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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/85

10:00 a.m., June 15, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	M. K. Diallo, Temporary
	H. G. Schneider
	A. Le Lorier
	M. Teijeiro
R. D. Erb	
M. Finaish	
	Jaafar A.
	T. Yamashita
R. K. Joyce	M. Casey
	C. Robalino
G. Laske	
G. Lovato	G. Gomel, Temporary
	V. K. S. Nair, Temporary
	J. E. Suraisry
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	
J. Tvedt	
N. Wicks	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Asian Department: A. N. Mansur. European Department: T. R. Boote, R. P. Hicks, B. J. Nivollet, H. O. Schmitt. Exchange and Trade Relations Department: C. D. Finch, Director; D. K. Palmer, Associate Director; S. Mookerjee, Deputy Director. External Relations Department: A. F. Mohammed, Director. Fiscal Affairs Department: M. I. Blejer, M. Katz. IMF Institute: D. Gottlieb, D. Zakai, Participants. Legal Department: G. F. Rea, Deputy General Counsel; W. E. Holder, Ph. Lachman. Middle Eastern Department: F. Drees. Research Department: W. C. Hood, Economic Counsellor and Director. Treasurer's Department: D. Williams, Deputy Treasurer; K. Boese, W. L. Coats, Jr., L. E. Escobar, D. Gupta, A. F. Moustapha, M. Sami, T. M. Tran. Western Hemisphere Department: S. T. Beza, Associate Director. Bureau of Statistics: S. Tarab. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, P. Kohnert, H.-S. Lee, P. D. Péroz, P. D. Péroz, P. Péterfalvy. Assistants to Executive Directors: E. M. Ainley, H. Arias, L. Barbone, J. Bulloch, M. B. Chatah, T. A. Connors, G. Ercel, I. Fridriksson, A. Halevi, H. Kobayashi, M. J. Kooymans, W. Moerke, J. A. K. Munthali, Y. Okubo, G. W. K. Pickering, M. Z. M. Qureshi, J. Reddy, J. Schuijer, Shao Z., D. I. S. Shaw, M. Toro.

1. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR JUNE-AUGUST 1983

The Executive Directors considered the proposed designation plan (EBS/83/111, 6/1/83) and operational budget (EBS/83/112, 6/1/83) for the quarterly period June-August 1983.

Mr. Lovato stated that both his Maltese and his Italian authorities could go along with the proposed designation plan and operational budget, although the inclusion of Italy had come as somewhat of a surprise. While Italy's reserve position had improved in the course of the first quarter of 1983 and in April, that improvement had followed a sizable loss in 1982 of approximately $5 billion, and represented in some ways a reflux of currency following the realignment of the European Monetary System (EMS) in March. Furthermore, even a cursory examination of current economic conditions revealed that the situation in Italy remained far from satisfactory and that there was insufficient confidence about the likelihood of a continuation of reserve inflow in future months. In the circumstances, it might have been more appropriate if the staff had waited until a clearer picture of the balance of payments position had emerged before including Italy in the operational budget and designation plan. In passing, he noted that his Italian authorities would have appreciated some advance warning of Italy's inclusion in the two plans; still, in view of the current liquidity position of the Fund, and in a spirit of cooperation, they could accept the staff proposals.

On a more general matter, Mr. Lovato considered that the ways in which the broad criteria for selecting countries for operational budgets and designation plans--as spelled out in Article XIX, Section 5--were applied might usefully be the subject of a short paper for the information of the Executive Board. As recent cases had shown, reserve data for any quarter could be influenced by an accidental occurrence during a given month that did not fully reflect the underlying trend in the reserve and balance of payments position.

Mr. Laske said that his authorities could accept the recommended amounts for which Germany had been included in both the designation plan and the operational budget. His only question concerned the United Arab Emirates, for which no reserves had been shown in the tables after the third quarter of 1982. He understood that there were difficulties in the United Arab Emirates in deciding what reserves should be reported to the Fund, but he hoped that those difficulties could be resolved promptly.

Mr. Zhang and Mr. Erb stated that they too could support the proposed decisions.

The Deputy Treasurer, responding to Mr. Lovato's concerns about the inclusion of Italy, remarked that the staff was well aware that the reflow of capital had been due in part to the most recent EMS realignment. However, the staff had perceived considerable underlying improvement in the reserve and balance of payments position, particularly given the marked decline in the current account deficit. According to the latest World Economic Outlook paper, Italy's current account deficit would fall from $5.5 billion in 1982 to a projected $1.5 billion in 1983.

On another point raised by Mr. Lovato, it was not normally the practice of the staff to provide advance warning to countries of their inclusion in--or exclusion from--the operational budget and designation plan, the Deputy Treasurer continued. Bilateral discussions with individual Executive Directors on such matters were generally considered inappropriate; the preferred approach was for the staff to make recommendations that could then be discussed by the entire Executive Board.

Regarding the request for a review of criteria for the inclusion of countries in the designation plan and operational budget, the Deputy Treasurer recalled that a major review of that matter had been held in 1979 and again in 1981. The staff could of course go over the papers produced for the earlier discussions, but he doubted whether a study would show the need for any substantial change in the staff's application of the criteria.

In response to a point raised by Mr. Laske, the Deputy Treasurer noted that the staff was in close contact with the Bureau of Statistics and the Middle Eastern Department with regard to the reporting of reserves by the United Arab Emirates. The U.A.E. authorities felt strongly that some of the foreign exchange balances held by certain of the individual Emirates were effectively private funds and not to be considered the central reserves of the country to be made available for balance of payments financing. Until the issue was resolved, the staff was reluctant to propose the United Arab Emirates for inclusion in the designation plan and operational budget on the basis of old data or data about which there was some disagreement. It was hoped that the matter would be resolved by the next quarter.

Mr. Finaish confirmed the staff's explanation of the difficulties regarding the definition of what constituted central reserves in the United Arab Emirates. An understanding on the matter was expected to be reached shortly.

The Acting Chairman, returning to Mr. Lovato's request for advance warning by the staff of its intention to include countries in the designation plan and operational budget, said that such an approach could result in bilateral negotiations that would put the staff in a difficult position. The final decision about whether members were to be included in the designation plan and operational budget was up to the Executive Board in its discussion of the staff proposals.

The Executive Board then adopted the following decisions:

Designation Plan

The Executive Board approves the designation plan for the quarterly period beginning June 15, 1983 as set out in EBS/83/111.

Decision No. 7429-(83/85) S, adopted
June 15, 1983

Operational Budget

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/83/112, page 3, footnote 2, and the operational budget for the quarterly period beginning June 15, 1983, as set out in EBS/83/112.

Decision No. 7430-(83/85), adopted
June 15, 1983

2. ISRAEL - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Israel together with a proposed decision concluding the 1983 Article XIV consultation (SM/83/68, 5/4/83; Sup. 1, 5/27/83; and Cor. 1, 6/14/83). They also had before them a report on recent economic developments in Israel (SM/83/73, 5/12/83; and Cor. 1, 6/14/83).

The staff representative from the European Department made the following statement:

Provisional data for the first four months of 1983 show a continued deterioration of Israel's trading position. Information is limited to trade excluding ships and aircraft. Total exports on this basis fell 8.1 percent compared with the corresponding period of 1982 while total imports rose 7 percent over the same period. The trade deficit widened by 43 percent. The authorities continued their attempt to curb inflation by controlling key nominal magnitudes--there was a real appreciation of the shekel against the dollar during the first four months of 1983 of about 8 percent. The consumer price index nevertheless rose 38 percent--or at an annual rate of about 160 percent--compared with 33 percent for the corresponding period of 1982.

Meanwhile the Israeli authorities have introduced a temporary advance import deposit requirement of 15 percent on a wide range of taxable imports. The measure, which came into operation on June 1, 1983, will be effective for a period of six months. The deposit is required for one year and is non-interest-bearing, which implies an effective tax on imports at current Israeli interest rates of 8 percent to 9 percent. The Israeli authorities have stated that the measure is intended to absorb liquidity consistent with their overall monetary policy. The staff has requested clarification of the measures so as to ascertain the applicability of Article VIII.

Mr. Polak made the following statement:

The Israeli authorities want to express their appreciation for the staff's thorough analysis of the current economic situation in Israel. The authorities are in general satisfied with the thrust of the staff paper. A number of points of difference in emphasis are brought out toward the end of my intervention.

This consultation report focuses to an unusual extent on the question of inflation. The report analyzes this question in a number of places: it is given important attention in the staff appraisal; and the report on recent economic developments contains a very careful ten-page appendix on the subject of inflation. This focus is entirely appropriate--inflation is the major problem of the economy of Israel. It contributes to the complexity of two other major problems--the external imbalance and slow growth--and it poses serious constraints on economic policy. Accordingly, debate on economic policy in Israel is to a very large extent centered on the inflation problem.

Israel does not rank among the countries where inflation can be considered endemic and where there may therefore be a tendency to take it for granted. As is evident from Table 9 of SM/83/73, Israel had a moderate inflation record in the 1960s (some 5 percent) and in the early 1970s (10-14 percent in 1970-72). But then inflation took off, with figures in the 20-30 percent range in 1972-74, in the 35-55 percent range in 1974-78, and at more than a 100 percent a year during each of the last four years.

A variety of approaches has been tried in the past with the aim of bringing inflation down. Recently, in an attempt to brake inflationary expectations and to moderate wage pressures, the impact of international price increases on the domestic price level has been mitigated by slowing down the rate of depreciation of the currency below what would be necessary to keep the domestic price level in line with that in competing countries. Such action was taken in spite of the fact that it had an unfavorable impact on the competitiveness of the Israeli economy--a subject on which the staff has brought together a great deal of valuable information in Appendix II of SM/83/73. These measures could be seen as buying some time to deal with the inflation process while accepting some costs in dealing with the balance of payments problem. It is clear, however, that there are severe limitations on this trade-off between the problems of inflation and the balance of payments for any country in which the payments and debt situations are of serious concern. Thus measures in this direction can only be of limited scope and duration. The authorities are adopting a flexible approach on this matter and, as the staff indicates (page 6 of SM/83/68, last full paragraph), they will not hesitate to change course if the expected benefits do not accrue quickly. The recent imposition of temporary advance deposits on the imports of consumer goods obviously favors the balance of payments at the expense of the inflation rate and can be seen as a partial reversal of earlier measures that affected the balance between these two critical variables in the opposite direction.

One severe handicap in the fight against inflation in Israel is that by far the largest component of domestic liquidity can no longer be determined by the authorities but has--as the staff puts it--become endogenous. This has been brought about by the fact that a large proportion of liquid assets is held in accounts that are indexed either to the consumer price index or to the dollar. Thus the automatic monetary brake on inflation that would normally be exercised by a contraction in the real money supply has been virtually eliminated in Israel (admittedly, in many other countries where this braking mechanism is still functioning, it is not allowed to perform its task as reductions in the real money supply continue to be offset by new credit creation).

The Bank of Israel has over the past year made determined and indeed successful efforts to restore some measure of exogeneity to the money supply and to improve the effectiveness of monetary policy. Through various measures to improve the liquidity of unlinked financial assets over that of linked assets, the authorities succeeded in 1982 in reversing the trend of previous years and raised the share of unlinked assets in total liquid assets (M-4) from 20 percent to 24 percent. A continuous effort led to a significant reduction in the ratio of directed credit (subsidized export credit) to total credit and in the interest subsidy element in directed credit. Ceilings on individual banks' lending in Israel shekels were abolished as a main instrument of monetary control in November 1982; they were replaced by a system of liquidity requirements and loans from the central bank that aims at influencing total credit via control of the monetary base. The planned introduction of fixed rate short-term treasury bills will also help the authorities to conduct a more active interest rate policy.

In analyzing the causes of the inflationary process in Israel it is most appropriate to focus attention on the domestic component of the budget deficit. Year-to-year figures of the total deficit can be greatly affected by irregular fluctuations in defense imports, which are in any event largely covered by foreign financing. The net impact of government deficit on credit from the Bank of Israel has in recent years been on the order of 4-6 percent of GNP. But, the process of inflation in Israel has by now developed into one in which the major role is played not so much by the inflationary gap, but rather by the techniques that permit most participants in the economic life of the country to guard themselves against any inroads of their real spending power from the side of inflation. Investment expenditure appears to be the only major component of GNP that is not fully inflation proof, and this of course has serious long-rum implications for the development of the economy, although it is encouraging to note that gross investment increased by 14 percent in real terms in 1982 after its decline in recent years and against the background of stagnation of the business sector in 1982.

The high degree of wage indexation, as well as frequency of wage adjustment, has obviously been an important factor in the persistence of inflation in Israel. The complicated adjustment mechanisms with respect to wage rates have gone beyond the protection of real wages from inflation; they have led to important increases in real wages. The increase in real wages in recent years--itself an important element in the underlying imbalance--is mostly attributable to the fact that wage negotiations that are supposed to take care of the nonindexed part of wage settlements have often proceeded on the basis of excessively high inflationary expectations. It is thus arguable that the less than 100 percent official wage indexation is in fact responsible for an important adverse effect of wages on the economic situation.

In a country where inflation protection is close to universal a small inflationary gap can indeed cause a rapid rate of inflation. The staff therefore stresses the need for a decisive attack on the budget deficit. An important step in this direction was made by a set of successful revenue measures in fiscal 1982/83. But the extremely high tax burden in Israel sets a natural limit to this course of action and the staff rightly emphasizes that expenditure discipline should be the main vehicle in bringing the budget into order--a task that is imperative for any progress in fighting inflation, restoring external balance, and restoring growth. Serious consideration is being given to the measures required to bring the budgetary situation under control, and recent spurts in the inflationary process are providing a strong incentive in this direction.

There is one brief section of the staff's report on which I want to comment in some considerable detail because its implications extend well beyond the Fund's work with Israel. I refer to Table 7 on page 25 (SM/83/68), which contains forward-looking data with respect to Israel's external debt service. Tables on this subject now appear regularly in consultation papers, in accordance with the Board's decision on this subject taken in April. I have followed these exercises with great interest to see how well the staff succeeds in clarifying to members and to the Board the implications of members' policies for their external debt prospects while remaining aware of the highly uncertain nature of any medium-term forecast of debt ratios. As far as I am aware, the consultation paper on Israel is the first one to give two sets of figures for these projections, one by the Israeli authorities and one that is presented as a "possible variant" and that contains strikingly different results, even though the projections are carried out only through 1985. A careful reading of the accompanying text shows that the differences in numbers are attributable to fundamentally differnt approaches underlying the two halves of the table. The figures provided by the Israeli authorities are targets for policy. The variant presented by the staff, on the other hand, represents a "cautious reading of present trends and policies" (page 16, second full paragraph). This latter variant raises no issue of principle if the projections are limited to a period for which policy may reasonably be assumed to be in place, or where results can no longer be substantially affected by adaptations that may still be taken during the period, e.g., for the current year. But, in my opinion, the approach followed by the staff rapidly loses relevance as one moves further out. Government policy is not set for three years ahead, without regard for the feedback provided by information on how it works out on critical variables. This applies above all to policies with respect to the balance of payments for any country where payments problems constitute a major policy constraint. For these reasons it is hard to know what to make of the juxtaposition of two sets of balance of payments and debt figures for a string of years ahead, one set having a normative character (as in the upper half of the table) and the other a predictive character on the assumption of present policy (as in the bottom half). For one thing, the difference between the two approaches is highly sensitive statistically to any deviations in the component variables from their predicted pattern. Any small negative deviation of exports from their projected growth rate can accumulate to very substantial deviations in the figures for the debt outstanding, or the debt service, after a number of years; and the effect is then further compounded in the figure for the debt service ratio, in which exports enter as the denominator. But quite apart from the question of statistical sensitivity, the staff should also be aware of the risk that what are in fact little more than simple exercises in calculation can easily be misread as a prediction of dangerous debt situations lying a number of years ahead. For these reasons I believe the staff, when faced with an essentially normative debt scenario of the authorities, would do best to present its view in terms of the policy changes it would consider necessary for the scenario to materialize.

I would also emphasize that the external debt problem of Israel, which has indeed taken a serious turn over the last two years or so, is basically different from that of most other LDCs. First, most of Israel's external obligations are held by foreign governments and reliable private holders, and about 85 percent of its debt is long and medium term. Second, the foreign liabilities of Israeli banks are more than covered by the foreign assets of these banks and do not, therefore, constitute a net debt service problem.

Extending his remarks, Mr. Polak said that some of the figures provided in the staff's opening statement deserved further explanation. The appearance of a strong deterioration in Israel's trading position in the first four months of 1983 had been due in large part to the particularly poor performance in the one month of April and to the technique of comparing a four-month period in one year to the same period a year earlier. The deterioration in the seasonally adjusted trade balance in the first quarter of 1983, which combined the import and export effects, had not been nearly as striking as the staff's figures seemed to suggest. Similarly, the April figure for the cost of living index tended to distort the overall inflation projections for the year. The increase in the cost of living index for the first quarter of 1983, that is, excluding April, was only 21.6 percent, which was nearly equal to the figure registered in the fourth quarter of 1982 and was notably lower than the two previous quarters of that year.

Mr. Erb indicated his agreement with the staff appraisal and his support for the proposed decision. He considered it unfortunate that more than two years had elapsed since the previous Article IV consultation with Israel, particularly given the serious economic and financial situation and the extent to which it had been deteriorating over the past year.

It was clear that Israel was suffering from high inflation, Mr. Erb continued. It would be necessary, although difficult, to restore price stability if acceptable growth rates over the medium term were to be realized, particularly since investment had been adversely affected. The effort to reduce inflation in Israel by slowing down the rate of depreciation of the exchange rate was not, in his view, a viable long-term policy approach to the problem, as was evident in a number of recent cases in Latin America. A better approach would involve further reductions in the indexation of wages, restoration of a better fiscal balance, and a reduction in money and credit growth. Because of the already high tax burden in Israel, emphasis should be placed on reducing government expenditures, rather than on raising revenues, and on making fundamental changes in monetary policy. The authorities had taken steps to regain control of the monetary aggregates and had in fact reversed the decline in the ratio of unlinked monetary assets to total monetary assets. He urged them to continue their efforts so that monetary policy could be an effective instrument in the pursuit of greater price stability. He also hoped the authorities would rely on a flexible interest rate policy to allocate available credit instead of on some of the more inefficient allocation schemes that had been employed in the past.

On the external side, Israel's exports had lost their competitiveness because the exchange rate instrument was being used to slow down inflation rather than to maintain competitiveness, Mr. Erb noted. As a consequence, the balance of payments had suffered. It was imperative to improve competitiveness, and an accelerated depreciation might well be necessary in conjunction with policies designed to reduce inflation, even if the increased rate of depreciation were to have an initial inflationary impact. The temporary advance import deposit requirement was another indication that the exchange rate needed to be adjusted. While there might have been strong fiscal reasons for adopting the scheme in the first place, the authorities should look toward raising revenues through means that did not discriminate between traded and nontraded goods.

Israel's balance of payments and debt position were worrisome, Mr. Erb considered, and the authorities should act quickly to address both problems as part of a stabilization program designed to restore some semblance of internal and external balance. Finally, unlike Mr. Polak, he had no difficulty with the staff's presentation of alternative debt scenarios, so long as caution was used in interpreting them. He would, however, be interested in hearing staff views about how the Government's policies might need to be changed to ensure that the stated targets were achieved.

Mr. Laske wondered whether the authorities had exercised sufficient determination in the effort to deal with the serious external and domestic imbalances in the Israeli economy. It was worrying that the Government appeared not to have developed a coherent and comprehensive adjustment strategy. While recognizing that political developments had in the past year imposed a heavy burden on the economy and had limited the authorities' room for maneuver, he believed that it was not possible for the authorities to postpone a serious attack on their two most pressing problems--inflation and the high and rising external deficit.

Among the developments with which the authorities should be particularly concerned were the long-run decline in the share of investment in GNP, which had negatively affected the economy's growth potential, and the rise in real wages, which had surpassed the economy's productivity gains and eroded competitiveness, Mr. Laske continued. Inflation was also a cause for serious concern; the pervasive practice of indexation threatened to frustrate all efforts to contain price increases.

The authorities' approach to the problems he had mentioned seemed somewhat inconsistent, Mr. Laske remarked. One of the forces leading to inflation had been excessive monetary expansion and, while the authorities appropriately saw the need to reduce that expansion, they apparently did not wish to accept the effects of a tight monetary stance on output and employment. Another questionable element in the authorities' strategy was the slowdown in the depreciation of the shekel. High rates of inflation, in conjunction with a deteriorating external account, had confronted the authorities with a well-known dilemma: they were apparently prepared to tolerate a further deterioration in the current account while slowing down inflation through the management of exchange rate policy because they believed that competitiveness continued to be adequate. However, Appendix II in SM/83/73, while providing only a rough measurement of the competitiveness of Israel's exports and of the import-substituting sector, suggested that losses in competitiveness had occurred since 1979 and had been particularly marked in the second half of 1982. A continuation of that deterioration would not be compatible with the long-term aim of reducing the trade deficit to a more satisfactory level.

The speed of the depreciation of the currency was related to movements in real wages, which had risen without interruption for a number of years, Mr. Laske noted. Changes had recently been introduced into the wage bargaining process to moderate the effect of indexation on the long-term upward trend in unit labor costs, but those changes did not appear to ensure that the stated objectives would be achieved. There was little doubt that the public sector had played a major role in the intensification of domestic and external imbalances. Partly as a consequence of the indexation mechanism, expenditures--especially wages, transfers, subsidies, and interest payments--had been rising constantly in recent years; as a result, the public sector deficit had increased. Since the tax burden in Israel was already high, the focus should be on cutting expenditures rather than on generating new revenues through higher taxes.

Monetary policy in Israel appeared not to have contributed to the adjustment effort in an effective way, Mr. Laske considered. In fact, monetary policy had been accommodating, mainly because of the indexation of financial aggregates. Some positive steps had been taken to increase the relative share of unlinked deposits; however, the share in M-4 had so far decreased only marginally. The monetary base in unlinked assets was thus still too narrow to provide the authorities with sufficient ammunition for pursuing an effective monetary policy. In the circumstances, he remained doubtful that the authorities would be any more successful than in the past in controlling credit expansion so long as indexation of monetary assets continued.

Mr. Gomel said that he was in general agreement with the staff's analysis and appraisal of the Israeli economy and with the recommended policy shifts. Of particular interest were Appendices I and II in SM/83/73, which discussed changes in economic behavior and institutional arrangements prompted by persistently high inflation in the economy and provided an overview of trends in competitiveness, and Mr. Polak's opening statement, which discussed policy trade-offs between inflation and external balance.

On a technical matter, Mr. Gomel observed that the authorities intended to restore some measure of control over the money supply and had, in that regard, effected a switch in agents' preferences toward unindexed financial assets. Short-term bank deposits of that sort had been introduced in 1982 with some initial success, and it was envisaged that fixed-yield treasury bills would serve the same purpose. He wondered, however, what incentives would be offered to private savers to hold such assets and whether any encouraging signs had been detected in the public's attitude toward the potentially new market.

Another issue concerned the statement often made in economic literature that fully anticipated inflation in a perfectly indexed economy would result mainly in welfare costs associated with the peculiar and costly mechanisms that had to be activated to accommodate a larger set and faster pace of transactions, Mr. Gomel continued. In actual practice, in economies like that of Israel, real variables--such as investment and output growth--seemed to be strongly affected by high inflation. He would welcome comment by the staff on the nexus between high inflation and low capital formation. Finally, he wondered whether there was any constituency in Israel that was seriously interested in a deceleration of inflation. The persistence of indexation and the methods chosen to control it seemed to suggest that there was not.

Mr. Casey remarked that inflation in Israel appeared to be bordering on hyperinflation, and there were several reasons for believing that the line could be crossed. First, there had been little or no focus to economic management in Israel: government spending had risen to 90 percent of GNP because of inexorable and often ad hoc increases in transfers and subsidies, defense spending, and interest rate payments. Moreover, with the high degree of indexation in the system, monetary policy had become almost by definition purely accommodating. He noted, in that context, that more than 80 percent of broad money was in indexed instruments.

Second, Mr. Casey continued, wage-push factors had contributed to inflationary pressures because the resulting wage increases had been automatically validated. Little or no attempt had been made to adjust wages for deteriorating terms of trade, even though the marginal productivity of labor had fallen. Third, productive investment had deteriorated, a development that was both a cause and an effect of accelerating inflation. Fourth, as noted in SM/83/73, "the inflation response to any given stimulus has become larger and more rapid." Fifth, the private savings ratio in Israel had, until recently, been quite high; perhaps individuals had attempted to save more in order to prevent inflation from eroding the real value of their savings. More recently, however, the savings ratio had fallen sharply, which could suggest that people were beginning to feel beaten by inflation. The result could be a growing desire to purchase consumer goods as rapidly as possible before inflation outstripped the indexation mechanism. If that were true, then the current situation could conceivably be characterized as one of hyperinflation. As pointed out by the staff, increasing ex ante demand had to be satisfied by price rises or increased imports or both; he suspected that it was both. The balance of payments in Israel was already under pressure, particularly on current account. Moreover, the debt service ratio was nearing 40 percent, and total external debt was 96 percent of GDP. Noting that the authorities had recently introduced an advance import deposit requirement, he could not rule out a scenario in which the balance of payments might come under such pressure that the currency would need to be substantially devalued from a position of weakness. Then, ongoing devaluations could set up an inflationary spiral that might jeopardize the entire fabric of the economy.

It was of course clear from the staff paper and Mr. Polak's statement that the authorities were beginning to pull back from the precipice and that serious consideration was being given to correcting the budgetary situation, Mr. Casey commented. If appropriate corrections could be made, the effect, inter alia, on inflationary expectations could be positive. Finally, with regard to the forward-looking debt analysis in the staff paper, he tended to agree with the points made by Mr. Polak in his opening statement.

Mr. Schneider said that, since he was in broad agreement with the staff appraisal, he would limit himself to commenting on the appropriateness of a policy by which an economy attempted to adjust to high inflation rates through an indexation system. As he had noted on other occasions, indexation under certain conditions could make an important contribution to the stabilization of prices; the difficulty, however, lay in choosing the optimal degree of indexation. If the choice was inappropriate, the authorities would be forced from time to time to resort to other corrective administrative measures, resulting in an across-the-board indexation of all economic aggregates over time.

In the particular case of Israel, Mr. Schneider continued, it was clear that the rapid increase in inflation, which had resulted in an indexation of almost all economic aggregates--wages, the bulk of financial assets, the exchange rate, and the fiscal aggregates--had altered the structure of the economy, because it had been impossible to insulate a number of areas from hyperinflation. As noted by the staff, real investment in the private sector had been severely affected, reaching a level in 1982 that was lower in real terms than it had been in 1971. It was obvious that, during periods of accelerating inflation rates beyond 100 percent, it was difficult to attract resources for real investment when rates of return were not guaranteed. That tendency was reinforced by declining profitability resulting from real wage increases.

Turning to the so-called inflation tax, as defined in Appendix I of SM/83/73, Mr. Schneider observed that indexation of all financial assets had caused a shift of resources from unindexed to indexed asset holdings. Table 47 of the same paper showed that the proceeds of the inflation tax had begun to decline--from 3.5 percent of GNP in 1979 to 1.4 percent of GNP in 1981--compared with budget deficits of 23 percent and 26 percent registered in 1981 and 1982, respectively. In the circumstances, the authorities had little room for maneuver in the control of monetary aggregates or in the administration of monetary policy because the broad money supply was close to being fully endogenous to the economic system.

Another important aspect of an across-the-board indexation scheme was its impact on exchange rate policy, Mr. Schneider continued. The long-range goal of the exchange rate policy of Israel was to link the depreciation of the currency to the inflation differentials of its major trading partners. The authorities had been pursuing policies aimed at slowing the rate of depreciation in order to reduce inflation; in the event, some loss of competitiveness had been unavoidable and had resulted in a further deterioration in the external accounts. In order to restore the role of the exchange rate as a tool for maintaining competitiveness, further modifications in policy would be needed. It was, of course, difficult to reduce the degree of indexation so long as inflationary expectations remain deeply imbedded. Any relaxation in the degree of indexation would almost certainly evoke protests from those who benefited from it, such as wage earners or interest earners. On the other hand, the cost-price spiral made a deceleration in the rate of inflation unlikely, and the vicious circle would continue unbroken.

The main conclusion to be drawn from the Israeli experience was that indexation had been so general and complete that the authorities had few if any policy instruments left to control economic developments, Mr. Schneider remarked. A partial breakdown of the generalized indexation was thus required before demand policies could be usefully pursued. The gradual imposition of strict demand policies in combination with appropriate adjustment policies and the reorientation of economic policies seemed all the more important in order to reverse the declining trend of real investment in the private sector.

Mr. Wicks said that, like others, he was in broad agreement with the staff appraisal, which set out clearly the two main problems facing the Israeli economy--inflation and the weakness of the traded goods sector. He was concerned that the anti-inflationary strategy of the authorities--which admittedly had not been particularly successful thus far--tended to exacerbate the difficulties experienced in the traded goods sector; indeed, there might even be a conflict in policy objectives in that regard.

In the absence of further progress on the inflation front, the risk of hyperinflation in Israel was a real one, Mr. Wicks continued. It was clear that the authorities were constrained in their fight against inflation by the widespread indexation of wages and financial assets and by the persistence of high inflationary expectations. The pervasive indexation made it particularly difficult to achieve a reduction in real wages. It was the hope of the authorities that the recent revision in the wage indexation mechanism could serve to reduce real wages, but the new system of more frequent adjustments might make matters even worse if the inflation rate continued its current rising trend. In the circumstances, it was difficult to be confident about the success of the counterinflationary program, and further drastic action might well be needed if the cycle of inflationary expectations was to be broken.

With regard to structural problems in the economy, Mr. Wicks agreed with the staff that the growth of real wages without equivalent productivity gains was one of the causes of the weak balance of payments position. Another cause was the large overall budget deficit, which had risen to 26 percent of GNP in the previous financial year. It was interesting to note in that regard that the authorities had recently had recourse to central bank credit, a move that had not been necessary in the past. The authorities had mounted an impressive revenue-raising effort in the previous year to help meet the deficit, but the recent borrowing seemed to illustrate the increasing difficulty of financing such a large deficit and suggested that further inflation was in store for the Israeli economy.

It would not be an easy matter to reduce the budget deficit in Israel, particularly given the wide measure of indexation and the demands of defense expenditures, Mr. Wicks remarked. Moreover, the authorities had narrowed their room for maneuver in correcting economic imbalances by holding to the idea that unemployment should not rise above 5 percent and that inflation should not increase in the short term. He hoped that the authorities would be open-minded about the contribution that higher administered prices--and, consequently, reduced subsidies--could make to containing government expenditure even if they added in the short run to the already high inflationary pressures.

Another factor leading to the real imbalance in the economy was the exchange rate, Mr. Wicks considered. Again, the authorities' current emphasis on reducing inflation tended to work against the effort to reduce the external imbalance. The appreciation of the shekel risked a further erosion of Israel's competitive position and export growth. Part of the 1982 decline in exports reflected the sluggishness of world demand; however, if the balance of payments situation continued to worsen, the authorities might wish to reconsider current exchange rate policy. In that regard, he understood that they had indicated a willingness to change course if current policy did not lead to a rapid reduction in inflation.

One aspect of the Israeli economy not highlighted in the staff appraisal was the evolution of external debt, Mr. Wicks noted. The matter had been well analyzed in the background paper and, in that regard, Table 43 of SM/83/73 was particularly helpful and might usefully serve as a model for inclusion in future staff reports. The growth in short-term borrowing by the banking system should be monitored carefully, particularly in view of its impact on debt service, which had already reached 30 percent of exports. If the trade balance were to worsen over the next two years--and there was some likelihood that it would--then continued recourse to borrowing could have a serious impact on the debt service burden and the current account deficit. In conclusion, he was happy to note that the import deposit scheme in Israel would be only temporary and that it was intended to hold future Article IV consultations with Israel on a normal 12-month cycle.

Mr. Morrell stated that he too could support the staff appraisal and proposed decision. There were clearly a number of major economic imbalances in the Israeli economy, most notably the high and rising rate of inflation to which the pervasive policy of indexation had greatly contributed; the efforts of the authorities to break the index link should therefore be continued. He agreed with Mr. Erb and others that the use of the exchange rate instrument was not an appropriate means of reducing the rate of internal inflation.

With regard to the evolving external debt situation, Mr. Morrell noted the indication in Tables 6 and 7 of the staff report that Israel had a high and rising level of debt servicing, regardless of which set of figures was chosen. The country was an unusual one, with government expenditure accounting for about 90 percent of GNP, a very high cost of maintenance of external security, and a very low rate of investment. If Israel was to avoid falling into a situation in which it was unable to service its external debt, it would be important to ensure a higher level of investment in industries that would generate foreign exchange earnings in future.

A number of pertinent comments had been put forward by Mr. Polak on the staff's presentation of the medium-term debt scenario in Table 7 of the staff paper, Mr. Morrell recalled. It had been recognized in a previous Board discussion that the medium-term debt scenarios for countries could produce some sensitivity; nevertheless, it had been acknowledged that such scenarios should be a part of Article IV consultation reports. In his view, it had been appropriate for the staff to present its forecasts in the Israeli case based on the assumption of no change in policy. It was perfectly acceptable to include alternative scenarios based on the views of the authorities, but it was not up to the staff to forecast what policy changes would take place in future. The differences between the alternative forecasts related not only to what policy actions the authorities might need to take, but also to different perceptions of the world economy and other factors affecting Israel's performance.

It would not be appropriate for the staff to attempt to spell out the measures that would be necessary to attain the authorities' stated goals, an effort that would be far too speculative and might be controversial, Mr. Morrell commented. It might be better if the staff simply provided a clearer description of its projections, perhaps including some brief description of the foundation upon which the alternative approaches had been based. The staff had made reference to those distinctions in the text, but the references were somewhat far removed from the tables themselves. Finally, the primary benefit to be derived from the debt scenario exercise was that it forced both the authorities and the staff to consider the medium-term implications of the debt position. In that respect, the advantage of doing the exercise outweighed the disadvantage of a possible disagreement between the staff and the authorities on the implications of the debt position.

The staff representative from the European Department remarked that the relatively small Israeli economy was faced with heavy demands on its resources; in the circumstances, policymaking was a difficult task, and the authorities would doubtless agree that it was not an easy proposition to develop a coherent or effective set of policies in a situation characterized by a succession of emergencies. In reviewing economic policy in Israel, the staff was sensitive to those difficulties and hoped that its objective criticism of the economy would be understood in that light.

Turning to specific questions, the staff representative recalled a query by Mr. Gomel on the incentives to hold unlinked assets in Israel. What incentives existed were mainly the interest rate return on those assets and tax deductibility on the credit side. Apart from improving the yield on unlinked assets, the authorities had taken various measures to reduce the liquidity of linked assets and to increase the cost of transfers.

Another question concerned how fully anticipated inflation--because of full indexation--could continue to affect the real variables in the economy, the staff representative continued. One answer was that inflation in Israel was not fully anticipated; indeed, the data showed that there were quite different inflation rates for various categories of spending. The degree of difference between, say, the price of final output and the price of labor tended to vary widely in actual experience. Hence, conclusions based on the notion that a single inflation rate applied to all expenditure categories and income categories to the same extent was a theoretical abstraction. A second answer to the question would be to suggest that, indifference to even a fully anticipated inflation depended on the assumption that the real quantities in the economy were in fact in balance. If one began with an economy in which there were serious real imbalances, then a perfect indexation of all prices would serve only to perpetuate those imbalances and to provide less scope for policy action to correct them. He hoped that the two answers he had provided would give some explanation of why, in practice, high inflation and the high degree of indexation in Israel did have some negative effects on real variables in the economy.

Regarding Mr. Gomel's inquiry about the existence or nonexistence of a constituency against inflation in Israel, the staff representative remarked that the strong switch from unindexed to indexed assets suggested that Israelis were at least aware of the inflation problem and were making an effort to soften its effects. The authorities, for their part, were adopting anti-inflationary policies that they hoped would appeal to the general population.

It had been suggested by Mr. Erb that it might be useful for the staff to provide some indication of the policy changes that would be necessary to achieve the authorities' objectives, the staff representative recalled. Such a specific approach would be difficult for the staff to take; when an actual program was not being negotiated, there were, a priori, more ways than one of reaching a target. Broadly speaking, the staff had in its appraisal provided the information sought by Mr. Erb by stating that the authorities should vigorously tackle the underlying imbalances in the economy. At present, the authorities believed that their approach would lead to reduced inflation and justify the temporary costs in balance of payments terms. It was to be hoped that that approach would be successful, although the authorities had indicated a willingness to change their tactics if it was not.

Mr. Polak observed that the fact that incomes and most categories of expenditure in Israel had been indexed had not led to any feeling of complacency about inflation. Israel had not been experiencing inflation at its current high level for very long, and most people--particularly those in government--were well aware that it was producing serious distortions. Unfortunately, the effort to control inflation in recent years had been plagued by the effect of inflationary expectations. The strategy thus far had been periodically to reduce taxes and to increase subsidies--which were later removed--and to operate through the exchange rate to affect the rate of price increase in the country; unfortunately, the experiment had not been particularly effective.

A number of Directors had suggested that the current situation in Israel might be described as hyperinflation, Mr. Polak recalled. His own view was that hyperinflation had not occurred, even though inflation had been running at a very high rate. It was something of a surprise to economists to note that inflation could be running at a rate of 100-150 percent for some time without taking off, as might be expected, to a much higher rate, as had occurred in countries like, say, Germany in 1922 and Greece in 1946. One of the reasons why the inflation rate in Israel had not taken off very rapidly was that the wage adjustment process had not speeded up to match the situation in which prices increased by 25 percent or more in a given quarter. Thus far, in contrast to Mr. Wicks's understanding of recent changes, it had been possible for the authorities to continue with a quarterly wage adjustment. In addition, some improvements had been made in the wage adjustment process. In the past, 80 percent of total adjustment had been guaranteed by law, while the remaining 20 percent had been based on a master contract between the centralized trade union and business. That remaining 20 percent was no longer fully guaranteed, and there seemed to be a general move toward weakening the automaticity of the adjustment mechanism. Still, he agreed with the staff that a further effort must be made to tackle the underlying problems. In that regard, Mr. Erb was probably correct in noting that the cost involved in more rapid depreciation--a cost that had been avoided in recent months--would have to be absorbed before ultimate stabilization could be achieved.

Finally, as an addendum to his earlier comments regarding distortions in the consumer price index in Israel for the first four months of the year, Mr. Polak noted that the figures for May showed an increase of only 5.5 percent, which was in sharp contrast to the 13.3 percent increase registered for the month of April.

The Acting Chairman made the following summing up:

Executive Directors focused their remarks on the considerable economic problems currently facing Israel, particularly the large balance of payments deficit and the high rate of inflation, which borders on hyperinflation. They were seriously concerned that these problems were becoming more pressing, and the consensus was that a comprehensive and coherent strategy to eliminate external and internal imbalances should be devised and implemented without further delay.

Directors agreed that inflation had imposed severe costs on the economy. In particular, they noted the disruptive effects on investment and emphasized the need for an increase in investment to secure future growth. While indexation was thought to have made it easier for the economy to function in the short term in an environment of high inflation, it was widely recognized that indexation had also helped to perpetuate the inflationary process. Directors felt, moreover, that the current government policy aimed at reducing the self-perpetuating element in the inflationary process by decelerating the growth of key nominal magnitudes could have little lasting effect without a determined and persistent attack on the underlying imbalance between demand and supply in the economy.

A point particularly emphasized in the discussion was the need to bring about a reduction in the very large fiscal deficit. The steps taken in 1982, in difficult circumstances, to contain the level of this deficit were welcomed, but it was noted that they had been far more effective in increasing revenue than in reducing public expenditure, and serious doubt was expressed about whether the process was sustainable. Directors expressed concern about the size of the projected deficit for fiscal year 1983/84 and stressed the need for future cuts in government expenditure.

Directors welcomed the measures taken by the authorities toward monetary reform, especially the abolition of shekel credit ceilings and the reduction of preferential credits. However, in view of the large budgetary imbalance and the still widespread indexation of financial assets and liabilities, they stressed that more fundamental steps would be required to enable monetary policy to contribute effectively to the control of inflation.

Concern was also expressed about the stance of exchange rate policy in Israel. Several Directors referred to the recent sharp real appreciation of the shekel, which had resulted in part from government policies to contain inflation. They mentioned that the sharp deterioration in the balance of payments and the unprecedented fall in exports in 1982 was partly due to the loss of competitiveness and partly to the world recession; and they stressed that the loss of competitiveness should be reversed. Directors stressed that the recently announced import deposit scheme was not a satisfactory substitute for needed exchange rate changes. They also expressed serious concern about Israel's current and prospective external debt burden.

Several speakers emphasized the close link between exchange rate policy and the level of real wages. While noting that it was difficult to conduct an effective incomes policy in Israel, they stressed the importance of re-establishing an appropriate wage level. The new wage contracts for 1983/84 were a first step in the right direction, speakers said, but it was important to reverse the excessive real wage rises of 1981.

Finally, Directors regretted the gap of more than two years since the previous Article IV consultation, especially in view of Israel's persistent economic problems and the recent signs of a worsening of those problems. The shortening of the gap that is now envisaged to the standard 12-month cycle was welcomed.

The Executive Board then turned to the proposed decision concluding the 1983 Article XIV consultation with Israel.

Mr. Casey wondered how, once all the data on the advance import deposit scheme became available, it was intended to proceed if the scheme required Fund approval.

The Deputy Director of the Exchange and Trade Relations Department observed that, if it was determined that the scheme was subject to Article VIII, a brief paper and a recommended decision would be circulated to the Executive Board.

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

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.

Decision No. 7431-(83/85), adopted
June 15, 1983

3. REPORT BY MANAGING DIRECTOR

The Managing Director, assuming the Chair, reported briefly on his recent trip to several European countries. On June 6, during a working luncheon with the Minister of Finance of Germany, he had held discussions on the Fund's liquidity position and on the role that the Fund might play in future in international financing. He had discussed similar matters with Mr. Poehl, Chairman of the Deutsche Bundesbank on June 7 and had covered in detail some of the policy implications of the Fund's liquidity position.

On June 8 and 9, the Chairman continued, he had participated in UNCTAD discussions in Belgrade, where he had noted the realistic approach of participants to current problems. While in Belgrade, he had also met with the Yugoslav authorities regarding the continuation of the Fund's program with Yugoslavia.

On June 11 and 12, he had visited Paris and met with Mr. Delors and Mr. Camdessus, again holding thorough discussions on the Fund's liquidity position and the institution's role in international financing, the Chairman said. On his return to the United States, he had met on June 13 in New York with the President of Ivory Coast regarding the policy recommendations that the Fund had been providing to that country.

The Executive Board took note of the report by the Managing Director and adjourned at 11:40 a.m.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/84 (6/13/83) and EBM/83/85 (6/15/83).

4. MANAGING DIRECTOR - SALARY - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/83/130, Supplement 2, 6/14/83) on the canvass of votes of the Governors on Resolution No. 38-2, with respect to the salary of the Managing Director, approved by the Executive Board (EBM/83/68, 5/12/83) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes		619,549
Total negative votes		12,100
Total votes cast		631,649
Abstentions recorded	0	
Other replies	0	
Total replies		631,649
Votes of members that did not reply		15,449
Total votes of members		647,098

Decision No. 7432-(83/85), adopted
June 14, 1983

5. NIGER - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

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 postpone its consideration of the 1983 Article IV consultation with Niger until not later than July 1, 1983. (EBD/83/168, 6/10/83).

Decision No. 7433-(83/85), adopted
June 14, 1983

6. EXTERNAL ASSIGNMENTS PROGRAM

1. The limit of the salary advances available to participants in the External Assignments Program is increased from six months' to twelve months' net salary. These salary advances shall be granted at the rate of one month's net salary for every two months of leave.

2. The shipping entitlements under the same Program for the staff member, but not his dependents, are increased as follows:

(a) Surface shipment of personal effects from 1,000 lbs. to 1,500 lbs.

(b) Air shipment of personal effects from 200 lbs. to 300 lbs.

3. The Committee on Administrative Policies will review the benefits available under the External Assignments Program in approximately six months from the date of the adoption of this decision.

Adopted June 14, 1983

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 83/3 through 83/6 are approved. (EBD/83/166, 6/8/83).

Adopted June 14, 1983

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/83/155 (6/10/83) is approved.

APPROVED: October 28, 1983

LEO VAN HOUTVEN
Secretary