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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/85

10:00 a.m., June 1, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
	T. Ramtoolah, Temporary
	H. G. Schneider
	X. Blandin
A. Donoso	M. Teijeiro
	M. K. Bush
	T. Alhaimus
T. Hirao	T. Yamashita
	Jaafar A.
R. K. Joyce	L. Leonard
	C. Robalino
	H. A. Arias, Temporary
	G. Grosche
	G. Gomel, Temporary
	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	A. Lindå
	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

Administration Department: H. Wiesner. European Department: L. A. Whittome, Counsellor and Director; T. R. Boote, R. P. Hicks, P. C. Hole, L. G. Manison, V. Marie, J. S. Van't dack, H. Vittas. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; N. Kirmani. External Relations Department: H. P. Puentes. Fiscal Affairs Department: M. Katz. IMF Institute: A. Leef, Participant. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; G. F. Rea, Deputy General Counsel; W. E. Holder. Secretary's Department: J. W. Lang, Deputy Secretary. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; D. H. Brown, W. L. Coats, R. B. Hicks, B. E. Keuppens, T. Leddy, J. T. McDonald, M. A. Tareen, G. Wittich. Bureau of Statistics: E. W. Saunders. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, C. J. Batliwalla, S. E. Conrado, S. El-Khouri, G. E. L. Nguyen, Y. Okubo, I. R. Panday, D. C. Templeman. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, J. R. N. Almeida, J. Bulloch, M. B. Chatah, L. E. J. M. Coene, M. Eran, V. Govindarajan, D. Hammann, N. U. Haque, A. K. Juusela, H. Kobayashi, M. Kooymans, G. W. K. Pickering, M. Rasyid, J. Reddy, S. Sornyanyontr, A. J. Tregilgas, Wang C. Y., M. A. Weitz, A. Yasseri.

1. ISRAEL - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Israel (SM/84/99, 5/2/84, and Sup. 1, 5/30/84). They also had before them a report on recent economic developments in Israel (SM/84/103, 5/8/84).

Mr. Polak made the following statement:

On behalf of the Israeli authorities, I wish to thank the staff for the effort in producing this concise and well-written paper. My authorities have read the report with great interest and agree that the picture that it presents broadly reflects the economic and financial situation in Israel.

As Directors know, the problems that the Israeli economy is facing are grave. They have culminated in three-digit inflation, which has persisted since 1979, and a current account deficit that has deteriorated by an average of $600 million a year in the last three years, to reach $2.6 billion in 1983.

In the belief that inflation was partly self-feeding on linkages and expectations, the Israeli authorities tried for a limited period to fight it by slowing the rate of depreciation of the shekel and the rate of increase of controlled prices. This policy, initiated in September 1982, met with much criticism in the Board discussion of the 1983 Article IV consultation last June: Directors found it not viable in the long term and advocated an accelerated rate of depreciation, even at the cost of an initial inflationary impact.

As was indicated in that discussion, the Israeli authorities were flexible in their approach on this matter, and stated that they would not hesitate to change course if the expected benefits did not accrue quickly. And indeed, in October 1983, when, after 13 months, no benefits of this policy were apparent, the course was changed when the newly appointed Minister of Finance switched the order of priorities and focused on the reduction of the current account deficit rather than on inflation as the foremost short-term target of economic policy. This implied a complete turnaround of policies, with an initial 19 percent devaluation of the shekel and a sharp cut in price-supporting subsidies, followed by a continuous adjustment, in line with inflation, of the exchange rate and controlled prices.

The initial impact of these measures on inflation was expected to be significant, as indeed it was. Inflation rose to unprecedented levels, but the rate of exchange was adjusted continuously, to maintain and even further improve external competitiveness. In spite of indexation and advance wage payments, real wages are estimated to have eroded in the last quarter of

1983 by 15 percent. It is hoped that the continuous improvement in competitiveness, together with policies aimed at restraining public and private demands, will eventually bring about balance in the economy.

The provisional trade figures for the first four months of 1984 already point to some improvement in the external balance: exports of goods, excluding diamonds, in January-April 1984 were 9 percent higher than in the corresponding period in 1983; imports of goods were 4 percent lower. The trade deficit decreased by 21 percent or by some $230 mllion over this period.

The Israeli authorities intend to continue with restrictive policies on all fronts. In this respect, they fully agree with the recommendations of the staff. However, they view the scope for monetary policy--in a highly indexed, highly sophisticated economy like Israel--somewhat differently from the staff.

Persistent high rates of inflation in Israel have given rise to the introduction of "inflation-proof" financial assets, notably foreign-currency-denominated deposits and bonds linked to the consumer price index. These form about 80 percent of M-4, the monetary aggregate most commonly referred to. While this composition of M-4 has ensured relatively high levels of domestic savings, this aggregate is, at the same time, resistant to inflation and to the "real balance effect." An increase in the price level, instead of eroding the public's financial assets, increases the nominal value of M-4. Similarly, an accelerated devaluation of the shekel increases the foreign-exchange-linked component of M-4 and thus also contributes to the nominal growth of this monetary aggregate. M-4 is therefore endogenous and does not lend itself to nominal targeting.

Because of this, the Israeli authorities believe that monetary policy should be examined mainly by reference to credit, interest rates, and private savings ratios. The performance of these indicators in 1983 was as follows: the expansion of bank credit to the private sector lagged consistently behind inflation; its nominal rate of growth in 1983 was the same as in 1982, even though inflation rose by 130 percent to 190 percent. Interest rates on dollar loans were still above 20 percent in 1983; there was virtually no consumer credit, and mortgages were severely restricted, even to first-time buyers. On the whole, although the business sector received some "directed" credit, all types of credit to the private sector have decreased in real terms (SM/84/103, Table 23). This, together with the extremely high real rates of interest that prevailed until the last quarter of 1983 (SM/84/103, Table 25), indicates a severe crowding out of the private sector. A further crowding out is, the authorities feel, both undesirable and impractical. Moreover, the private savings ratio, at more than 20 percent of private disposable

income, is high by any standard and also points to a consistently restrictive monetary stance. The even higher saving ratios that prevailed in the early 1970s, referred to by the staff, were achieved under special circumstances and should be considered a historical peak, not likely to be reached again.

The Israeli authorities believe, therefore, that in the circumstances described monetary policy can play only a secondary role to fiscal and incomes policies. The large magnitude of the budget deficit and the high ratio of domestic debt to GDP (115-120 percent) limit the scope for any further nonmonetary financing of the budget deficit. Moreover, since any nonmonetary financing of the budget deficit--i.e., sale of bonds to the public--contributes to further growth of M-4, the only way in which the growth of the financial assets held by the public can be abated is by decelerating the growth of domestic debt, which is the mirror image of these assets; in other words, by reducing the budget deficit. The authorities believe that a "social contract," or a package deal, by which all parties--Government, employers, and the Histadrut (the labor union)--would agree on a freeze on prices, the rate of exchange, and wages might provide the solution and, so that the economy would return to a stable growth path without having first to undergo a phase of deep unemployment.

Let me now make some comments on a number of additional points raised by the staff.

In the analysis of the 1983 financing of the budget deficit in Israel, one should bear in mind that the difference between the sale of bonds to the public and the increase of dollar-denominated deposits by the public is not that great. In the first case, the public increases its holdings of government bonds and the proceeds are channeled directly to the Government; in the second case, the public increases its deposits with the banking system. Since the required reserve ratio against these deposits is 100 percent, the banks increase their own deposits with the Bank of Israel by the same amount. When the Bank of Israel then lends the proceeds to the Government, it is in essence still the nonfinancial private sector rather than the central bank that finances the Government. The switch in the public's portfolio from shekel-denominated assets to assets denominated in foreign currency during the second half of 1983 thus partly accounted for the increase in the share of the budget financed by credit from the Bank of Israel (SM/84/99, Table 5).

It should also be remembered, as noted above, that the Israeli public is highly sophisticated in its financial dealings. The annual increase of more than 6.5 percent in the number of persons employed in financial services since 1979, while total employment in the business sector increased by less than 2 percent annually (SM/84/103, Table 12), indicates the growing demand for

these services, as the public was trying to hedge against inflation and shift quickly from one financial asset to another. In such circumstances, capital markets have become extremely sensitive to any change in mood, and the authorities are hesitant to introduce radical changes in rates of interest lest the capital market should suffer a severe shock, from which it would take a long time to recover.

Moreover, in view of the relatively liberal foreign exchange market, the introduction of uncertainty in the capital market could easily lead to a "run into the dollar" and capital flight, which would also disrupt stability. The authorities therefore feel that extreme caution is required in dealing with these two markets.

Finally, I would like to comment on some exchange restrictions that have been either imposed or tightened in the past two years. The Israeli authorities totally agree that a liberal exchange system, with a uniform exchange rate, would be ideal. They are fully aware of the cost involved in differentiated rates of import duty and other restrictions. Indeed, over the years, the external market has been liberalized to a great extent, and any decision to go back on liberalization is taken with great reluctance. However, the authorities believe that in view of the weakening of the balance of payments and the rising inflation, resort to some short-term measures described by the staff--like the general import levy, the import deposit scheme, the travel tax, or the restrictions on the outflow of capital--was justified. In fact, while the staff would have welcomed the expiration of the import deposit scheme in June, such action might be regarded in Israel as a sign of political weakness, rather than as a positive step aimed at alleviating the economy's external position.

Ms. Bush remarked that economic developments in the last few years in Israel revealed a clear case of overconsumption, fed by an extremely expansionary budget deficit, rather large increases in real wages, and an unrealistic exchange rate policy over an extended period. During the 1981-83 worldwide recession, the average annual real growth of private consumption in Israel had been nearly 8.5 percent, compared with average growth of consumption in the industrial countries of less than 1 percent and with a rate of growth of real GNP in the non-oil developing countries of slightly more than 2 percent. Furthermore, the ratio of the budget deficit to GNP in the previous three fiscal years had been an extremely high 22.6 percent. The annual growth of real wage rates in 1979-83 had averaged 4.3 percent, while the real effective exchange rate had appreciated steadily during 1982.

Those adverse developments were already jeopardizing economic growth, Ms. Bush continued, as real GDP growth in the past three years had averaged only 2 percent annually and was expected to be slightly negative in 1984. Similarly, productivity growth had averaged only about 1 percent annually in the period 1979-83, and the balance of payments position appeared to be on an unsustainable path. However, there were some positive features of the economic situation: savings and investment rates, except for investment in construction, remained fairly high, the rate of unemployment was still less than 5 percent, and Israel had been able to benefit from a steady inflow of both private and official capital, which had provided support to the balance of payments.

Israel was now clearly at an economic crossroads, Ms. Bush commented. The need for developing a political and social consensus in support of corrective economic action was more crucial than ever, if the present large disequilibria were to be addressed successfully over the medium term. The staff had correctly highlighted the critical budget deficit problem--expenditures in FY 1983/84 had amounted to more than 74 percent of GNP, while revenues had amounted to only 48 percent. Interest payments alone had risen from only 4.7 percent of GNP in 1979/80 to an expected 14.2 percent in the FY 1984/85 budget. Furthermore, the three budget scenarios presented by the staff for the medium term set out clearly unsustainable patterns, if an adequate rate of economic adjustment did not occur. Even in the most favorable outcome, interest payments would remain at a rather high 9 percent of GNP, and total expenditures would be about 59 percent of GNP. In the worst case scenario, interest payments would rise steadily as a share of GNP, reaching 36 percent by FY 1988/89. The latter outcome should not be allowed to happen. Moreover, for FY 1984/85, given the difficulties of reducing expenditures, there were doubts that the cut of 9 percentage points in the ratio of the deficit to GNP would actually occur. If the planned cut did not occur, it would greatly add to the problem of financing the deficit, given the public's recent shift out of government bonds and the need to avoid even larger resort to inflationary central bank financing of the deficit. Different views had been expressed by the staff and Mr. Polak regarding the prospects and desirability of financing the deficit through bond sales to the public. Both would agree that a reduction in the deficit itself would be preferable. She invited the staff or Mr. Polak to comment further on the financing methods mentioned.

In the monetary area, Ms. Bush went on, indexation complicated monetary management, quite apart from the monetary expansion created by discretionary actions. Moreover, past and present concerns about exchange rate policy and about the adequacy of domestic interest rate policy seemed to have driven the Israeli saver into non-shekel assets. It was essential that domestic financial instruments should be made attractive to savers, particularly by reducing inflation at its source, i.e., through reduction of government expenditures and, thereby, the budget deficit. She expressed interest in the staff suggestion that the authorities needed to consider carefully the establishment of nominal monetary targets and to

stick to them over the medium term, rather than accept somewhat accommodative targets. On the other hand, Mr. Polak had presented different arguments, on which she invited the staff to comment.

The continued growth in private consumption and inflation suggested that further reductions in wage indexation were needed, Ms. Bush considered. A complicating factor was the high tax burden, which caused a considerable discrepancy between the high cost of labor to the employer and the aftertax take-home pay of the worker. She hoped that the authorities would consider actions in that area but would avoid resort to artificial controls.

Commenting on the balance of payments, Ms. Bush welcomed the authorities' abandonment of the previous attempt at limiting inflation by slowing down the pace of exchange rate depreciation and of adjustments in administered prices. There were no examples of such a strategy having worked. In Israel's case, the current account deficit had widened, while inflation had increased substantially. For example, the average ratio of the current account deficit to GNP, which had exceeded 10 percent in the previous two years, could not be sustained in the medium term. Export growth, which had not done well in the past two years, was the key to balance of payments sustainability. The services account had also been weakening, in large part owing to the growing burden of interest payments; there was also some question about the adequacy of exchange rate policy with regard to such items as travel. In the capital account, the persistently negative errors and omissions item in 1979-81 reinforced the need for realistic exchange rate and interest rate policies. Furthermore, the Israeli authorities' use of various administrative trade and payments also raised questions about the adequacy of exchange rate policy and about the sustainability of the balance of payments position.

In sum, the steps taken so far by the authorities to address the budget deficit and other problems were welcome, Ms. Bush said. She concurred with the staff that those actions could only be considered first steps. Therefore, she urged the authorities to act promptly to develop the political consensus that would permit comprehensive actions to correct the disequilibria in the economy. In the meantime, close monitoring of developments and a large degree of policy flexibility would be required in order to respond promptly to unexpected developments.

Mr. Leonard commented that there were not many positive aspects to economic developments in Israel since the previous Article IV consultation (EBM/83/85, 6/15/83). There had been a small increase in GDP, exports had risen slightly, and the number of persons employed had risen by 3.5 percent. Otherwise, the trends had been almost uniformly bad, whether in the foreign balance, the increase in aggregate demand relative to output, the acceleration of inflation, the absolute rise in external debt, the marked weakening of the public finances, or the surge in liquid financial assets held by the public.

Those adverse developments could be linked directly or indirectly to attempts by the authorities to reduce inflation by treating its symptoms rather than its causes, Mr. Leonard continued. Fortunately, they had abandoned those attempts. Indeed, the great source of hope for the future was the authorities' readiness to recognize the failure of their earlier efforts and to switch to a fresh strategy. He welcomed the change in policy emphasis toward improving the external trade balance, reducing aggregate domestic demand, and maintaining the real exchange rate.

The only questions were whether the measures being applied to those ends were adequate, Mr. Leonard remarked, and whether, even with full commitment by the authorities, a regime of controlled austerity of the degree envisaged could be successfully carried through. He fully supported the authorities in their aims of cutting back on public expenditures and reducing the fiscal deficit. However, the improvement in the budget balance also depended on a large rise in nontax revenue in both real and nominal terms. Even if the higher revenue were achieved, there would still have to be uncomfortably large recourse to the Bank of Israel to help finance the remaining fiscal gap. Any slippages either in the expenditure cutbacks or in revenue raising would mean that the residual gap would be even wider. In that connection, it would be preferable if the relatively easy option of monetization of the debt were not so readily available to the authorities.

In the absence of an accommodating monetary policy, the problems arising from fiscal imbalances would be less severe, Mr. Leonard suggested, and there would be stronger pressure on the Government to see that fiscal targets were met. The staff described the task of monetary policy as "complex and difficult." Complexity and difficulty were certainly strong characteristics of the financial scene in Israel, but at least in certain aspects, the task being set the monetary authorities was lacking in challenge. It was true that the real decrease in bank credit to the private sector and the high positive real interest rates would indicate a tight policy stance even though the significant real increase in the monetary aggregate, M-4, would appear to suggest otherwise. However, the scope of monetary policy also embraced the financing of the government sector, and, in that regard, the approach had been easy for the last several years; it appeared set to be easy in 1984 also. He suggested that means should be devised to make it less attractive for the public sector to have recourse to the Bank of Israel in satisfying its huge appetite for resources. The contribution that such an approach would make to restraining public expenditure would be valuable not only in itself, but would also assist in the re-emergence of unlinked short-term shekel deposits, an aim that monetary policy alone could not achieve but that depended on the re-establishment of confidence in domestic economic policy generally.

It was difficult to believe that the practice of linking liquid financial assets to the dollar or to the consumer price index was not a factor of consequence in sustaining inflation, Mr. Leonard continued. By automatically raising the nominal shekel value of such assets, the income effects would necessarily raise aggregate demand, possibly substantially.

The practice might, therefore, be scrutinized to assess its significance in that regard and to see what remedial measures, if any, might be taken. He accepted the point made by Mr. Polak that there was no great difference between the sale of bonds to the public and the increase in dollar-denominated deposits by the public; the corollary was that one was as inflationary as the other. He invited Mr. Polak or the staff to comment further on the issue. The absence of an assessment of the inflationary effects of linkage and action to counteract them could also jeopardize attempts to improve competitiveness and to reduce aggregate demand through action on wages, as at present contemplated by the authorities.

The Israeli officials acknowledged that achieving the expected reduction of the external trade gap under the new strategy would depend on improvements in competitiveness, increases in external market shares, reduction in domestic demand, and good management of the factors that influenced demand, Mr. Leonard continued. The provisional data for the first four months of 1984 were not reassuring. If the information in SM/84/99, Supplement 1 could be taken as a reasonably reliable guide to the outturn for the year as a whole, the targeted reduction in the civilian trade deficit of $1.2 billion would be undershot by about one third. A prospective shortfall of that order necessarily raised questions about the adequacy of the policies being pursued, and it underscored the need for contingency action to adjust policies, as the staff had pointed out.

In sum, he fully supported the resolve of the Israeli authorities to restore balance to the economy, Mr. Leonard said. However, a number of actions might be considered to strengthen the measures already under way. Even with a strong commitment by the authorities, circumstances might prevent them from making the progress that they desired. Therefore, contingency plans to cope with the situation should be made immediately.

Mr. Grosche remarked that, after years of continuing excess domestic demand relative to available resources, it was astonishing that Israel's situation was not worse. Large foreign grants and external borrowing seemed to have fostered the impression that adjustment could be deferred for a long time. However, the economy's decline had reached a point at which a steep fall was close. The already high inflation rate had risen even further, the financing of the budget had required about 20 percent of GNP, and the deficits in the external accounts had reached a magnitude that was no longer sustainable.

In October 1983, Mr. Grosche continued, the Government had changed its economic priorities. Efforts to counter inflationary pressures now ranked second, with the reduction of the current account deficit regarded as the most important task. The explicit change in priorities reflected a somewhat distorted view of economic strategies. The fight against inflation deserved the same degree of attention as the external balance. Inflation, like the deterioration of the current account, was indicative of overheated domestic demand. Moreover, it had large negative medium- and long-run repercussions, especially when the rate of inflation was high

and volatile. Relative prices and incentives lost their allocative roles. Thus, inflation was not conducive to productive investment, and it might even erode the productive base of the economy.

The reduction of the high budget deficit was probably the most urgent action to be taken by the Government, Mr. Grosche considered. Emphasis should be clearly laid on cuts on the expenditure side. Taxes and other revenue-raising measures had reached an upper limit, and further action would only increase the attractiveness of the hidden economy. He agreed with the staff that, to finance the deficit, the authorities should approach exclusively the capital market by offering interest-bearing assets. He invited the staff to comment on the interesting remarks by Mr. Polak on monetary financing. As explained by Mr. Polak, credit to the Government from the Bank of Israel could be regarded as credit from the nonfinancial private sector because of the 100 percent reserve requirement on dollar-denominated deposits. It would be useful to have further information on the amounts in question. From a purely political point of view, recourse to central bank credit was certainly easier than the alternative, but in economic terms it was certainly no less harmful. What mattered was the degree of real crowding out of private activity, which did not depend on the manner of financing the excess of government expenditures over revenues.

Furthermore, Mr. Grosche went on, the authorities had to face the damaging impact on monetary control and on price developments. The management of monetary policy was impaired not only by the fiscal position, but also by the uncertainties about the underlying rate of inflation and about structural shifts in the composition of monetary aggregates. A more restrictive stance was an indispensable precondition of improved economic performance.

Commenting on external policies, Mr. Grosche said that he agreed with the staff on the need for a further slight adjustment of the exchange rate. The higher rate of inflation and the increase in unit labor costs supported that view. While he was glad that the authorities had not turned to quantitative import restrictions, he regretted the introduction of import duties and exchange controls. Finally, the savings ratio was very high, a surprising fact in view of the high inflation rate and by comparison with savings ratios in other countries. Mr. Polak had suggested that it was partly the result of the restrictive stance of monetary policy; perhaps the staff could comment further on the question.

Mr. Clark said that it was clear that the policy mix pursued by the Israeli authorities between September 1982 and October 1983 had led to a sharp deterioration in economic performance, especially a worsening of the fiscal and trade deficits. The measures adopted since October 1983 were, therefore, welcome. The adjustments in the exchange rate and in subsidies should help the balance of payments in 1984; in that sense, they represented important first steps. Mr. Polak had characterized the October measures as a switch in the order of priorities. However, he agreed with the staff and Mr. Grosche that there could be no downgrading

of the priority of curbing inflation. The situation required a simultaneous attack on both the balance of payments and the inflation problems. He encouraged the authorities to persevere in their efforts to reduce the fiscal imbalance and to resist expansionary pressures. He also encouraged them to build on the measures already taken to adopt a longer-term approach to economic policymaking in contrast to the past tendency to focus on short-term crisis management.

The planned reduction in the budget deficit to 18 percent of GNP in 1984 was welcome, Mr. Clark continued. It was important that it should be carried through as planned, which, on the basis of past experience, would not be easy. For example, the staff had stated in SM/84/103 that "it is estimated that over the period April-August 1983 the rate of real government expenditure was over 10 percent above that planned." In the same paper, the staff suggested that little progress had been made in reducing public sector employment. It would be important not only to avoid slippages, but also to make further progress in 1985 and beyond. By all ordinary standards, a fiscal deficit of 18 percent of GNP was grossly excessive. In that regard, it was encouraging that the authorities intended "to build on the improvement anticipated in 1984 during 1985-87." The need for continuing adjustment of the fiscal balance was underlined by the information in Table 7 of SM/84/99, which showed how, in both the "partial adjustment" and the "no adjustment" cases, interest payments would continue to grow as a proportion of GNP, in the "no adjustment" case almost explosively.

The Israeli economy was suffering from the distortions that normally accompanied a persistently high rate of price increase, Mr. Clark commented. Israel, like Brazil, provided an example of how measures to accommodate inflation could make the control of inflation more difficult, a point that applied, in both countries, especially to the operation of financial policy. He agreed with the staff's comment that "what is needed is a nominal anchor" and that "a clearly articulated policy of monetary contraction" was required. In addition, however, there seemed to be a clear need for a cut in real wages in favor of increased profits. One helpful factor in achieving that goal would be a reduction of inflationary expectations. The package deal with the social partners mentioned by Mr. Polak could play an important role. He hoped that the authorities would be able to negotiate a decrease in the frequency of wage indexing and would resist pressures in the opposite direction.

Mr. Gomel remarked that he basically agreed with the staff's diagnosis of the Israeli economic situation and with its discussion of the policies required to overcome the country's severe maladjustments. On the inflation front, while he sympathized with the reordering of priorities that the authorities had undertaken in October 1983, emphasizing the contraction of the fiscal and external deficits and the deceleration of inflation through an emergency stabilization program, the wisdom of that approach for the medium term was questionable. He understood the rationale for the "controlled austerity" program for 1984. Financial discipline under that scheme should stabilize the economy at a lower

inflation rate; at a later stage, incomes policies and "social pact" arrangements could be set in place to compress inflation gradually. However, he shared the staff's concern that gradualism might not be an effective avenue for disinflation at the present juncture of the Israeli economy.

Economic theory suggested that anticipated inflation in a fully indexed economy should result mainly in welfare costs associated with the costly mechanisms that needed to be activated to accommodate larger and faster transactions, Mr. Gomel continued. In real-world economies, however, real magnitudes were affected by high inflation. In Israel, it could be said that capital formation and growth were being depressed with a lag by a persistent and accelerating inflation. He invited the staff to comment further on that linkage. There was merit in the staff's advocacy of a "concerted attack on inflation" in the conduct of economic policy in Israel. Incomes policies, including a revision of the indexation mechanism, and monetary restraint would have to be necessary complements to fiscal action in such a concerted attack.

However, the management of public finances was seen as the first priority, Mr. Gomel observed. He appreciated the authorities' resolve to reverse the steep rise in the budget deficit in 1983, and he agreed with the staff that the required cutbacks in noninterest-related expenditures were sizable and could not be deferred any longer. On the revenue side, doubts remained that the planned increases could be achieved. With regard to monetary and debt management policy, the techniques of monetary control still seemed remarkably ill-equipped to tackle the precarious situation. Nonindexed assets, both bank deposits and treasury bills, had been given attention for some time, but it was not clear from the staff's account whether private demand for such assets had emerged on a significant scale and whether monetary management had accordingly been enhanced.

On the external front, Mr. Gomel added, following a period of misguided exchange rate policy that had undercut considerably Israel's competitive position, as shown by the indicators in SM/84/99, policies appeared to be on the right track. They should help the country to improve its current account position through a sizable resource transfer toward exports and through reductions in imports.

Mr. Teijeiro commented that the situation of the Israeli economy was worrisome. On the external front, the authorities had begun a correction of policy in October 1983 with a devaluation; they were consolidating their new approach by indexing the exchange rate to domestic prices and by the recently agreed wages policy that contemplated only partial indexation to past inflation. There was a long way to go to restore relative prices, but the authorities were moving in the right direction.

On the domestic front, Mr. Teijeiro continued, the discrepancy between the need for adjustment and policy intentions was important. The increase in the public sector deficit of almost 8 percentage points of GDP between 1982/83 and 1983/84, in contrast to an expected decline of

2.5 percent of GDP, was most disappointing; it cast serious doubts over the deficit projections for 1984/85. A fiscal deficit of 27 percent of GDP could lead in the present circumstances to a rapid acceleration of inflation.

In 1983, the private sector had continued to be crowded out of the capital markets as the Bank of Israel had absorbed about 11 percent of GDP through the 100 percent reserve requirements on PATAM deposits (shekel accounts denominated in foreign exchange), Mr. Teijeiro observed. In other words, most of the transfers to the Treasury, amounting to more than 13 percent of GDP, had been financed through nonmonetary financing of the deficit, instead of through treasury bonds placed on the market. There had, thus, been a major increase in the indebtedness of the central bank. However, continuing significant crowding out of private sector credit seemed to be the only way to avoid an explosion of inflation. Room for monetary financing of the public sector deficit was small, as the narrow monetary base was equivalent to a little more than 2 percent of GDP. It was, therefore, particularly worrisome that the authorities believed that further crowding out of the private sector was both undesirable and impractical. He agreed with the staff that crowding out of the private sector might be the unavoidable cost of the current fiscal deficit; policies aimed at maintaining credit to the private sector in real terms would soon lead to a major acceleration of inflation, a worsening of the external account, or both. The consequences of the fiscal situation were serious: a major improvement was essential and should be the first priority of economic policy. If the fiscal deficit were not brought under control, plans to implement a social contract or "package deal" would be short-lived.

The concept of the public sector deficit used in the staff papers on Israel did not correspond to the traditional concept used in most staff papers, Mr. Teijeiro noted. In Israel's case, the concept excluded the monetary correction of the domestic public debt; it was similar to the concept of the "operational deficit" in Brazil. In most countries, the Fund used only the traditional definition, while in some cases, such as that of Brazil, both definitions of the public sector deficit were used. In Israel's case, the staff had used only the "operational concept." He did not question the appropriateness of that definition for analysis of Israel's situation. In fact, the traditional definition might indicate a public sector deficit of more than 200 percent of GDP, which would make it difficult to explain why the inflationary situation had not already exploded. In general, both definitions could be useful, if used appropriately, because they addressed different questions. It might be useful if the staff could produce a paper discussing the appropriate use of both definitions or of other relevant definitions. Perhaps the issue could be raised in the context of the forthcoming discussion on the design of Fund programs.

Another problem arising from the proliferation of definitions involved the aggregate fiscal data in the tables produced for the World Economic Outlook paper, Mr. Teijeiro concluded. It could be that the

data was an aggregation based on different deficit concepts. Furthermore, aggregation of data, even on the basis of the traditional definition, could give a distorted picture if inflation rates among countries varied greatly.

Mr. Ramtoolah stated that Mr. Tshishimbi had requested him to express his (Mr. Tshishimbi's) agreement with the staff appraisal and his support for the proposed decision.

The staff representative from the European Department, taking up Directors' comments on monetary policy and the financing of the budget, said that the staff agreed with Directors that a sharp reduction of the budget deficit was a prerequisite for economic stabilization in Israel and for the effective functioning of monetary policy, which had played a relatively passive role over a number of years. The budget targets for the current fiscal year were appropriately ambitious; therefore, the staff had not urged a greater role for fiscal policy in the present context. However, monetary policy could no longer be accommodating. As Mr. Polak had pointed out, the situation was extremely difficult, given that more than 80 percent of liquid financial assets were indexed. The staff believed that the authorities should deal with the nonindexed component of liquid assets in two ways: first, by strictly limiting its growth in nominal terms in the short run; second, by inducing a shift from indexed to nonindexed assets over time and thus increasing the share of the latter as a proportion of M-4 in order to increase the scope for discretionary policy. A key element, given the size of the Government's financing requirement, would be to place greater reliance on longer-term and less liquid financing instruments. An appropriately tight policy stance would require a more active interest rate policy. In that context, it should be noted that PATAM deposits and tradable bonds both represented relatively liquid financing of the Government. A development of concern had been the switch by the public away from longer-term, less liquid financing of the Government into PATAM deposits in 1983. The authorities now explicitly recognized in the Government's accounts that PATAM deposits represented a particular source of financing; beginning in 1984/85, such deposits with more than three months' maturity were to be considered a component of bond issues rather than credit from the Bank of Israel. The amount budgeted for the coming fiscal year, approximately one fifth of overall bond sales, was a little over IS 100 billion.

The traditional high savings ratio in Israel was the result of several factors, the staff representative suggested. First, the indexation of financial assets had helped to generate a high rate of savings. Second, demographic factors had played a role, with the large-scale inflows of relatively poor immigrants in the 1950s who had needed to build up wealth, especially to finance housing. Third, there had been recurrent forced savings in the form of war bonds or loan levies.

Investment had performed remarkably well in the face of persistent and rising inflation in recent years, the staff representative went on. However, the data in that regard could be somewhat misleading because of

the special circumstances of the previous two years. It had been economically advantageous for enterprises to accelerate their purchases of capital goods, many of which were imported, because of exchange rate expectations. In addition, while there had been a decline in the growth of short-term credit in real terms in 1983, medium-term and long-term credit had increased somewhat. An important element in the reduction of short-term credit, moreover, had been the cutback in credit for financial transactions, particularly share purchases. Thus, the private business sector might not have been crowded out severely by credit policy. However, one matter of concern in credit policy was that the credit aggregate being targeted was only part of total credit. The authorities would have to look closely not only at short-term credit but also at medium-term and long-term credit.

Commenting on the presentation of the budget, the staff representative from the European Department noted that, given the high degree of indexation of financial assets offered by the Government, interest payments largely represented real returns. The authorities accounted for the indexation element of principal below the line in part because they wished to focus on the operational implications of budget financing, and the staff had followed the authorities' presentation.

The Deputy Director of the Exchange and Trade Relations Department recalled that comments had been made on conceptual aspects of the budget deficit. The staff would consider how best to respond to those comments in a paper.

Mr. Polak said that he agreed with Executive Directors that the economic situation in Israel was serious and that the change in policy emphasis since October 1983 needed to be pursued even more vigorously. In particular, the authorities needed to develop a consensus among the various social classes on an anti-inflation policy. Agreement on a "package deal" would be an important way of making progress, as a number of Directors had suggested. On financing the budget deficit, he agreed with Ms. Bush that, given the present policy of supporting the prices of bonds, the distinction between bond financing and monetizing of the debt was not great; however, as the staff representative had pointed out, if a more active interest rate policy were developed, the distinction would become more important, and the case for bond financing would become stronger.

It had been suggested that, in view of the data for the first four months of 1984, the pace of the desired adjustment in the current account was not sufficiently rapid, Mr. Polak continued. Although such data had usually provided a good indication of the outturn for the year as a whole, the situation at present might be different because the effects of the change in policy were only beginning to make themselves felt and their impact might become stronger in the course of the year. Furthermore, the data referred only to the trade account; part of the current account improvement was expected to come on the services side. In general, the figures suggested that the aim of the Israeli authorities to bring about an improvement in the current account of a little over $1 billion for 1984 as a whole was achievable.

The question of how best to reduce the contribution of indexed-linked components of the money supply to inflation had also been raised, Mr. Polak noted. The Israeli authorities were aware of the problem and, in that connection, were looking closely at the experience of Iceland, where a significant reduction in inflation had been brought about by recent government measures. It was worth bearing in mind that, in Iceland's case, the indexing of wages through cost of living adjustments had been abolished first, while the indexing of financial assets had been maintained because the authorities had been convinced that it would have been impossible to change that element of the picture without causing serious disruption in the financial system. In Israel also, a major reduction in the indexing of financial assets would have to come in the later stages of the anti-inflation process. With regard to the high savings ratio, another factor, in addition to those mentioned by the staff representative, was that the Israeli authorities had long been offering attractive financial assets with high guaranteed real interest rates for extended periods through various forms of indexation; some of those assets had also been tax exempt. Finally, he agreed with the points made by Mr. Teijeiro on the concept of the budget deficit and with his suggestion that the issue should be studied by the staff.

The Chairman made the following summing up:

As on the occasion of the previous Article IV consultation with Israel, Executive Directors focused their remarks on the considerable and persistent economic imbalances and problems facing the authorities, particularly the continued excess demand, the large deficit in the current account of the balance of payments, and the extremely high rate of inflation. They noted that those complex problems, far from diminishing, had become much more pressing during 1983. In particular, the adverse effects of the strategy of slowing the adjustment of the exchange rate and of controlled prices and the failure to tackle the sizable underlying imbalance between demand and supply had contributed to the poor performance of the economy. The need to implement a comprehensive package of policies to correct those imbalances, which Directors had emphasized already in 1983, was thus seen as having become even more urgent.

Against that background, Directors welcomed the shift in exchange rate and budgetary policies initiated in late 1983. They also welcomed the continued high levels of savings and investment. They emphasized, however, that the measures taken to date constituted only a beginning. Restoration of better balance in the economy would require a sustained and substantial reduction in the budget deficit, a lasting cut in real wages, and a marked deceleration in the nominal rate of monetary expansion. The urgency of achieving the political consensus needed to implement a package of comprehensive measures to that effect could not be overemphasized.

Directors viewed as of fundamental importance and appropriate the attainment in 1984 of the authorities' target of an improvement of about $1 billion in the external balance on goods and services. The very high and rising level of debt, together with the widening current account deficit, had generated a gross external financing requirement that threatened to become untenable if not quickly and substantially reduced. With partial data for the opening months of 1984 suggesting that the trade balance was strengthening less than targeted, speakers questioned whether the adjustment of the real exchange rate to date was sufficient to achieve the improvement sought in the external current account.

All Directors expressed considerable concern about recent and prospective developments in prices and some urged that greater priority should be given to tackling that problem. High inflation over a prolonged period had adversely affected resource allocation and the growth rate of productive potential, and the recent doubling of inflation had put the efficient functioning of the economy under new strain. It was also noted that institutional mechanisms--particularly the system of wage determination and the indexation of financial assets--were tending to perpetuate the higher rate of inflation. A number of speakers believed that a continuation of current price trends could only jeopardize attainment of the authorities' basic external objectives, and it was the general view that concerted measures of fiscal, monetary, and incomes policy were needed to reverse the present trends.

A reduction in the budget deficit in FY 1984/85 was a basic prerequisite, both for achieving a meaningful improvement in the external position and for halting the acceleration of inflation. The rise in the overall budget deficit was clearly unsustainable, Directors commented. They noted that emphasis was appropriately being given to cutting expenditures, particularly to reduce commodity subsidies. The extraordinarily high level and the forecast further growth of the ratio of interest payments to GNP was viewed with particular concern. Many Directors stressed that the authorities would need to show great determination if their budget targets were to be achieved.

Even with a reduction in the budget deficit as targeted, Directors feared that monetary growth would remain excessive in 1984, in part because financing of the deficit by the central bank, while declining, would still be sizable, and in part because of the widespread indexation of financial assets. Most speakers saw a more active monetary policy as a key ingredient in a coherent strategy to reduce inflation and to enforce budgetary discipline. They urged the authorities to adopt a firm program of monetary contraction, and to secure nonmonetary financing of the fiscal deficit consistent with such a program. The authorities were encouraged to start reviewing the mechanism of indexation of financial assets.

Mr. Jayawardena said that his authorities continued to believe that the position that they had put forward at EBM/84/84 was the only reasonable decision that the Executive Board could reach in the interest of debtors as well as creditors of the Fund and in consonance with the larger objectives of the Fund. He regretted that his proposal had not found adequate acceptance in the Executive Board. With a view to achieving an honorable and fairer compromise, his chair had been willing to move forward to a 50/50 allocation of excess income and a 6.97 percent rate of charge, provided that the determination of the rate of charge was made in a symmetrical manner. The instructions from his authorities ended at that point.

However, he had been deeply impressed by the spirit of Mr. Polak's compromise proposal at EBM/84/84, preceded by a strong justification of the need for symmetrical determination of the rate of charge, Mr. Jayawardena continued. Thus, as a further move toward compromise, and even though he had not yet received instructions from his authorities, he was willing to accept Mr. Polak's compromise proposal. The symmetrical adjustment inherent in that proposal could easily be achieved by a simple amendment of Rule I-6(4)(b). It would suffice to add the words "above or" after the words "annual basis, is" in line 4, to add the words "decreased or" after the words "shall be" in line 11, and to add the words "3 percent" after the words "reach the" in line 12 of the Rule as presented on page 18 of EBS/84/91. He hoped that such an amendment could be the basis for an honorable compromise.

He would prefer to withhold comment on Mr. Polak's additional suggestion, which followed the lines suggested by Mr. Nimatallah at EBM/84/84, until there was greater assurance that it would have the general acceptance of the Executive Board, Mr. Jayawardena concluded.

Mr. Blandin recalled that his authorities favored the lowest rate of charge compatible with the agreed reserve target of 3 percent. They also favored a possible revision of the rate of charge at the time of the midterm review. Mr. Polak's proposal to set a 7 percent rate of charge in conjunction with the deeming of SDR 20 million of FY 1984 income as income of FY 1985 was a reasonable compromise. However, the possibility of revising downward the rate of charge at the time of the next midterm review should also be included in the Rules, if possible. He could go along with Mr. Polak's proposed understanding.

Mr. Schneider remarked that his chair had already shown flexibility with regard to the rate of charge and that he had supported Mr. Polak's compromise proposal at EBM/84/84. He could continue to support that proposal with the additional understanding suggested by Mr. Polak. However, he could not support the idea that the Executive Board should decide at present to reduce the rate of charge at the next midterm review.

Mr. Mtei commented that, if the Executive Board took an objective and serious approach to determining the target for the annual accretion to the reserves of the Fund, it would be necessary to increase the rate

of charge if it appeared that the target would not be reached. Rule I-6 was worded to that effect. However, if developments revealed that the target would be substantially exceeded, it was logical to reduce the rate of charge, as Mr. Jayawardena had suggested. As he and other Directors had repeatedly pointed out, the Executive Board could not treat lightly the impact of increases in the rate of charge on the debt burden of users of Fund resources, particularly the low-income countries whose position was especially serious in present circumstances. The proposal by Mr. Jayawardena would introduce the element of symmetry that the developing countries sought for the Rules. However, in light of the reluctance of some Executive Directors to agree to a formal amendment of the Rules, he could support an understanding along the lines proposed by Mr. Polak.

Mr. Tvedt reiterated his support for Mr. Polak's proposal to increase the rate of charge to 7 percent and to deem SDR 20 million of the excess income in FY 1984 as income for FY 1985. He could warmly endorse the idea suggested by Mr. Nimatallah at EBM/84/84, which Mr. Polak had expressed in his proposed understanding, that the Executive Board should "make a declaration of goodwill" about how it would act at the time of the next midyear review.

Mr. Morrell stated that he could accept Mr. Polak's compromise proposal put forward at EBM/84/84. However, with regard to the proposed understanding, the expression "the staff will propose and the Board will consider a reduction..." was a matter of concern. It could be interpreted as limiting the staff to one proposal, namely, recommending only a reduction in the rate of charge. Like other Directors, he was concerned about the reserves target; it had been suggested that that target should be reviewed. Therefore, he would prefer to accept an understanding under which a possible reduction of the rate of charge would be only one of several proposals that the staff might put forward.

Mr. Mtei remarked that the point made by Mr. Morrell was already covered by the present Rule I-6(4)(b), which stated that, when the income target was not met, there would be an automatic increase in the rate of charge. The proposal by Mr. Jayawardena and himself was to introduce an element of symmetry, so that when the target was exceeded the rate of charge would be lowered.

Mr. Nimatallah suggested that it would be useful to bear in mind the distinction between reviewing the adequacy of the reserves target and the more short-term question of reviewing the rate of charge at the next midterm review.

Mr. Morrell commented that it was appropriate for a financial institution to err on the side of prudence; the Rules were designed to protect the stability of the Fund if the reserves target were not met. Before he could agree to an automatic mechanism to reduce the rate of charge, he would wish to have a fuller discussion of the adequacy of the reserves target.

Mr. Jaafar recalled that at EBM/84/84 his chair's preference had been to maintain the rate of charge for FY 1985 at its present level. However, so that the Fund would not have to plan for an operating deficit for FY 1985, he had been prepared to accept an increase in the rate of charge to 6.89 percent. His chair's preference had been based on a number of factors. It was inappropriate for the Fund to require debtor countries to contribute to the accumulation of reserves of the Fund at a time when the world financial community and the debtor countries were extremely concerned about debt servicing problems and were considering ways to alleviate those problems. His chair had also taken into account the fact that the Fund's reserves had been growing at an average rate of about 8 percent in the past six years compared to the annual target for reserve growth of 3 percent. His authorities had also borne in mind that there was a program in place to raise gradually the rate of remuneration to market rates.

Among the suggestions made at EBM/84/84 was the proposal to set the rate of charge at 7 percent and to split the excess of net income of SDR 39 million between reserve accummulation and deemed income for FY 1985, Mr. Jaafar continued. That proposal had merit, and he could support it conditionally. He could also support Mr. Jayawardena's proposal. In addition, he could support the idea that an understanding should be reached to reflect the concerns expressed by Mr. Mtei, Mr. Polak, and Mr. Jayawardena.

The Chairman said that the Executive Board had agreed to a 3 percent reserve target for the present, despite the doubts of some Directors about its adequacy; of course, the Executive Board could review its decision whenever it wished. The proposal put forward by Mr. Polak was designed to deal with the circumstances of a substantial excess of net income over the target of 3 percent of reserves; in those circumstances, the staff would examine the consequences of that excess for the rate of charge, and the Executive Board would consider the staff's proposal. Mr. Polak's proposal was focused only on the circumstances prevailing at the time of the midyear review of the Fund's income position for FY 1985.

Ms. Bush stated that she continued to believe that the appropriate action would be to set the rate of charge at 7 percent with the buildup in the reserves that such a course implied. However, she could accept Mr. Polak's suggestion of a 7 percent rate of charge in conjunction with a 50/50 division of the excess income. With regard to Mr. Polak's proposed understanding, she agreed with Mr. Morrell that it would be inappropriate to prejudge the staff review of circumstances prevailing at the time of the midyear review of FY 1985 income. Perhaps the proposed wording could be amended to say that the staff would take into account all relevant factors, including the level of reserves.

Mr. Nimatallah remarked that the staff normally took into account all relevant factors when it put forward proposals at the midyear review of income. For example, if the Executive Board decided, for whatever reason, to change the reserve target, that decision would be one of the factors that the staff would take into consideration.

The Chairman said that he agreed with Mr. Nimatallah. The point was covered in Mr. Polak's proposal, where it was stated that the staff would put forward a proposal if net income for FY 1985 was estimated to be substantially in excess of "the target," i.e., the target set by the Executive Board, whatever that target might be. Furthermore, the Board was free to consider any proposal put forward by the staff.

Mr. Joyce stated that he could accept the proposed understanding. He did not share the concerns of Mr. Morrell and Ms. Bush, because the issues could be dealt with on the occasion of the review of the reserves target itself. However, in order to meet their concerns, perhaps Mr. Polak's text could be amended to read:

> If at the midterm review the net income for FY 1985 is estimated to be substantially in excess of the target, the staff will make proposals for consideration by the Executive Board regarding the rate of charge, including a proposal for a reduction in the rate of charge for the remainder of the year.

Mr. Clark commented that the appropriateness of a reduction in the rate of charge and the adequacy of the reserve target were issues that could not be separated. A judgment whether income was "substantially" in excess of the target was to some extent conditional on a judgment as to the adequacy of the target in relation to the Fund's financial position.

The Director of the Legal Department suggested that the point raised by Mr. Morrell might be covered by referring to a reduction in the rate of charge "on the basis of appropriate staff proposals." Alternatively, the reference to the staff could be omitted. Consideration of the question was the prerogative of the Executive Board; in the normal course of events, the staff would put forward proposals that it judged appropriate.

At 11:35 a.m. the Executive Board agreed to adjourn the discussion until 12:05 p.m.

Mr. Nimatallah stated that he could support the wording proposed by Mr. Polak, in conjunction with Mr. Polak's original compromise proposal of a 7 percent rate of charge and a 50/50 division of the SDR 39 million of excess income.

Mr. Zhang, Mr. Jayawardena, Mr. Blandin, Mr. Alhaimus, Mr. Doe, Mr. Arias, and Mr. Donoso said that they could support Mr. Polak's proposal and his wording of the suggested understanding.

Mr. Joyce remarked that, while he believed that the amendment that he had suggested to the wording proposed by Mr. Polak would meet the concerns of Mr. Morrell and other Directors, he could accept the understanding as put forward by Mr. Polak.

Mr. Mtei stated that, in a spirit of compromise, he also supported Mr. Polak's proposed understanding. However, he could not accept the amendment suggested earlier by Mr. Joyce.

Ms. Bush said that she could support Mr. Polak's proposal if the understanding were amended to read:

> If at the midterm review the net income for FY 1985 is estimated to be substantially in excess of the target, the staff, taking into account all relevant considerations, will make proposals for consideration by the Executive Board that might include a proposal for a reduction in the rate of charge for the balance of the year.

Mr. Clark said that he could support Mr. Polak's original proposal and the suggested understanding as revised by Ms. Bush.

Mr. Grosche said that he could support the revised understanding if it was generally acceptable to other Directors.

Mr. Zhang considered that the revised wording suggested by Ms. Bush changed the spirit of the compromise that the Executive Board was trying to reach.

Mr. Hirao stated that he could support Mr. Polak's compromise proposal made at EBM/84/84 and the suggested understanding, as amended by Mr. Joyce. He could also support Ms. Bush's revisions.

Mr. Jayawardena commented that he agreed with Mr. Zhang that the revisions put forward by Ms. Bush departed radically from the spirit of the understanding as originally proposed by Mr. Polak. His chair and others had moved a considerable way from their original position in order to support Mr. Polak's proposal; he urged other Directors to show a similar spirit of compromise.

Mr. Nimatallah remarked that the additional points suggested by Ms. Bush were already covered under the Rules. If those points were included in the proposed understanding, they would be redundant, as Mr. Joyce had indicated, and would reduce the effect of the compromise that the Executive Board was trying to reach.

Mr. Morrell stated that he could accept Mr. Polak's wording.

The Chairman suggested that the proposed understanding might be amended to read:

> If at the midterm review the net income for FY 1985 is estimated to be substantially in excess of the target, management will make its judgment on an appropriate reduction in the rate of charge for the balance of the year, and the Executive Board will consider the proposal.

Mr. Clark proposed the addition of the phrase "in the light of this and other relevant factors" following the words "management will make its judgment."

Ms. Bush suggested a further amendment of the understanding to read: "...management will make its judgment in the light of this and other relevant factors on the appropriateness of a reduction in the rate of charge...."

Mr. Grosche, Mr. Hirao, Mr. Morrell, Mr. Tvedt, Mr. Nimatallah, Mr. Polak, and Mr. Clark said that they could accept the wording proposed by the Chairman, as amended by Mr. Clark.

Ms. Bush stated that, while she could accept the amended wording, she would prefer the modification that she had put forward.

The Executive Board then took the following decisions:

A. Net Income Placed to Special Reserve

The net income for the financial year that ended on April 30, 1984 shall be placed to the Special Reserve.

Decision No. 7712-(84/85), adopted
June 1, 1984

B. Rate of Charge Under Rule I-6(4) for Financial Year 1985

Pursuant to Rule I-6(4), it is decided that effective May 1, 1984:

(a) The rate of charge on the Fund's holdings of currency acquired as a result of the purchases referred to in that Rule shall be 7 percent per annum; and

(b) for the purposes specified in Rule I-6(4)(d), SDR 20 million of net income in excess of the target amount for the financial year that ended on April 30, 1984 shall be deemed as income for the financial year ending on April 30, 1985.

Decision No. 7713-(84/85), adopted
June 1, 1984

C. Rate of Interest on SDRs - Review

Pursuant to Rule T-1(d), the Executive Board has reviewed the rate of interest on holdings of SDRs.

Decision No. 7714-(84/85) S, adopted
June 1, 1984

The Executive Board also reached the following understanding:

If at the midterm review the net income for FY 1985 is estimated to be substantially in excess of the target, management will make its judgment, in light of this and other relevant factors, on an appropriate reduction in the rate of charge for the balance of the year, and the Executive Board will consider the proposal.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/84 (5/30/84) and EBM/84/85 (6/1/84).

3. VIET NAM - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/84/154 (5/25/84). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with Viet Nam to not later than June 18, 1984.

Decision No. 7715-(84/85), adopted
May 30, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/113 (5/29/84) and EBAP/84/116 (5/30/84) is approved.

5. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/84/118 (5/31/84) is approved.

APPROVED: January 4, 1985

LEO VAN HOUTVEN
Secretary