FOR AGENDA

SM/84/99

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May 2, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Israel - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Israel. A draft decision appears on page 18.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Hole (ext. (5)8811) or Mr. Boote (ext. (5)8812).

Att: (1)

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INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 1984 Article IV Consultation

Prepared by Staff Representatives
for the 1984 Consultation with Israel

Approved by Brian Rose and Subimal Mookerjee

May 1, 1984

I. Introduction

A staff team consisting of Messrs. Hole, Manison, Boote, and Van't Dack (all EUR), with Miss Emerson (EUR) as secretary, held Article IV consultation discussions in Jerusalem and Tel Aviv during March 1-14, 1984. The Israeli representatives included officials of the Bank of Israel and the Ministries of Finance, Commerce and Industry, and Defense. The mission had discussions with the Deputy Prime Minister, Mr. Levy; the Minister of Finance, Mr. Cohen-Orgad; the Minister of Commerce and Industry, Mr. Patt; and the Governor of the Bank of Israel, Mr. Mandelbaum. Meetings were also held with representatives of the Manufacturers' Association, the Bankers' Association, and the Histadrut Trade Union Federation. Mr. Polak, Executive Director for Israel, attended some of the meetings. Israel continues to avail itself of the transitional arrangements under Article XIV.

Since the visit of the staff, the Israeli Parliament has voted to advance general elections, which will now be held on July 23, 1984.

II. Background

Following a cutback in domestic expenditure and an accompanying improvement in the external current account in 1980, domestic demand in Israel resumed a rapid rate of growth in 1981 and 1982. In the latter year, exports declined in volume terms under the combined influence of reduced competitiveness and stagnant demand in foreign markets, and the foreign resource gap widened sharply (to 13 percent of GDP), reverting almost to the very high level reached in 1979. The rate of inflation, meanwhile, ran consistently in excess of 100 percent per annum over the three-year period, while fluctuating in a relatively narrow range as a large proportion of year-to-year variations in the degree of excess domestic demand was shifted abroad.

Viewing high and persistent inflation as the priority problem, the authorities in September 1982 initiated a policy of slowing the depreciation of the shekel vis-à-vis the U.S. dollar to 5 percent a month (corresponding to 80 percent a year, compounded) and limiting the rise in controlled prices (representing about one fifth of the CPI basket) to a similar monthly rate. This strategy, which was based on the belief that the prevailing rate of inflation could not be explained by real imbalances alone but also reflected a purely monetary element, was to be supported by some reduction both in the demand stimulus of the budget and in real wages. It was recognized that a slowing down in the depreciation of the exchange rate could, in the short run, adversely affect the balance of payments, but it was thought that any such impact would be manageable.

These various developments were reviewed by the Executive Board on the occasion of the last Article IV consultation with Israel (EBM/83/85, 6/15/83). In his summing up of that discussion, the Acting Chairman discerned a serious concern on the part of Executive Directors that Israel's economic problems were becoming more pressing, together with a consensus that a comprehensive and coherent strategy to eliminate external and internal imbalances should be devised and implemented without delay. In this connection, Directors had felt that the policy of decelerating the growth of key nominal magnitudes could have little lasting effect on the inflationary process without a determined and persistent attack on the underlying imbalance between demand and supply in the economy; had emphasized in particular the need to reduce the fiscal deficit; had stressed that more fundamental steps were required to enable monetary policy to contribute effectively to the control of inflation; had expressed concern about exchange rate policy; and had underscored the importance of re-establishing an appropriate real wage level.

III. Economic Performance and Policies in 1983

The misgivings voiced a year ago were for the most part borne out, as during much of 1983 the economy's imbalances deepened. Reflecting this, the external resource gap widened further and inflation failed to abate during the first three quarters of the year. In the final quarter, the worsening in the external balance was stemmed, but at the cost of a major surge in inflation.

At the root of the continued deterioration in economic performance was the policy strategy initiated in late 1982 and a failure to contain the claims on resources of the public sector--which interacted to sustain an excessive growth in expenditures. With demand pressures and institutional rigidities, including widespread indexation of wages and financial assets, effectively putting a floor under the rate of inflation, the policy of holding down the rate of depreciation of the shekel entailed a persistent appreciation of the real exchange rate. This spurred demand for imports--the more so inasmuch as the exchange rate policy was increasingly viewed as being unsustainable for more than a short period--and, together with a continued slow recovery of demand in major markets, depressed exports. Similarly, holding the rate of rise in controlled prices below the increase in production costs entailed a persistent rise in subsidies, the impact of which on the budget was exacerbated by an unplanned increase in defense expenditure. As a result, the direct demand stimulus of government transactions remained high. At the same time, the financing deficit of the Government widened sharply. And, with expectations of a substantial real depreciation of the exchange rate prompting a flight into foreign currency assets and goods, domestic bond sales became steadily more difficult and sharply higher recourse was needed by the Government to credit from the Bank of Israel.

With the economic situation becoming increasingly untenable, the shekel was depreciated moderately in real terms in August and more substantially in October. The second depreciation was accompanied by a basic change in exchange rate policy to ensuring maintenance of the real effective rate; at the same time, budget subsidies were cut back substantially and steps taken to begin reducing other expenditures. The immediate upshot was a release of repressed inflation, a sharp consequential erosion in real incomes, and a downturn in activity around the turn of the year.

1. Demand, output and prices

As in the two preceding years, demand grew substantially faster than output in 1983 (Table 1). With a decline in the relative price of imported consumer and capital goods that was widely perceived to be temporary, and with a continued rapid expansion in domestic defense expenditures, all components of final domestic demand increased strongly in volume terms. Private consumption rose by nearly 7 percent, against an increase in disposable income of less than 3 percent, with a particularly strong rise (17 percent) in expenditure on consumer durables (most of which are imported) and in travel abroad (22 percent); public consumption grew by nearly 8 percent; and fixed investment expanded by 9 percent, paced by a rapid increase (27 percent) in imported machinery and equipment. With real GDP rising by only about 1 percent 1/ for the second consecutive year, the foreign deficit on goods and services (on a national accounts basis) widened to 16 percent of GDP--more than double its level in 1980. Virtually all of this deterioration from 1980 mirrored an increase in the share of total consumption in GDP, due primarily to a cumulative growth of 27 percent in real terms in private consumption.

Despite the policy from September 1982 onward of slowing the adjustment of the exchange rate and controlled prices, no significant dent was made in inflation. Over the year to September 1983, consumer prices increased by 128 percent, compared with 131 percent in the preceding 12-month period. The failure of inflation to abate reflected several factors: (i) the self-perpetuating tendency of the inflationary process in the short run, deriving in part from institutional rigidities; (ii) a high level of liquidity in the economy at the outset, and a failure subsequently to reduce real imbalances in the economy; (iii) deeply ingrained inflationary expectations, which were sustained by a visible lack of progress in reducing the budget deficit; and, (iv) sizable real

1/ As measured (provisionally) from the expenditure side. Other indicators, however, suggest a stronger rise (2-3 percent), with a smaller decline in the private sector savings ratio.

wage increases, especially in the public sector--where, after about a year's delay, a new wage contract was finally agreed which inter alia provided compensation for the loss of real income ad interim.

Following the abandonment by the authorities of their anti-inflationary strategy in October 1983, an unprecedented surge in prices ensued. In the six months from September 1983, consumer prices rose by more than 120 percent (actual rate) and by March 1984 stood more than 240 percent higher than one year earlier (Table 2). Since wages are adjusted incompletely and with a lag through indexation, 1/ real earnings fell by 15 percent between the third and fourth quarters, notwithstanding an advance payment of index compensation. With the shift in policies also realigning relative prices, domestic expenditure and output turned down in the fourth quarter and the rate of unemployment, after falling by September to its lowest level in three years (4 percent) moved back up to 4 3/4 percent at the year end. For the year as a whole, wages still increased by 5 percent in real terms, which, with productivity declining for a second consecutive year, implied a further reduction in the share of profits in national income (Chart A).

2. Balance of payments and external debt

The increase in the economy's domestic disequilibrium in 1983 propelled external current transactions more deeply into deficit. The deterioration in the civilian goods and services balance (i.e., excluding direct defense imports, which are closely linked to the receipt of intergovernmental transfers and loans) amounted to US$0.8 billion, divided equally between the goods and the services accounts (Table 3). The weakening in the trade balance occurred despite a continuing improvement in the terms of trade (Chart B) and stemmed from three broad factors: (i) a further adverse shift in the economy's relative cyclical position (particularly as Western Europe, Israel's main market, recovered only slowly from recession); (ii) a marked decline in the shekel price of imports and exports relative to the price of goods produced for the domestic market, consequent on the real appreciation of the exchange rate; and (iii) increased payments difficulties in a number of developing countries, which impinged adversely on exports of military equipment. All told, exports remained unchanged in volume terms in 1983, as against a growth in markets of about 5 percent, while the volume of nondefense imports again increased by some 10 percent.

Imports of defense equipment, by contrast, fell sharply further in 1983, and by substantially more than total receipts from transfers. The current account deficit, correspondingly, widened somewhat less than

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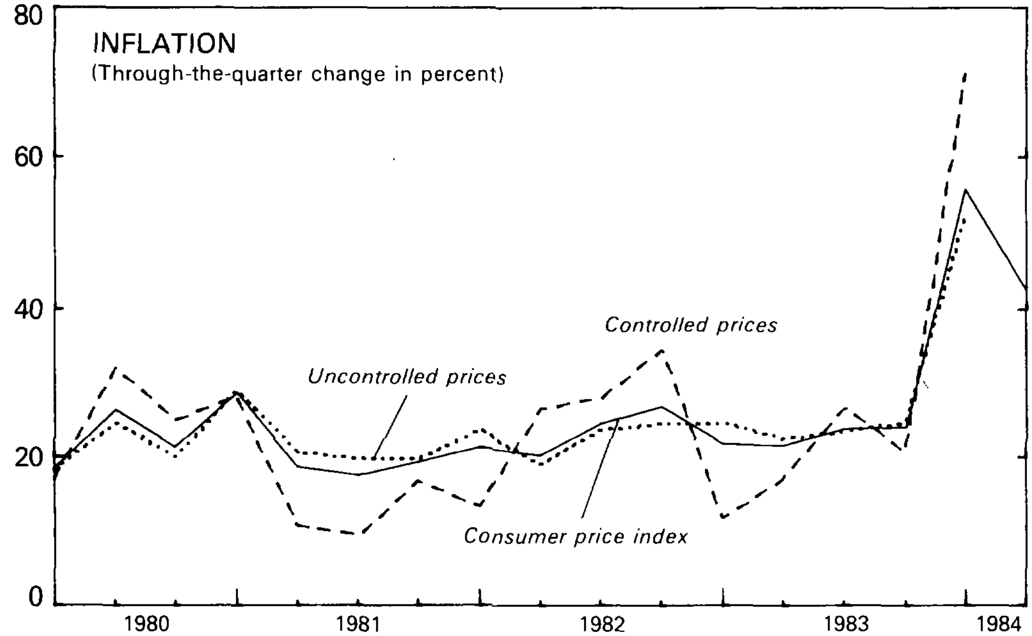
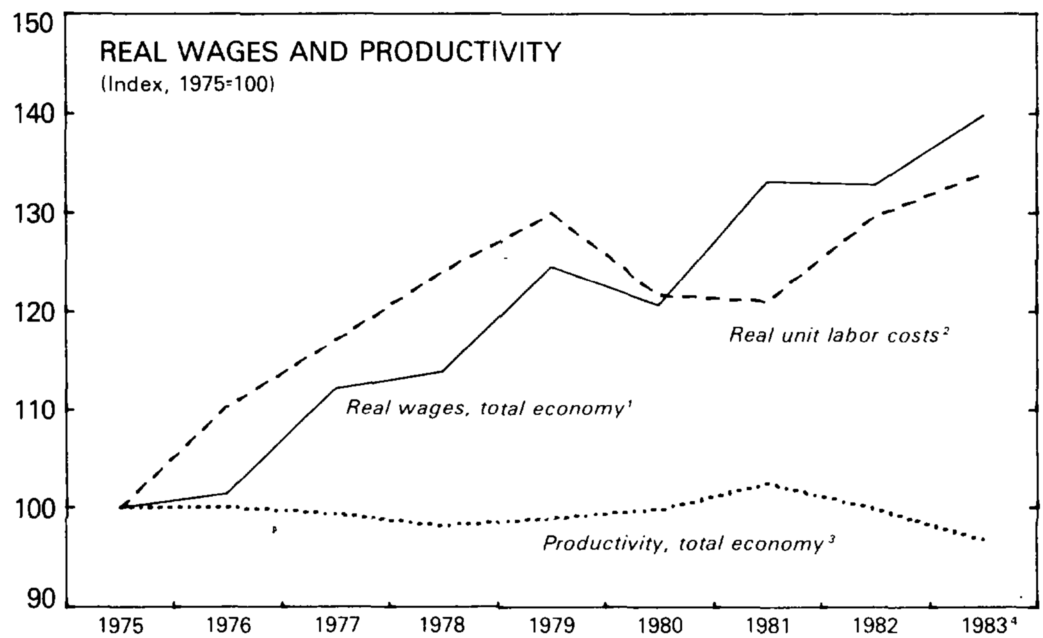
1/ Compensation is based on the rate of inflation as measured by the CPI over the course of each calendar quarter and is paid in the month following the end of the calendar quarter. It amounts to 80 percent of the calculated inflation rate if that rate is less than 20 percent, 85 percent if it is between 20 percent and 25 percent, and 90 percent if it exceeds 30 percent (as it did in the fourth quarter of 1983).

CHART A

ISRAEL

INFLATION, REAL WAGES AND PRODUCTIVITY





Sources: Bank of Israel, *Annual Report;* Central Bureau of Statistics, *Monthly Bulletin of Statistics;* IMF *International Financial Statistics;* and staff estimates.

[1] Average wage per employee post at fixed 1978 prices

[2] Business sector employee compensation (including nonwage compensation) divided by net business sector product

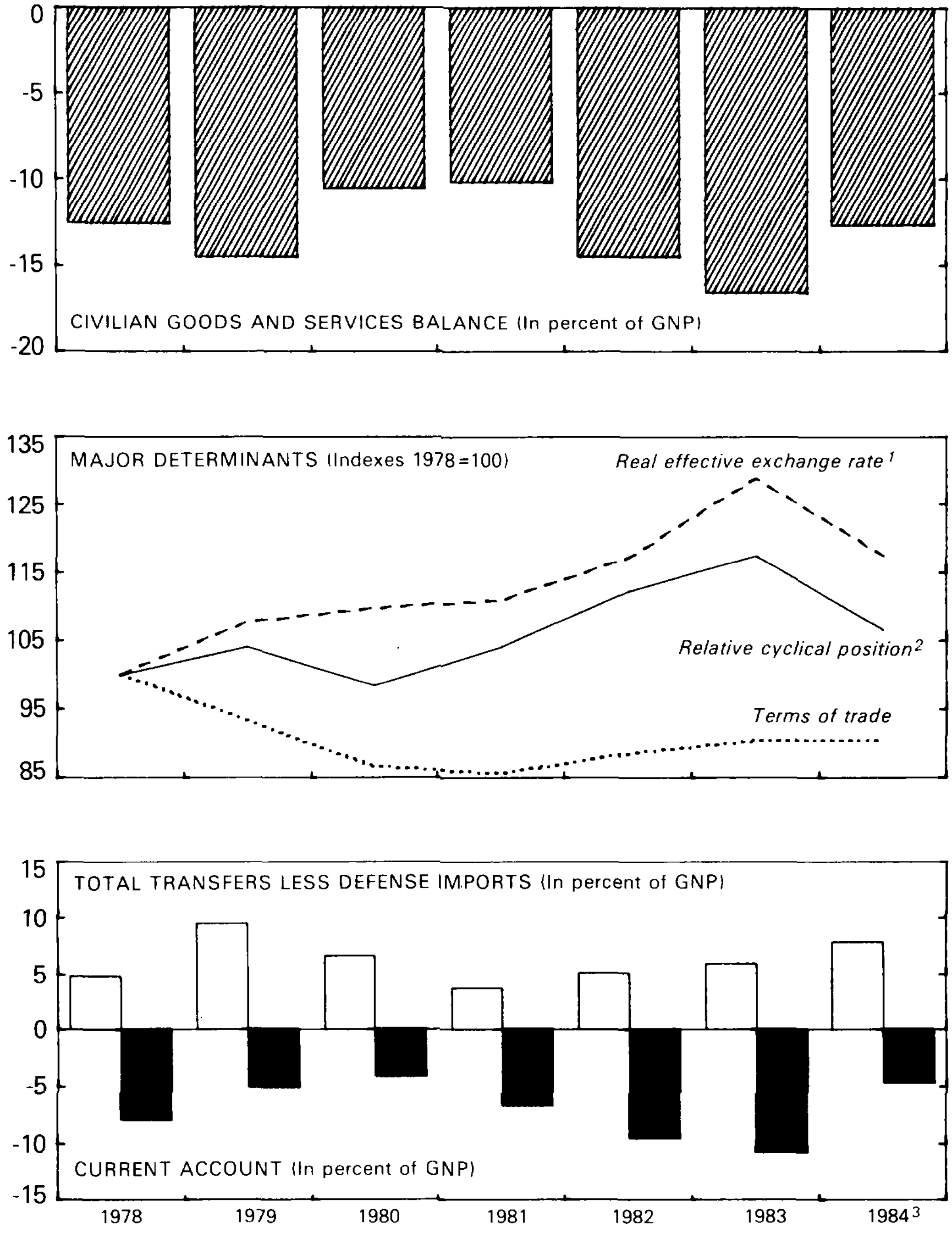
[3] Real net national product per employed person.

[4] Estimate.

CHART B

ISRAEL

MAJOR DETERMINANTS OF THE EXTERNAL CURRENT ACCOUNT



Sources: Information provided by the Israeli authorotries, and IMF staff estimates.

[1] Standard index used for the Fund's Information Notice System

[2] Ratio of index of real domestic demand in Israel to index of real domestic demand in partner countries, with latter index weighted by partners' import shares

[3] Forecast.

the civilian goods and services deficit, but still by some US$0.5 billion, to a level of US$2.6 billion, the equivalent of nearly 11 percent of GNP. The deficit was covered virtually entirely by medium- and long-term capital inflows, including an exceptional level of borrowing by the private nonbank sector of some US$0.9 billion and an exceptional inflow of direct investment estimated at some US$0.5 billion. The former amount is believed to have reflected a strong rise in trade credits, induced by tighter limitations on short-term foreign borrowing and a reduced availability of shekel credits. The latter is thought to have taken the form largely of support purchases of bank shares--whose prices came under severe pressure in 1983--by nonbank subsidiaries of Israeli banks.

Over the course of the year gross external debt minus the foreign assets of Israeli commercial banks is provisionally estimated to have increased by US$1.4 billion, or 6 percent, to US$22.3 billion, but to have edged down slightly (to 92 percent) in relation to GNP (Table 4). Debt obligations of the private sector (which for the most part carry market terms) again increased proportionately faster than those of the Government (which typically bear concessional interest rates and are of long maturity) 1/ and at end-1983 amounted to 30 percent of total debt, against 24 percent at end-1980. Largely as a result of the tightening of exchange controls, virtually all of the increase in debt in 1983, as noted, was of medium- and long-term maturity. As a result, the share of short-term debt in the total eased slightly to 14 percent. Aggregate interest payments on gross debt net of banks' foreign assets are estimated to have amounted to US$1.6 billion in 1983; with amortization of the medium- and long-term component of such debt put at some US$0.9 billion, the debt service burden amounted to 28 percent of exports of goods and services, much the same as in 1982.

3. External policies

In September 1982, as noted, the authorities initiated a policy of holding the nominal depreciation of the shekel to 5 percent a month vis-à-vis the U.S. dollar. As, subsequently, the monthly rate of inflation in Israel generally exceeded this amount, and as the U.S. dollar on balance appreciated against European currencies, a fairly persistent real effective appreciation of the shekel ensued. By July 1983, on the basis of the standard index used for the Fund's Information Notice System (FINS), the real effective rate of the shekel had appreciated by nearly 18 percent. On August 10, against the background of mounting purchases of foreign exchange, the daily adjustment of the exchange rate was amplified by a discrete depreciation against the U.S. dollar of 7 percent. This reduced purchases of foreign exchange only briefly. In the face of a renewed upsurge in demand for foreign currency, the shekel was depreciated by a further 19 percent against the U.S. dollar on October 11 and thereafter adjusted sufficiently on a daily basis to bring about a further small

1/ The implicit weighted average interest rate on total gross external debt in 1983 was about 8 1/2 percent.

real depreciation in subsequent months. Together, the various changes served by February 1984 to restore the real exchange rate index approximately to its level in September 1982. At this level, the real rate remained about 10 percent higher than at the beginning of the decade on the basis of the FINS measure, with other measures showing similar or somewhat higher rates of appreciation (Chart C).

In June 1983, the authorities took steps to temper the adverse consequences of exchange rate policy on imports by introducing a non-interest-bearing (one-year) import deposit requirement of 15 percent on a range of (mostly consumer) goods accounting for about 15 percent of total imports. Initially introduced for six months but subsequently extended through June 1984, the measure amounted to a tax of close to 10 percent at average shekel interest rates prevailing during the second half of 1983 (and to rather more currently as interest rates have since risen). The Israeli representatives believed that the measure had contributed to a significant reduction in imports of consumer durables after mid-1983, but found it difficult to quantify this impact separately from other factors. Also on the import side, the 3 percent levy introduced on all imports in June 1982, and originally intended to lapse on April 1, 1983, was extended through March 31, 1984 (and has since been extended for a further year), although the rate of levy was reduced to 2 percent in April 1983 when a 1 percent levy on purchases of foreign exchange by the public was introduced. On the export side, the adverse impact of exchange rate policy on profitability continued to be partly offset by a scheme, introduced in 1981, to provide insurance to exporters against deviations of the real exchange rate from that implied by purchasing power parity. Net payments to exporters under this scheme rose to US$435 million (8 percent of exports) in 1983, from US$200 million (3 1/2 percent) in 1982.

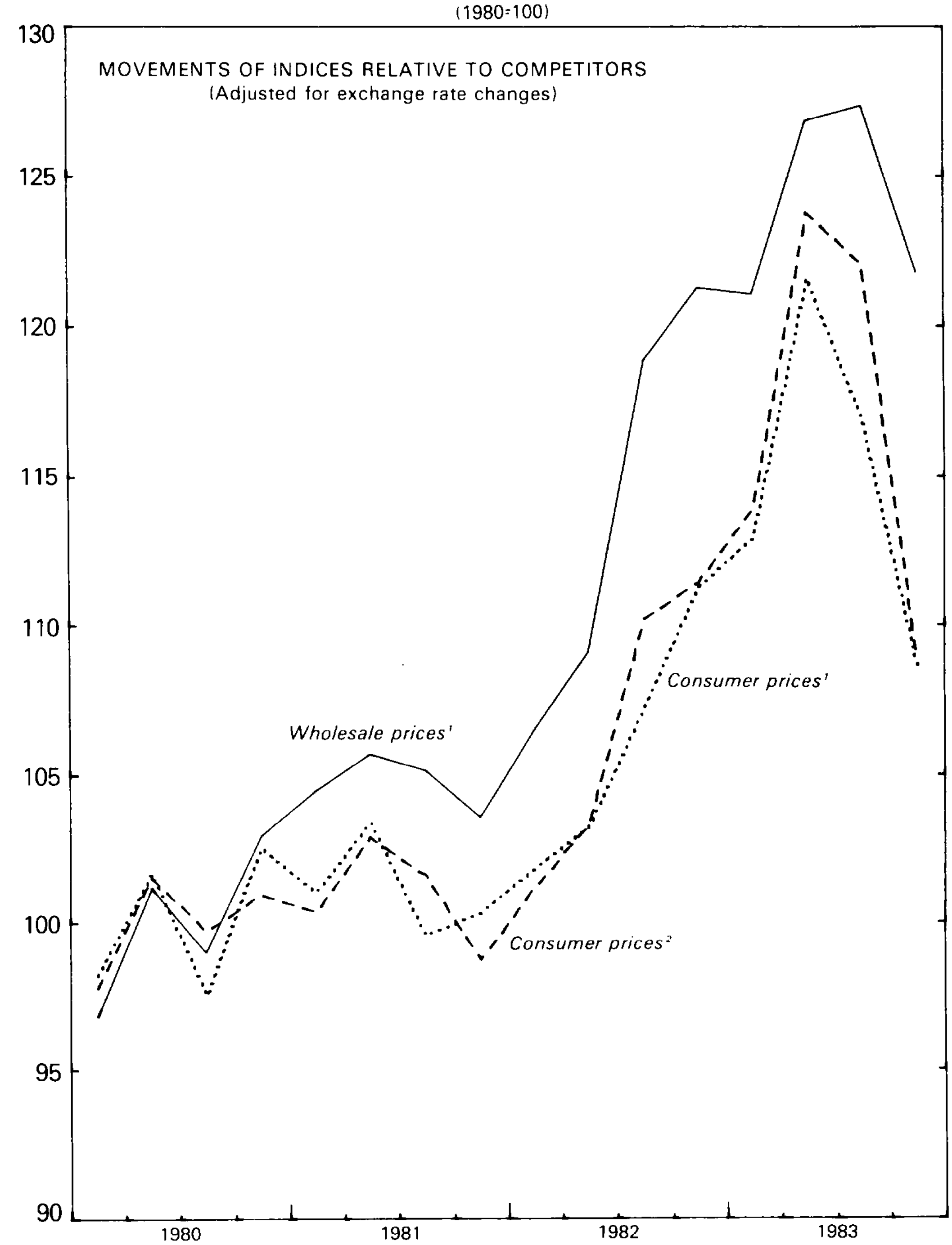
Israel's import system remained virtually free in 1983 from licensing and quantitative restrictions. In the face of continued sizable purchases of foreign currency, a number of exchange controls were, however, changed in November 1983 and January 1984. The travel allowance was reduced from US$3,000 to US$2,000 per person per trip; purchases of foreign currency by residents for the purpose of holding it as an asset were prohibited; the general permit to purchase foreign securities was terminated; the permit to maintain accounts with foreign banks was cancelled and residents obliged to repatriate such holdings within a year; and the right of emigrating residents to export assets was substantially reduced. The Israeli representatives said that the changes were intended to be temporary. They noted that the new travel allowance remained substantially higher than the average foreign exchange purchase for travel purposes in 1982-83 (US$1,100) and, by itself, was unlikely to reduce tourism expenditures much. The termination of purchases of foreign securities was expected to save about US$150-200 million in 1984. No reliable estimates were available of the foreign exchange impact of the other measures. None of the measures taken, in the view of the staff, involves any exchange restriction subject to Article VIII, Sections 2 and 3.

CHART C

ISRAEL

INDICATORS OF EXTERNAL COMPETITIVENESS

(1980=100)



Sources: Staff calculations based on IMF, *International Financial Statistics* and *Direction of Trade Statistics Yearbook, 1982;* and *Statistical Abstract of Israel, 1982*

[1]Based on 1981 bilateral trade weights excluding diamonds.

[2]Based on standard index developed in connection with the Fund's Information Notice System.

4. Public finances

A major factor underlying the economy's deepening disequilibria in 1983 was a dramatic weakening in the budgetary situation. In the first half of the fiscal year (April-September) expenditures ran ahead of plan by about 10 percent in real terms due primarily to additional price subsidies, higher outlays of the exchange rate insurance scheme and extra defense costs arising from the protracted involvement in Lebanon. Beginning in August, a number of measures were taken aimed at restraining expenditure growth. These included cuts in various programs (the main effect of which will not take effect until 1984/85), increased taxes on consumer durables, and an increase in controlled prices of 50 percent in October, followed by subsequent adjustments at rates somewhat above the monthly rate of inflation. 1/ The budget, however, continued to weaken during the second half of the year, under three principal influences.

First, in early October, in the face of a massive sell-off of bank shares--by holders intent on moving into foreign assets and goods in anticipation of a further devaluation--the Government intervened to support the prices of such shares in order to preserve confidence in the financial system. The Israeli representatives noted that this decision should be seen against the background of a general perception of bank shares as liquid assets (due to the policy of most banks of supporting the price of their shares), as well as of the very widely distributed holdings of such shares. The cost of support to the budget approximated some 3 percent of estimated 1983/84 GNP in the fourth quarter of 1983. Second, tax revenues, after rising in real terms in the first half of the fiscal year, declined in the second half. In part this mirrored the contemporaneous downturn in real incomes, activity and purchases of highly taxed consumer durables. But it also reflected greater collection problems as inflation surged and penalties for tax arrears lagged behind. Third, nontax revenues--especially income from public enterprises--continued to fall very sharply in real terms.

For the fiscal year as a whole, the budget deficit widened by the equivalent of 8 percentage points of GNP, to nearly 27 percent of GNP (Table 5). With foreign grants and borrowing from abroad rising only moderately in real terms, and with domestic bond sales falling below plan--in circumstances of a reduction in the private sector savings ratio and a preference, at prevailing interest rates and real exchange rates, for financial assets denominated in foreign currency--recourse to credit from the Bank of Israel increased to the equivalent of 13 1/2 percent of GNP, from 5 1/2 percent of GNP in 1982/83.

1/ The latter served both to reduce the average rate of subsidy by the end of the fiscal year to about 50 percent, against 100 percent in September 1983, and to hold total subsidy outlays in 1983/84 at broadly the same level in relation to GNP as in 1982/83.

5. Money and credit

With the surge in monetary financing of the budget, and with some four fifths of the public's liquid financial assets (M4) linked to the U.S. dollar or the CPI, the growth of such liquid assets in nominal terms remained high in the first three quarters of 1983 and accelerated very rapidly in the fourth quarter (Table 6). In real terms, the M4 monetary base increased by 26 percent during 1983, after declining in 1981 and 1982. While the bulk of the underlying nominal expansion remained due to automatic revaluation increments on index-linked assets, the discretionary element in base liquidity growth--stemming from monetary financing of the budget and Bank of Israel credit to the private sector--increased very sharply. Part of the resulting expansion was neutralized by a higher average level of reserve requirements, with the result that the real growth in M4 itself (9 percent) was smaller. This growth entirely reflected an increase in foreign currency-linked (PATAM) deposits. Correspondingly, the share of unlinked shekel assets in M4 fell (from 24 percent at end-1982 to 18 percent at end-1983), limiting further the scope for an active monetary policy.

A broader barometer of liquidity in the economy has traditionally been M4 plus the public's holdings of bank shares. With a precipitate fall (nearly 30 percent in nominal terms) in the value of the latter during the fourth quarter of the year, this aggregate (M5) fell by 19 percent in real terms during 1983. Against this, there was a substantial (if less than fully offsetting) increase in the public's holdings of foreign currency; in addition, a significant proportion of financial assets classified as being long term (and thus outside M5) have now been held for their full term and thus, in fact, become liquid.

The principal focus of discretionary policy in 1983 continued to be short-term bank credit to the private sector, which was reduced in real terms by 18 percent. This result was facilitated by the effect of the shift in the composition of the public's portfolio on the shekel credit base, as well as by the retention of ceilings (which were tightened) on credit in foreign currency. The banks, for their part, did not adjust the yields on shekel deposits in line with those available on foreign currency assets. The authorities' policy was to allow these contractionary forces to find expression in a reduction in real credit, while preventing too tight a squeeze--implementing this policy primarily through discount window lending and changes in liquidity ratios. Against this background, interest rates on overdraft credit rose from 5 percent on average in real terms in 1982 to 11 percent during January-September 1983, but fell back sharply (to minus 45 percent) in the fourth quarter as banks were slow to adjust rates.

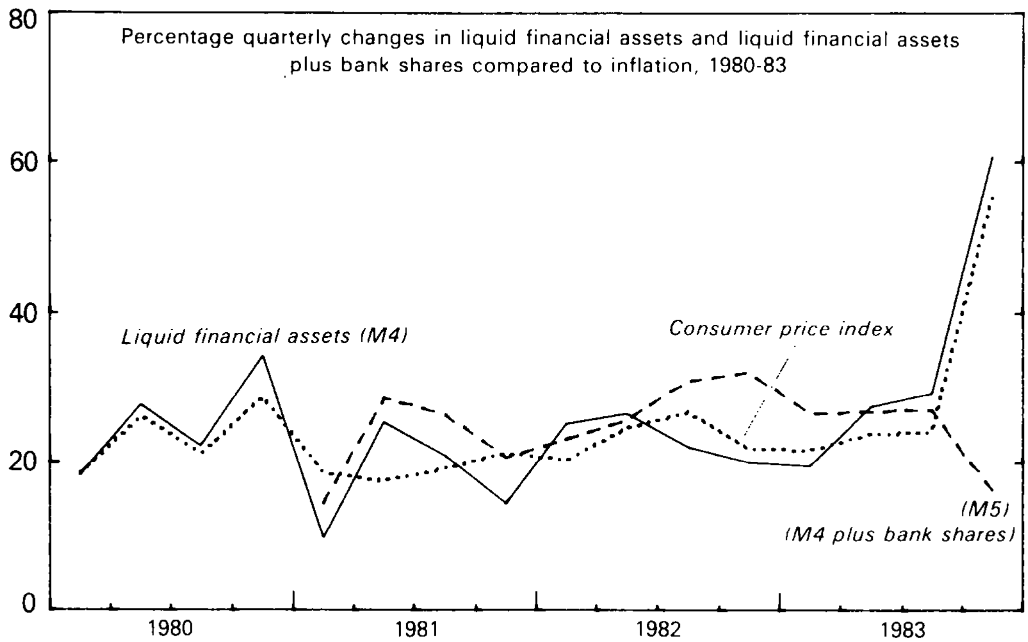
IV. Policies for the Period Ahead

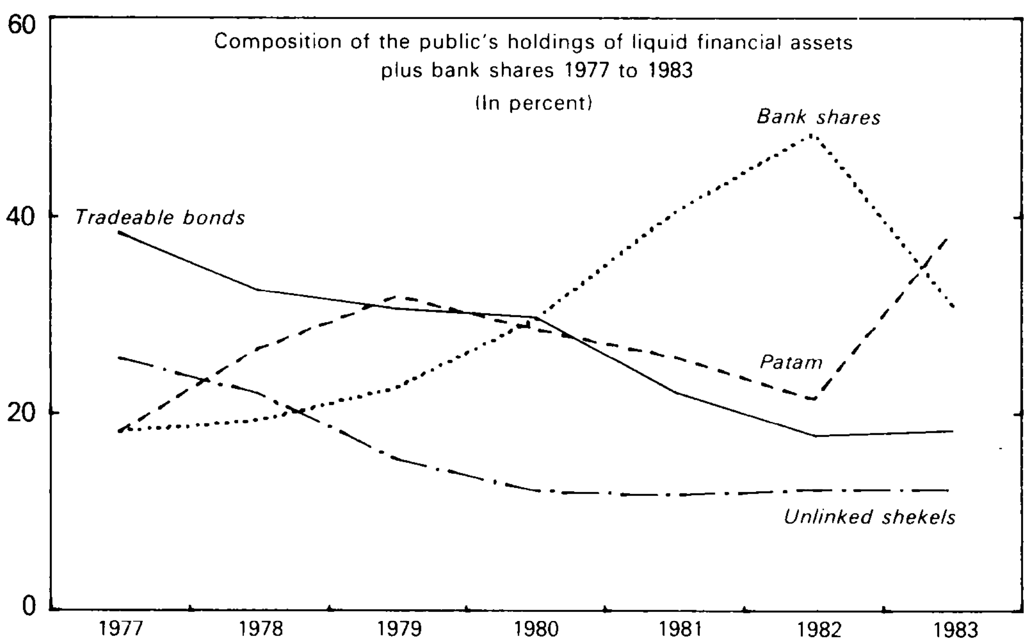
The Government considers that, without a substantial strengthening, the balance of payments position could shortly become unsustainable. Paramount importance is thus attached to achieving an improvement of

CHART D

ISRAEL

FINANCIAL ASSETS OF THE PUBLIC





Source: Bank of Israel.

about US$1 billion in the external balance on goods and services in 1984. Toward this end a sizable reduction in the budget deficit is planned, which is to be supported by continued restraint on credit to the private sector, a reduction in real wages, and maintenance of the real exchange rate. Thereby, domestic demand is to be cut back, the adjustment in relative prices of late 1983 consolidated, and the required transfer of resources into exports and reduction of imports achieved.

Reducing inflation is for the time being given secondary priority, and no target has been set for prices in 1984. Officials acknowledged that high inflation had adversely affected resource allocation, reduced the growth rate of the economy's productive potential, and weakened the effectiveness of the tax system, and they recognized that a continuation of current price trends could not be disregarded if the external objectives were to be attained. As the planned policies of financial restraint took hold, however, they expected the economy to stabilize at a somewhat lower rate of inflation, laying the basis for the possible negotiation then of an anti-inflationary "package deal" with the social partners.

Officials characterized the planned program for 1984 as one of controlled austerity. In their view, a more severe adjustment policy would lack credibility--not least given the wide political acceptance of the need to limit the extent of any increase in unemployment--and on that account would surely fail.

1. The budget for 1984/85 and its financing

The budget for 1984/85 targets a reversal of the very sharp increase in the deficit in 1983/84, with a planned cut in expenditures to the equivalent of 67 percent of GNP (from 74 percent of GNP in 1983/84) and an increase in revenues from 48 percent to 49 percent of GNP (Table 5). All expenditures other than interest payments are budgeted to fall in real terms, with particularly sharp cutbacks in capital outlays (32 percent) and in defense expenditure (21 percent). On the revenue side, the targeted downturn in real incomes, consumption and imports is expected to result in a reduction in tax revenues of 7 percent in real terms, notwithstanding measures to improve collection procedures, eliminate various exemptions, and raise new revenues. Nontax revenue, however, is forecast to rise by a half in real terms, due primarily to a strong growth in income of public enterprises and substantial transfers to the budget from the social security fund.

Allowing for an essentially unchanged (in relation to GNP) level of foreign financing of the government that is in prospect, attainment of the budget targets would result in a sizable real reduction in the financing requirement to be met from domestic sources. But, faced with a substantial increase in maturing debt and a weakening in the public's demand for government securities, officials foresee only a small proportion of this requirement being financed by new nonliquid bond sales. As a result, financing equivalent to some 6 percent of GNP would still be needed from the Bank of Israel. Officials acknowledged that this was an uncomfortably large amount, although much less than in 1983/84. While a number of improvements had been announced in long-term savings schemes, and while thought was being given to some use of a modified auction system for bond issues, they saw major limitations to a more active debt management policy--and the higher and more variable interest rates that this would entail--for three reasons: the crowding-out effect on the private sector; the cost effect to the budget itself, particularly given the large size of the debt to be rolled over and of other government debt which could be switched without penalty; and the potential effect on consumption of increased interest income. Greater variability of interest rates, meanwhile, would risk severely straining the stability of a financial system which had become accustomed to government intervention. Officials thus considered that the solution to curtailing monetary financing of the government deficit had to be found in a further reduction of that deficit, which could only take place over the medium term.

Further reductions in the budget deficit are also recognized as needed to reverse the sharply rising trend of interest payments to abroad and on domestic bonds that is now under way (notwithstanding substantial, and effectively interest-free, recourse to credit from the Bank of Israel). In this regard, the staff explored with officials the dynamics of persistently large deficits in the framework of a number of medium-term budget scenarios. The estimates that emerge (Table 7) are necessarily extremely rough, although the broad indications seem reasonably clear. They suggest that if the budget deficit were to remain unchanged at the 1983/84 level (Scenario III)--and assuming that monetary financing of the deficit could not be allowed to continue at present levels--mounting interest payments would require progressively larger real cuts in noninterest budgetary expenditures, which would soon become implausible. If only half of the targeted reduction in the deficit were achieved in 1984/85 and the deficit thereafter remained unchanged (Scenario II), cuts in noninterest expenditures would continue to be required which eventually would also likely reach beyond the range of practical possibility. If, by contrast, the 1984/85 budget were implemented as planned and further expenditure cuts were carried out in 1985/86, the ratio of interest expenditures to GNP could begin to fall after 1985/86, allowing the deficit itself to be reduced further or the ratio of taxes to GNP to be cut back without any further reduction in noninterest expenditures.

2. Monetary policy

The task for monetary policy in 1984 is complex and difficult, not only in view of the essentially passive approach that is envisaged to domestic debt management, but also because of uncertainty about the underlying rate of inflation, about the appropriate target of policy in the wake of the past year's shifts in financial portfolios of the private sector, and about the possible scale of reverse shifts from PATAM and foreign currency back into shekel-denominated assets.

The Israeli representatives were of the view that whereas M5 had been the relevant monetary aggregate to target before October 1983, bank shares were no longer liquid and it would take time for a stable public demand to emerge for a new aggregate. Against this background, policy in 1984 would be targeted on short-term bank credit to the private sector, the growth of which would be restrained below the rate of inflation. Officials recognized that medium-term credits had gained considerably in importance in the past few years and, more generally, that nontargeted assets tended to expand relatively rapidly when the targets themselves were not comprehensive in coverage. At the same time, however, some reintermediation of the banking system in the provision of credit was envisaged as the banks moved to reduce the spread between their lending and deposit rates and thereby compress the scale of the gray credit market. In view of these, and other factors, flexibility would be needed in setting precise credit targets, and the authorities would be guided by indications of the degree of credit restraint suggested by movements in real interest rates. As to policy instruments, the authorities will shortly introduce treasury bills and intend to influence the development of bank credit and interest rates increasingly through open market operations, together with discount window lending, rather than through the blunter instrument of changes in reserve requirements. The authorities also plan to renew their efforts to encourage the growth of unlinked short-term shekel deposits, so as to increase the role for discretionary policy.

3. Incomes policy

Major wage negotiations are due in 1984 which encompass two elements: the formula for adjusting wages to increases in the cost of living, and changes in the general level of wages beyond this. On the former element, the Trade Union Federation has taken the position--in view of the surge in inflation--that index compensation should be paid more frequently and at a higher rate. The authorities have acknowledged the need for a cost of living formula which is better geared than the present one to current rates of inflation. But they have also taken the position that real wages should not increase in 1984 above the level reached in the fourth quarter of 1983--which would be consistent with a reduction of 5 percent on average between 1983 and 1984.

Officials believe that such a reduction, together with policies of financial restraint, would bring about some deceleration of inflation, but probably only gradually. Accordingly, and taking into account the unemployment constraint, thought is being given to the possible negotiation of a package deal with the social partners--perhaps embracing a temporary freeze on wages and prices--aimed at interrupting the inflationary process more abruptly. Officials emphasized, however, that such a compact was envisaged as a complement to, not an alternative for, tight financial policies; in particular, they would not be prepared to "buy" agreement to it at the cost of an increase in the budget deficit.

4. External policies

The Israeli representatives affirmed that it was intended to continue the policy pursued since October 1983 of adjusting the exchange rate of the shekel on a daily basis at least in line with inflation differentials against a basket of currencies. They were of the view that, at the present level of the real exchange rate, the relative prices of imports and exports to production for domestic use had been sufficiently realigned as to be able, together with the planned program of demand restraint, to induce an improvement in the civilian trade balance on the scale targeted. They believed that most measures of relative prices overstated shifts in Israel's competitive position in recent years; in particular, such measures did not allow for the contribution of technological advances to Israel's industrial exports, nor for the benefit to export profitability since 1981 of the export insurance scheme.

With regard to imports, the Israeli representatives said that there were no illusions about the distortions which the import levy and the import deposit scheme, as well as highly differentiated rates of import duty, gave rise to. The import restrictions were viewed as a temporary expedient--resorted to in light of the coincidence of a weakening balance of payments situation and accelerating inflationary pressures--and would be removed as soon as feasible.

More generally, officials noted that moves were being taken, or contemplated, to dismantle trade barriers vis-à-vis Israel's two major trading areas, the EC (accounting for more than a third of exports and of imports) and the United States (about one quarter of imports and of exports). Under the terms of the EC-Israel Agreement of 1975, tariffs on industrial imports from the EC have been reduced by 50 percent, with full removal to be phased in by January 1, 1989. Active negotiations, meanwhile, are currently under way to establish a U.S.-Israel Free Trade Area. Like the EC agreement, such an arrangement would not only open up export opportunities for Israeli producers but also subject domestic industry to increased competition.

V. Outlook

1. 1984

On the basis of the policy plans outlined above, officials look for the turnaround in the economy in the latter part of 1983 to continue in 1984. Domestic demand is projected to fall by 7 percent in real terms, with reductions in all components (Table 1). The forecast decline in private consumption implies an increase in the private sector savings ratio to 26 percent (from 22 percent in 1983)--which, however, would represent only a partial recovery to the longer-term average of 29-30 percent--and would entail little further decline in consumer spending from the level reached at end-1983. The fall expected in public consumption is consistent with the budget, while that in investment is seen as stemming from the slackening in activity and cutbacks in government investment grants. Only part of the resulting compression in demand is expected to be shifted into the balance of payments, with the result that real GDP is projected to fall by 1-1 1/2 percent and the unemployment rate to rise on average to 6 1/2 percent.

Mirroring the fall in demand, nondefense imports are forecast to fall by 6 percent in volume, with particularly sharp declines in imports of consumer goods (18 percent) and machinery and equipment (14 percent). Exports, by contrast, are forecast to rise by 12 percent--and nondiamond industrial exports (accounting for three quarters of the total) by 15 percent. 1/ Officials acknowledged that this would entail a major recouping of market shares--market growth is estimated at about 7 percent--but considered it feasible in view of the stagnation of the past two years and the concurrent expansion of export capacity, as well as of an apparent lengthening of order books. With export and import prices expected to remain unchanged and the net services balance to change little, the civilian goods and services deficit is forecast to decline by nearly US$1.2 billion (Table 3). While direct defense imports are expected to rebound by some US$400 million, total transfer receipts are projected to rise by considerably more (US$750 million), largely on account of increased U.S. Government grants. As a result, the current account deficit is projected to fall by US$1.5 billion (or 6 percentage points of GNP), to US$1.1 billion, or the equivalent of about 4 1/2 percent of GNP. The deficit is expected to be financed almost entirely by medium- and long-term capital. In the process, external debt would rise to somewhat more than 100 percent of GNP.

The Israeli representatives emphasized two points concerning these forecasts. First, following the adjustment of policies since October 1983, the economy was considered to be at a turning point; the margin of forecasting error, accordingly, was greater than usual. Second, the forecast was a conditional one which assumed that the budget and accompanying policies would be implemented exactly as planned. It also assumed that recovery in the industrial countries would strengthen and spread, and that European currencies would stabilize against the U.S. dollar. If the latter assumptions should prove unrealistic, an adjustment of policies would be needed.

2. Medium term

Officials stated that it was intended to build on the improvement anticipated in 1984 during 1985-87. In the latter period, the strategy would be one of controlled growth, with real GDP targeted to increase in all by 11-12 percent primarily on the basis of a continued strengthening in the real foreign balance and gains in export market shares, which in turn would rest on further cuts in the budget deficit and maintenance of a flexible exchange rate policy. An "adjustment" scenario of the kind envisaged by the authorities is set out in the upper section of Table 8. U.S. aid to Israel (both grants and loans) is assumed to rise further in 1985 and thereafter to remain unchanged in real terms, although after 1985 all U.S. defense aid is scheduled to take grant form, so strengthening

1/ In the first quarter of 1984, the U.S. dollar value of imports (excluding ships and aircrafts) was 2 1/2 percent higher than one year earlier; export growth over the same period was about 9 1/2 percent.

the current account. All other medium-term borrowing, and also private transfers, are assumed to remain unchanged in real terms beyond 1984, with the residual financing being covered by short-term borrowing. On this basis, both the ratio of external debt to GNP and the debt service ratio would fall at a steadily increasing rate after 1984.

Table 8 also presents two variants of the above scenario which, analogously with the fiscal scenarios, take as their starting assumption the achievement of only half the improvement targeted for 1984 in the civilian goods and services deficit (Scenario II), and no improvement in that deficit from the 1983 outturn (Scenario III). In addition, exports are assumed to grow in line with markets in the former scenario and slower than markets in the latter. As with the fiscal scenarios, both variants would sooner or later lead to an untenable position, with the trigger likely to be the inability to roll over a rapidly rising level of short-term debt.

VI. Staff Appraisal

1983 saw a sharp deterioration in economic performance in Israel, as for much of the year the prices of foreign exchange and subsidized goods and services were held down in an attempt to reduce inflation, in circumstances of a continuing excess of domestic demand over available resources. Reflecting the deepening in the economy's already sizable imbalances, the external current deficit widened to the equivalent of nearly 11 percent of GNP. Inflation, meanwhile, failed to abate, and indeed surged to an unprecedented level around the turn of the year.

In the course of the year the combination of an overvalued exchange rate and too low interest rates generated expectations which severely strained the financial system and prompted a flight from domestic currency into foreign currency assets and goods. Eventually, the expectations became self-fulfilling and the shekel was depreciated substantially in October, followed by a shift in policy to maintenance of the real exchange rate and a cutback in subsidies. These changes are much to be welcomed, but constitute only a beginning, as is recognized. Restoring better balance to the economy will require a sustained reduction in the real budget deficit, an enduring cut in real incomes, and a progressive diminution in the nominal rate of growth of the monetary aggregates.

The authorities are well aware that without a substantial strengthening in 1984 the balance of payments could become untenable. Priority is thus being given to achieving an improvement of about US$1 billion in the external balance on goods and services. Reducing inflation, by contrast, is for now being given decidedly secondary priority. Questions arise whether this represents a sustainable approach. The rate of increase in prices has now reached levels which put the existing institutional mechanisms for coping with high inflation--and, with them, the functioning of the economy itself--under extreme strain. In these circumstances, adherence to a gradual approach to disinflation--particularly via its effects on expectations--risks complicating attainment of the basic external goal; a concerted attack on inflation, based on a clearly articulated policy of monetary contraction, would facilitate external adjustment.

The policy strategy to achieve an improved balance of payments focuses centrally, and appropriately, on a reduction in the budget deficit. Fiscal deficits of the size recorded in recent years have led to a growth in financial assets that has been excessive in relation to the development of real output and real interest rates. This has sustained pressure on the balance of payments, as well as on prices, particularly since the authorities have chosen to prevent financing of the Government's borrowing requirement from crowding out the private sector to any major degree. Seen from a longer-run perspective, the increasingly pervasive involvement of government in economic activity in Israel appears to have blunted the economy's responsiveness to changes in market conditions and, in the process, lowered its growth potential. More directly, public expenditure heavily favors consumption over investment and, given its huge size, has contributed to a pattern of overall expenditure that dampens productivity growth. At the same time, the high level of expenditure has led to a high level of taxes. This has contributed to a large difference between wages as a cost to the employer and the aftertax earnings of the employee, exacerbating the struggle over income shares and raising the total cost of labor to a very high level.

The budget proposed for 1984/85 targets a reversal of the extremely sharp rise in the deficit in 1983/84, with a sizable cut in real expenditures and a small increase in real revenues. The authorities will need to show great determination and persistence if these targets are to be attained. With interest payments projected to account for more than one fifth of total outlays, the noninterest component of expenditure will have to be cut in real terms by as much as 15 percent. The revenue estimate, meanwhile, rests on a highly uncertain increase of fully a half in real terms in nontax receipts. Given the record of efforts to control expenditure in recent years, as well as the impact of high and accelerating inflation in undermining the tax collection system, questions inevitably arise as to whether these targets will be reached. Yet there is little, if any, margin for slippage if the balance of payments is to show the improvement needed.

Implementation of the budget as planned is all the more important since financing of the resulting deficit will again be problematic in the year ahead. Faced with substantial domestic debt maturities to refinance, and a preference on the part of the public--given the prevailing level and structure of interest rates--for liquid assets and goods, the authorities expect to have to finance an amount equivalent to 6 percent of GDP by credit from the Bank of Israel. While much less than last year, this still portends a worrisomely large addition to the monetary base, especially in light of the planned reduction in the absorption of liquidity through the balance of payments. The level of such residual financing is highly sensitive, moreover, to deviations from the revenue and expenditure estimates. And doubts cannot but exist--in view of net redemptions recently--whether the authorities will in fact be able to roll over maturing debt on the scale assumed.

Against this background, it is in the staff's view a matter of urgency to step up efforts to secure greater nonmonetary financing of the deficit--for instance, through bond issues by tender over a range of maturities. To be sure, more reliance on longer-term and less liquid financing instruments will entail an increase in interest rates, particularly at the longer end, and greater variability in such rates. This is bound to result in some crowding-out effects and make the fiscal deficit somewhat worse. These, however, are unavoidable costs which will have to be faced in the short run if the financing deficit cannot be cut further and if inflation is to be reduced at all significantly.

Even with a more active debt management policy, credit policy will need to be sharply restrictive. In this context, a policy aimed at holding the growth of credit to the private sector somewhat below a nontargeted inflation rate runs the risk of accommodating inflation and any upsurge thereof. What is needed is a nominal anchor--which would argue, first, for targeting a rate of expansion in total domestic credit (including credit to the public sector) which, after allowing for the expected development of the overall balance of payments, would hold the nominal growth of broad money to a rate consistent with a marked deceleration of inflation; and, second, for holding to such a course over an extended period, so as to change inflationary expectations.

Adherence to tight fiscal and monetary policies would have consequences for employment, the extent of which would depend on the response of real wages. While there has been a substantial fall in real wages since the third quarter of 1983, a large part of this decline clearly needs to be preserved if external and internal disequilibria are to be reduced. Any reform of the indexation system that may be needed to lessen the heightened uncertainty associated with current rates of inflation must be consistent with such a reduction. In this context, the negotiation of a package deal with the social partners might improve the trade-off between unemployment and inflation and facilitate a deceleration in the inflationary process; but it would be essential that a firm policy of monetary contraction be clearly in place and be kept in place.

Whatever may be decided on a package deal, there can be no relenting, for reasons of short-run expediency, in continuing to adjust the exchange rate at least in line with inflation differentials. If competitiveness is maintained and financial policies are genuinely restrictive, a marked improvement in the balance of payments may reasonably be expected in 1984. Even so, the targeted strengthening in the current account requires a major recouping of market shares. It is debatable whether the devaluations of August and October--together with the small further real depreciation that has been achieved since October--are sufficiently large to permit the improvement postulated. In this regard, the trade figures for the first quarter of 1984 are somewhat disappointing. The staff would therefore encourage the authorities to keep under constant review the need for some moderate further real exchange rate depreciation.

A flexible exchange rate policy is all the more necessary in view of the desirability of removing the import curbs (the levy and deposit scheme) which were put in place or extended in 1983. The staff views the departure by Israel in the recent period from the more liberal trade stance introduced in 1977 as unfortunate, particularly from the standpoint of an efficient allocation of resources domestically. It regrets the decision in March 1984 to extend the import levy for a third year and hopes that the deposit scheme will be allowed to expire in June. The staff also hopes that the recently introduced foreign currency controls will be temporary.

In summary, an important shift in policies has taken place which the authorities have indicated that they intend to build on and make effective. Whether the economy is genuinely at a turning point will depend not only on whether stated policy intentions are implemented as planned but also on whether they are complemented by supporting action.

It is recommended that the next Article IV consultation with Israel be held on the standard 12-month cycle.

The following draft decision is proposed for adoption by the Executive Board:

Proposed Decision

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Israel, in light of the 1984 Article IV consultation with Israel conducted under Decision No. 5392-(77/63), adopted April 24, 1977 (Surveillance Over Exchange Rate Policies).

2. The Fund notes with satisfaction that Israel continues to maintain a liberal system of payments and transfers for current international transactions.

Table 1. Israel: Demand and Supply

	1979	1980	1981	1982	Estimate 1983	Official Forecast 1984
	(Percentage change at constant prices)					
Private consumption	8.0	-2.7	11.0	7.5	6.8	-5.1
Government consumption 1/	2.5	3.5	0.7	4.6	7.7	-5.5
Domestic defense expenditure	(2.9)	(-1.2)	(0.7)	(9.0)	(10.9)	(-7.3)
Other	(2.1)	(7.8)	(0.7)	(0.1)	(1.0)	(-3.1)
Gross domestic investment	13.7	-16.3	-5.4	13.7	4.9	-13.5
Gross domestic expenditure	8.1	-4.5	5.1	8.0	6.6	-6.9
Exports of goods and services	3.3	6.3	4.4	-2.6	0.9	8.5
Aggregate demand	6.7	-1.8	4.9	4.8	5.0	-3.0
Imports of goods and services 1/	10.2	-10.7	7.8	11.3	11.4	-6.4
GDP	5.0	3.1	3.4	1.2	1.1	-1.2
	(In percent of GDP at current prices)					
Gross domestic expenditure 1/	114	107	107	113	116	109
Private consumption	62	59	61	64	66	63
Domestic defense expenditure	13	14	14	16	17	16
Other government consumption	12	12	11	10	10	10
Gross domestic investment	27	22	21	23	23	20
Foreign balance	-14	-7	-7	-13	-16	-9
Exports of goods and services	45	46	45	41	39	42
Imports of goods and services 1/	59	53	52	54	55	51

Sources: Central Bureau of Statistics; and official estimates and forecast.

1/ Excludes direct defense imports, purchases of which are very closely associated with the receipt of intergovernmental transfers and loans.

Table 2. Israel: Prices and Wages

(Change in percent)

	1979	1980	1981	1982	1983	Sept. 1983	March 1984
Yearly average							
Consumer prices	78	131	117	120	146	...	...
Wholesale prices	79	135	123	126	144	...	...
GDP deflators	81	127	127	121	151	...	...
Real wages (as income) 1/	8	-2 1/2	10 1/2	-1/2	5 1/2	...	...
Real wages (as cost) 2/	9	-7	8 1/2	-2	2 1/2	...	...
Real unit labor costs	4 1/2	-8	-1	4	3 1/2	...	...
Through the year 3/							
Consumer prices	111	133	102	132	191	128	241
Wholesale prices	111	138	105	138	202	122	...

Sources: Central Bureau of Statistics; Bank of Israel; and official estimates.

1/ Wages per employee post deflated by the consumer price index.
2/ Wages per employee post deflated by the net domestic business sector product deflator.
3/ December on December change, except for September 1983 and March 1984 columns, which show percentage change on corresponding month of preceding year.

Table 3. Israel: Summary Balance of Payments

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983 1/	1984 2/
Exports	4,759	5,798	5,903	5,546	5,483	6,151
Nondefense imports	-6,769	-7,326	-7,250	-7,352	-7,673	-7,211
Civilian trade balance	-2,010	-1,528	-1,347	-1,806	-2,190	-1,060
Net services	-494	-593	-822	-1,421	-1,858	-1,825
Civilian goods and services	-2,504	-2,121	-2,169	-3,227	-4,047	-2,885
(In percent of GNP)	(14.5)	(10.6)	(10.2)	(14.5)	(16.6)	(12.6)
Direct defense imports	-1,153	-1,655	-2,160	-1,520	-951	-1,335
Intergovernmental transfers	1,393	1,496	1,352	1,199	975	1,705
Private and other transfers	1,400	1,474	1,586	1,450	1,422	1,445
Current account	-864	-806	-1,391	-2,098	-2,601	-1,070
(In percent of GNP)	(5.0)	(4.0)	(6.6)	(9.5)	(10.7)	(4.6)
Medium- and long-term capital, net	1,268	1,234	1,260	1,231	2,510	1,130
Official	(1,151)	(1,422)	(1,299)	(1,241)	(1,130)	(...)
Private nonbank sector	(133)	(-137)	(-34)	(-8)	(880)	(...)
Direct investment	(-15)	(-51)	(-5)	(-1)	(500)	(...)
Commercial banks, net	740	114	778	1,599	200	...
Short-term capital	231	579	516	131	)	...
Official	(-262)	(-221)	(141)	(-5)	-10)	(...)
Private	(463)	(800)	(375)	(136)	)	(...)
Errors and ommissions	-956	-692	-663	-26	)	...
Overall balance	419	429	500	837	100	...

Sources: Central Bureau of Statistics; Bank of Israel; and official estimates and forecasts.

1/ Provisional.
2/ Staff estimates based on official forecast.

Table 4. Israel: Selected External Debt Data

	1980	1981	1982	1983	1983
	(In millions of U.S. dollars; end-period)				
Gross debt	22,090	24,505	27,959	28,127 1/	
Adjusted gross debt 2/	16,552	18,289	20,973	22,325	
(In percent of GNP)	(83.0)	(86.0)	(94.4)	(91.7)	
Net debt 3/	11,640	13,370	15,501	16,768	
	(In percent of total)				(In millions of U.S. dollars)
Adjusted gross debt, by debtor					
Government sector	73	72	68	67	14,909
Private sector	24	25	29	30	6,636
Other 4/	3	3	3	3	780
Adjusted gross debt, by creditor					
Foreign governments and international institutions	48	47	45	46	10,168
State of Israel bondholders	17	16	15	15	3,251
Foreign banks and other	35	37	40	39	8,906
Adjusted gross debt, by maturity					
Long term (5 years +)	75	74	71	70	15,715
Medium term (1-5 years)	14	13	14	16	3,458
Short term	11	13	15	14	3,152
	(In percent of exports of goods and services)				
Debt service					
Gross debt	28.1	31.8	36.2	34.1	
Adjusted gross debt	25.8	24.8	28.5	27.9	
Net debt	21.9	20.9	24.2	24.2	
	(In percent of total current receipts)				
Debt service					
Adjusted gross debt	19.7	18.9	22.0	22.0	

Source: Information provided by the Israeli authorities.

1/ End-September.
2/ Gross debt minus foreign assets of commercial banks.
3/ Adjusted gross debt minus official reserves and export credit provided.
4/ Deposits with Bank of Israel against deposits of foreign residents and deposits of banks abroad.

Table 5. Israel: Summary Budget Transactions

(In percent of GNP)

	1979/80	1980/81	1981/82	1982/83	Estimate 1983/84	Budget 1984/85
Total expenditure	66.9	64.2	70.0	70.6	74.4	67.2
Transfers and subsidies	16.4	18.5	21.7	20.5	19.4	18.3
Interest payments 1/	4.7	5.9	9.5	11.7	12.7	14.2
Defense	26.4	24.2	22.2	21.2	22.8	18.1
Other current	10.5	8.0	8.2	9.0	7.9	7.7
Capital expenditures 2/	8.9	7.6	8.4	8.2	8.8	6.0
Unallocated	--	--	--	--	2.8	2.9
Total revenue	47.8	48.7	47.4	52.0	47.7	49.2
Tax revenue	39.5	35.8	36.5	40.3	40.3	37.8
Nontax revenue 3/	8.3	12.9	10.9	11.7	7.4	11.4
Budget balance	-19.1	-15.5	-22.6	-18.6	-26.7	-18.0
Foreign grants	8.7	9.0	8.3	5.2	6.6	9.2
Financing requirement	-10.4	-6.5	-14.3	-13.4	-20.1	-8.8
Foreign borrowing, net	7.9	4.9	4.4	5.3	5.3	1.6
Domestic bond issues, net	5.7	3.9	6.1	2.6	1.2	1.3
Net credit from Bank of Israel	-3.2	-2.3	3.8	5.5	13.6	5.9

Source: IMF staff compilation from information provided by the Ministry of Finance.

1/ Excludes computed interest payments to the Bank of Israel.
2/ Includes support purchases of bank shares in 1983/84.
3/ Excludes Bank of Israel profits.

Table 6. Israel: Selected Monetary and Credit Developments

(In percent from end of preceding year) 1/

	Dec. 1980	Dec. 1981	Dec. 1982	Sept. 1983	Dec. 1983
Monetary base					
Nominal change in M4 base	147	88	119	106	265
Due to (in percentage points)					
"Automatic" indexation-related increments	122	85	114	81	206
"Discretionary" factors					
Public sector injection	33	32	37	32	82
Directed Bank of Israel credit	20	-20	-20	4	13
Loans to banks	--	--	2	5	16
Other	3	8	2	4	5
Less: net foreign currency purchases by private sector	-31	-17	-16	-20	-57
Real change in M4 base	6	-7	-5	11	26
Monetary and credit aggregates					
Nominal change in M4	148	90	132	97	217
Real change in M4	6	-6	--	5	9
Money supply (M1)	-14	-11	-9	-9	-25
Time deposits and CDs	19	60	68	-6	-15
PATAM deposits	5	1	-4	28	46
Tradable government bonds	14	-17	-7	-13	-17
Real change in M4 plus bank shares (M5)	17	12	16	9	-19
Real change in short-term bank credit to private sector	-3	-8	1	-12	-18
Directed credit 2/	4	-12	-18	-9	-7
Nondirected credit	-7	-5	13	-13	-24

Source: Information provided by the Bank of Israel.

1/ Real changes are all deflated by changes in the consumer price index.
2/ Credit granted on preferential terms, with the subsidy element borne by the Bank of Israel.

Table 7. Israel: Medium-Term Public Finance Scenarios 1/

(In percent)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
			I. "Adjustment" Scenario			
Assumptions						
Revenue/GNP ratio	47	49	49	48	46	44
Expenditure/GNP ratio	74	67	65	63	61	59
Deficit/GNP ratio	27	18	16	15	15	15
Foreign financing	(12)	(11)	(12)	(11)	(11)	(11)
Net credit from Bank of Israel	(14)	(6)	(2)	(2)	(2)	(1)
Net sale of bonds	(1)	(1)	(2)	(2)	(2)	(3)
Change in real GNP	1.0	-1.0	-1.0	3.0	5.0	6.0
Average real rate of interest on government debt	7	8	9	8	7	6
Results (in percent of GNP)						
Government interest payments	13	14	15	13	11	9
Noninterest expenditures	62	53	50	50	50	50
Government debt	191	174	186	169	120	94
			II. "Partial Adjustment" Scenario			
Revenue/GNP	48	47	47	47	47	47
Expenditure/GNP	74	70	70	70	70	70
Government interest payments/GNP	13	15	16	17	19	21
Noninterest expenditures/ GNP	62	55	54	53	51	49
			III. "No Adjustment" Scenario			
Revenue/GNP	48	47	47	47	47	47
Expenditure/GNP	74	74	74	74	74	74
Government interest payments/GNP	13	16	20	25	30	36
Noninterest expenditures/GNP	62	58	54	49	44	38

Source: IMF staff.

1/ In all scenarios, foreign financing of the budget is assumed to be the same. Financing from domestic sources would thus be substantially higher in scenario II than in scenario I, and higher still in scenario III. It is further assumed that a sizable part of such higher levels of financing would be met from sales of bonds to the nonbank public--in order to avoid an intolerably high level of recourse to credit from the Bank of Israel--and that this would require that higher interest rates be offered on domestic debt issues.

Table 8. Israel: Medium-Term External Debt Scenarios 1/

(In billions of U.S. dollars, except where noted)

	1983	1984	1985	1986	1987
		I. "Adjustment" Scenario			
Civilian goods and services balance	-4.0	-2.9	-2.8	-2.5	-1.8
Defense imports	-1.0	-1.3	-1.8	-2.0	-1.8
Total transfers	2.4	3.2	3.4	4.3	4.4
Current account balance	-2.6	-1.0	-1.2	-0.2	+0.8
Assumed increase in reserves	0.1	--	0.3	0.4	0.5
Rollover of short-term debt	3.2	3.2	3.2	4.3	5.3
Medium- and long-term debt amortization 2/	0.9	1.1	1.3	1.5	1.6
Total financing requirement	6.8	5.3	6.0	6.4	6.6
Net medium- and long-term capital	2.7	1.0	0.4	-0.4	-0.4
Short-term borrowing, net	--	--	1.1	1.0	0.1
External debt (end-year) 3/	22.3	23.3	24.8	25.4	25.1
Debt in percent of GNP	92	102	101	94	83
Short-term debt in percent of GNP	13	14	18	20	18
Debt service in percent of exports of goods and services	28	28	27	25	22
		II. Modified Adjustment Scenario			
Civilian goods and services balance	-4.0	-3.4	-3.6	-3.8	-3.7
Debt in percent of GNP	92	102	104	104	102
Short-term debt in percent of GNP	13	17	23	30	35
Debt service in percent of exports of goods and services	28	29	30	29	29
		III. Unchanged Civilian Goods and Services Balance			
Debt in percent of GNP	92	103	106	106	104
Short-term debt in percent of GNP	13	19	26	33	37
Debt service in percent of exports of goods and services	28	29	31	32	33

Source: IMF staff.

1/ For the main assumptions underlying the scenarios, see pages 13-14.
2/ Differs from amortization forecast shown in RED, Chapter V, by virtue of (i) prepayment of debt and modifications to original maturity schedules; (ii) different treatment of foreign liabilities of Israeli banking system; and (iii) amortization payments on debt incurred after end-1983.
3/ Gross external debt minus foreign assets of commercial banks.

Israel: Fund Relations

(As of March 31, 1984)

I. Membership Status

(a) Date of membership: July 12, 1954

(b) Status: Article XIV

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 446.6 million

(b) Total Fund holdings of Israel shekels: SDR 446.61 million (100 percent of quota)

III. Previous stand-by arrangements approved during the last ten years

(i) One year stand-by arrangement for SDR 32.5 million (25 percent of quota) approved on November 8, 1974. Fully disbursed; cancelled on February 14, 1975.

(ii) One year stand-by arrangement for further SDR 32.5 million (25 percent of quota) approved on February 14, 1975. Fully disbursed.

(iii) One year stand-by arrangement for SDR 29.25 million (22.5 percent of quota) approved on October 20, 1976. Utilization: SDR 12 million.

IV. SDR Department

(a) Net cumulative allocation SDR 106.36 million.

(b) Holdings SDR 0.27 million (0.25 percent of net cumulative allocation).

(B) Nonfinancial Relations

V. Exchange arrangement: flexibly managed floating rate based on a currency basket reflecting the composition of foreign trade.

VI. The Board concluded the 1983 Article IV Consultation on June 15, 1983 with the following decision:

"1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Israel, in the light of the 1983 Article IV

Consultation with Israel conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Israel continues to maintain a liberal system of payments and transfers for current international transactions."

Israel is on the standard 12-month consultation cycle.

Israel - Statistical Issues

1. Coverage, Currentness, and Reporting Frequency

		Latest Date in April 1984 IFS
Real Sector	- National Accounts	Q3 - 1983
	- Prices	Jan. 1984
	- Production	Nov. 1983
	- Employment	Oct. 1983
	- Earnings	Nov. 1983
Government Finance	- Deficit/Surplus	1980
	- Financing	1980
	- Debt	1980
Monetary Accounts	- Central Bank	Jan. 1984
	- Deposit Money Banks	Nov. 1983
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	Jan. 1984
	- Merchandise Trade: Prices	Q3 - 1983
	- Balance of Payments	Q2 - 1983
	- International Reserves	Jan. 1984
	- Exchange Rates	Feb. 1984

During the past year, the reporting record of the IFS correspondent has been excellent for international reserves and general economic data; however, data on monetary accounts and government finance have been reported irregularly.

2. Outstanding Statistical Issues

Government Finance: Annual data in IFS are those reported in the Government Finance Statistics Yearbook; the data relate to budgetary central government and social security fund transactions as reported by the Ministry of Finance. The data shown extend only through 1980 with the exception of data on outstanding debt which extend only through 1978. Information for the year 1981 was received recently and it is now being processed.

The analytical usefulness of the fiscal data in IFS would be enhanced by the inclusion of quarterly data.

Monetary Accounts: Data for the monetary authorities and commercial banks published in IFS differ substantially from those published and used in Israel due to the complexity of the financial system, and the conceptual treatment of lenders and borrowers (netting of transactions). The conceptual basis for adding an IFS section on other financial institutions has been established, but it appears to require detailed data not currently available which would require extensive reorganization of compilation methodology.

The authorities are still considering the issue of participation in the Fund's project on international banking statistics.

Israel--Basic Data

Population (average 1983)	4,099 million
GNP in 1983 (market prices)	IS 1,369,183 million (US$24,357 million)
Origin of GDP in 1983 (at factor cost)	(in percent of GDP)
Agricultural, forestry, and fishing	11.0
Industry, mining, and quarrying	28.0
Construction	7.0
Transport and communication	14.0
Finance, trade, and services	40.0
Gross domestic product	100.0

	1981	1982	1983 1/	Official forecast 1984
	(Annual percentage change)			
National accounts (at constant prices)				
GDP	3.4	1.2	1.1	-1.2
Gross domestic expenditure	5.1	8.0	6.6	-6.9
Private consumption	11.0	7.5	6.8	-5.1
Government consumption 2/	0.7	4.6	7.7	-5.5
Gross domestic investment	-5.4	13.7	4.9	-13.5
Prices and employment				
Consumer prices (end-year)	101.5	131.5	190.7	...
Wholesale prices (yearly average)	122.7	125.8	144.5	...
Unemployment rate (in percent)	5.1	5.0	4.3	6.5
Real wages per employee post 3/	10.4	-0.3	5.0	...
Net immigration balance (thousands)	-11.4	4.8	13.6	...
	(In percent of GNP)			
Budget aggregates (fiscal years)				
Expenditures	70.0	70.6	74.4	67.2
Of which:				
Defense	22.2	21.2	22.8	18.1
Interest payments 4/	9.5	11.7	12.7	14.2
Revenues 5/	41.4	52.0	47.7	49.2
Deficit	22.6	18.6	26.7	18.0
	(Real percentage change; 6/ end of period)			
Monetary developments				
Liquid financial assets and bank shares	11.6	15.6	-18.6	...
Total financial assets of public	14.6	37.6	-30.3	...
Short-term bank credit	-8.2	0.5	-18.0	...
	(Annual percentage change)			
External sector				
Exports, f.o.b.	1.8	-6.0	-1.1	12.2
Imports, f.o.b.	4.8	-5.7	-2.8	-1.3
Of which: nondefense	-1.0	1.4	4.4	-6.0
Export volume	5.1	-0.9	0.2	-12.2
Import volume	2.8	10.9	10.2	-6.0
Terms of trade	-1.1	3.3	2.2	--
Nominal effective exchange rate 7/	-47.0	-47.0	-61.4	...
Real effective exchange rate 7/	-2.2	12.9	-2.3	...
	(In percent of GNP) 8/			
Current account deficit	6.6	9.5	10.7	4.6
Debt outstanding 9/	86.0	94.4	91.7	...
Gross official reserves end-year (in months of total imports)	2.9	3.1	3.0	...
Gross debt service as a percentage of current receipts 10/	24.8	28.7	27.4	26.5

1/ Provisional data.
2/ Excluding direct defense imports.
3/ At fixed 1978 prices.
4/ Excludes interest accrued on central government debt owed to Bank of Israel.
5/ Excludes transfers of profits from Bank of Israel derived from accrued interest on loans to Central Government.
6/ Deflated by consumer price index.
7/ Based on the standard index (using consumer prices) developed in connection with the Information Notice System; fourth quarter over fourth quarter.
8/ GNP figures in dollars in 1982 and in particular 1983 reflect the overvaluation of the shekel in these years; the 1982 and 1983 percentages therefore arguably understate somewhat the underlying position.
9/ Gross external liabilities minus foreign assets of commercial banks.
10/ Exports of goods and services plus private and official transfers.