VEHICLES FOR NONCOMMERCIAL USE, OTHER INVESTMENT GOODS HAVE BEEN EXEMPTED FROM THE OBLIGATION TO RECEIVE SUPPLIERS' CREDIT AS A CONDITION FOR IMPORT.

WITH BEST REGARDS,

DR. MOSHE Y. MANDELBAUM
GOVERNOR, BANK OF ISRAEL