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SM/85/118  
Correction 1

CONTAINS CONFIDENTIAL  
INFORMATION

May 21, 1985

To: Members of the Executive Board  
From: The Acting Secretary  
Subject: Israel - Staff Report for the 1985 Article IV Consultation

The following corrections have been made in SM/85/118 (4/26/85):

Page 1: reissued to correct typographical errors

Page 25, Table 5, last column, line 13: for "-21.9" read "-21.4"

Page 33, under "Real percentage change; end of period,"

column 2, line 1: for "-5.6" read "-3.3"

column 1, line 3: for "-7.4" read "-2.9"

under "Annual percentage change," column 5, line 4: for "13.3"  
read "15.7"

line 5: for "-4.3"  
read "-2.4"

Corrected pages are attached.

Att: (3)

Other Distribution:  
Department Heads

CONTAINS CONFIDENTIAL  
INFORMATION

INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the  
1985 Consultation with Israel

Approved by L.A. Whittome and J.T. Boorman

April 24, 1985

I. Introduction

A staff team consisting of Messrs. de Fontenay (EUR), Kreis (FAD), Hicks (EUR), Boote (EUR), and Mayer (EP-EUR), with Ms. Montgomery (EUR) as secretary, held Article IV consultation discussions in Jerusalem and Tel Aviv during March 3-18, 1985. The Israeli representatives included officials of the Bank of Israel and the Ministries of Finance, Commerce and Industry, Economy and Defense. The mission had discussions with the Prime Minister, Mr. Peres, the Minister of Finance, Mr. Moday, the Minister of Economy, Mr. Ya'akobi, the Minister of Commerce and Industry, Mr. Sharon, and the Governor of the Bank of Israel, Mr. Mandelbaum. Meetings were also held with the heads of the Manufacturers' Association, the Bankers' Association, and the Histadrut Labor Federation. Mr. Polak, Executive Director for Israel, and Mr. Steinberg, Advisor to the Executive Director, attended some of the meetings.

Israel continues to avail itself of the transitional arrangements under Article XIV.

II. Background

The expansionary fiscal policy pursued since 1981, which contributed to a rapid growth of domestic demand, the policy of slowing down the depreciation of the shekel against the U.S. dollar, and the fall in foreign demand all combined to produce a marked worsening of the balance of payments for the third consecutive year in 1983. During the three years 1981-83, Israel's net external debt 1/ increased by 54 percent in U.S. dollar terms.

The growth of private consumption averaged 8 1/2 percent per annum in 1981-83 and that of public consumption, boosted since mid-1982 by the

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1/ Defined as gross external liabilities minus foreign assets of commercial banks, Bank of Israel's reserves, holdings of other monetary institutions and export credits.

cost of military operations in Lebanon, was also rapid over this period. A sizable increase in the tax burden, however, contained the overall budget deficit (after grants) to around 15 percent of GNP. Growth of output remained well below its rate of the early 1970s, while inflation averaged 120 percent in 1980-82 and remained at that (annual) rate in the first three quarters of 1983.

In October 1983, the deterioration in the external position led to a change of policy. The shekel was devalued by 19 percent against the U.S. dollar, price subsidies were cut back, and reductions in other expenditures were announced. At the same time, the policy of allowing the real exchange rate to appreciate to reduce inflation was abandoned. The immediate result was a sharp run-up in the rate of inflation to more than 190 percent by year-end.

At the conclusion of the 1984 Article IV consultation with Israel (EBM/84/85, 6/1/84), the Chairman's summing up noted that Executive Directors had focused on the considerable and persistent economic imbalances facing the authorities and the fact that these had become more pressing in 1983. The need to implement a comprehensive package of policies to correct those problems was thus seen as having become urgent.

Directors viewed as of fundamental importance the attainment in 1984 of the authorities' target of an improvement in the external balance on goods and services account and expressed considerable concern about recent and prospective developments in prices. A reduction in the budget deficit in FY 1984/85 was seen as a prerequisite, both for achieving a meaningful improvement in the external position and for halting the acceleration of inflation.

### III. Recent Economic Developments 1/

Israel's economic difficulties came to a head in 1984 although some of the underlying trends were improving. The shift in policy in the last quarter of 1983 which succeeded in reversing the rising trend of domestic demand was pursued for most of 1984 and resulted in an improved current account position of the balance of payments. Nevertheless, prices soared at an annual rate in excess of 1,000 percent in September-October before a wage-price freeze went into effect, while unrecorded capital outflows were largely responsible for a deterioration of the overall balance of payments and substantial losses in reserves.

Both private and public consumption (excluding direct defense imports) fell in real terms in 1984 (Table 1). Private consumption was affected by the 1983 stock market collapse, which resulted in a 30 percent real

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1/ High and variable rates of inflation mean that calculations in real terms and comparisons to GNP need to be viewed with extreme caution. The same caveat applies to figures in U.S. dollars, which are also affected by large variations in the rate of depreciation of the shekel.

Table 5 . Israel: Developments of Summary Budget Transactions, 1980/81-1985/86

(In percent of GNP)

	1980/81	1981/82	1982/83	1983/84	Estimate 1984/85	Budget 1985/86
Total revenue	44.3	44.6	51.2	50.0	44.7	47.9
Tax revenue	35.7	36.7	40.5	39.3	37.2	39.6
Nontax revenue <u>1/</u>	8.6	7.9	10.7	10.7	7.5	8.3
Total expenditure and net lending	64.8	70.5	71.1	72.8	78.9	69.3
Transfers and subsidies	18.4	21.9	19.8	19.0	20.4	17.5
Interest payments <u>2/</u>	5.9	9.5	11.8	12.2	14.0	15.0
Defense	24.1	22.4	21.3	22.0	25.8	18.9
Domestic expenditure	(12.8)	(13.2)	(14.9)	(12.3)	(12.0)	(10.5)
Purchases abroad	(11.3)	(9.2)	(6.4)	(9.7)	(13.8)	(8.4)
Other current expenditure	8.0	8.2	9.7	9.5	8.7	8.3
Capital expenditure <u>3/</u>	8.4	8.5	8.5	10.1	6.5	6.6
Unallocated	--	--	--	--	3.5	2.9
Budget balance	-20.5	-25.9	-19.9	-22.8	-34.2	-21.4
Foreign grants	8.9	7.5	5.2	7.2	14.6	12.3
Financing requirement	-11.6	-18.4	-14.7	-15.6	-19.6	-9.1
Financing						
Foreign borrowing (net)	4.9	5.3	5.3	5.8	2.9	-1.6
Domestic bond issues						
(net) <u>4/</u>	8.3	9.3	3.9	2.4	5.3	2.0
Net credit from Bank of Israel	-1.6	3.8	5.5	7.4	11.4	8.7

Sources: Ministry of Finance; and Fund staff estimates from information provided by the Israeli authorities.

1/ Excludes Bank of Israel profits and sales of bonds to the National Insurance Institute.

2/ Excludes computed interest payments to the Bank of Israel.

3/ Includes support purchases of bank shares in 1983/84.

4/ Includes sales of bonds to the National Insurance Institute.

Table 6. Israel: Selected Monetary and Credit Developments

(End period; except where stated)

	1980	1981	1982	1983	1984
(Nominal percentage change over previous year)					
Monetary base					
M4 base	147	94	120	256	421
Due to (in percentage points)					
Automatic indexation related increments	122	91	114	204	380
Discretionary factors					
Public sector injection	33	32	36	82	107
Directed Bank of Israel credit	20	-20	-19	13	9
Loan to banks	--	-1	2	15	-9
Other	3	8	2	-1	-5
Less net foreign currency purchases by private sector	-31	-17	-16	-57	-79
M4	148	95	132	215	435
(Real percentage change from previous year) 1/					
M4 base	6	-4	-5	22	-4
Monetary aggregates					
M4	6	-3	--	8	-2
Money supply (M1)	-14	-12	-9	-20	-17
Time deposits and CD's	19	60	68	-11	2
Patam deposits	5	1	-4	44	12
Tradable government bonds	14	-12	-7	-17	-25
M4 plus bank shares (M5)	17	13	15	-19	13
Liquid and medium-term financial assets	17	15	37	-30	13
Total financial assets 2/	14	16	30	-20	11 3/
Credit aggregates					
Bank credit to the private sector	-3	-8	1	-18	10
Directed credit 4/	4	-12	-18	-6	13
Nondirected credit	-7	-5	13	-23	9
Medium- and long-term credit	-12	13	22	23	16 3/
Total credit	-7	1	11	4	14 3/
(As a percentage of GNP, 5/ year average)					
Total financial assets	149	154	195	192	198 3/
Government liabilities in total financial assets	121	118	128	157 6/	179 3/6/

Sources: Information provided by Bank of Israel; and staff calculations.

- 1/ Nominal rate deflated by consumer price index.  
 2/ Includes social insurance and life insurance funds.  
 3/ Provisional estimates.  
 4/ Credit granted on preferential terms, virtually all for exports.  
 5/ GNP comparisons are heavily distorted by the rate of inflation and can only be taken as broad order of magnitude showing the direction of trend. Calculations based on dollar conversions would show significantly lower percentages.  
 6/ Includes bank shares under the October 1983 arrangement as a contingent government liability; if these shares are excluded, the percentages are 147 for 1983 and 164 for 1984.

Israel--Basic Data

Population (end-year estimate 1984): 4.2 million  
GNP in 1984 (market prices): IS 6,486 billion  
(US\$22.344 billion)  
GNP per capita in 1984: US\$5,320

Origin of GDP in 1984 (at factor cost) (In percent of GNP)  
Agriculture, forestry and fishing 11  
Industry, mining and quarrying 28  
Construction 12  
Transportation and communications 13  
Finance, trade, and services 36  
GDP of the business sector 100

	1980	1981	1982	1983	1984 1/	Official forecasts 1985
(Annual percentage change)						
National accounts (at constant prices)						
GDP	3.1	2.8	1.0	1.8	1.6	0.8
Gross domestic expenditure 2/	-4.5	4.7	8.1	6.7	-5.9	-2.6
Private consumption	-2.9	10.9	7.2	7.0	-5.6	-0.5
Government consumption 2/	3.5	0.8	4.8	4.8	-3.9	-1.4
Gross domestic investment	-15.2	-7.1	14.6	8.0	-9.2	-10.6
Prices, wages and employment						
Consumer prices (end-year)	133.0	101.5	131.5	190.7	444.9	...
Wholesale prices (yearly average)	135.1	122.7	125.8	144.5	396.5	...
Real wages per employee post 3/	-3.2	10.4	-0.3	6.1	-1.9	-2.0
Unemployment rate (in percent)	4.8	5.1	5.0	4.5	5.9	7.4
(In percent of GNP)						
Budget aggregates (fiscal years)						
Expenditures	64.8	70.5	71.1	72.8	78.9	69.3
Of which:						
Defense	24.2	22.4	21.3	22.0	25.8	18.9
Interest payments	5.9	9.5	11.8	12.2	14.0	15.0
Revenues	44.3	44.6	51.2	50.0	44.7	47.9
Foreign grants	8.9	7.5	5.2	7.2	14.6	12.3
Deficit	11.6	18.4	14.7	15.6	19.6	9.1
(Real percentage change; 3/ end of period)						
Monetary developments						
Liquid financial assets (M4)	6.4	-3.3	0.1	8.4	-1.8	...
Total financial assets of public	16.5	15.4	37.3	-30.1	12.7	...
Bank credit to private sector	-2.9	-8.2	0.5	-17.6	10.2	...
(Annual percentage change)						
External sector						
Exports, f.o.b. (in U.S. dollars)	21.9	1.9	-5.9	-0.9	11.2	6.7
Imports, f.o.b. (in U.S. dollars)	13.4	4.8	-5.9	-1.0	0.2	5.2
Of which:						
Nondefense	8.2	-1.0	1.2	5.8	-5.7	-2.5
Export volume	9.8	5.1	-0.9	-1.9	15.7	7.7
Import volume 2/	-11.5	2.8	10.9	6.1	-2.4	-1.5
Terms of trade 2/	-7.2	-1.1	3.3	1.1	-1.2	...
Nominal effective exchange rate 4/	-51.3	-47.0	-47.0	-61.4	-81.6	...
Real effective exchange rate 4/	2.7	-1.8	12.6	-2.3	-3.3	...
(In percent of GNP) 5/						
Current account deficit	4.1	6.8	10.1	9.1	7.6	1.1
Debt outstanding 6/	111.8	116.8	128.9	120.1	132.0	...
Gross official reserves, end-year (in months of total imports)	3.0	2.9	3.1	2.9	2.4	...
Gross debt service (as a percentage of exports of goods and services)	31.5	37.6	43.8	40.3	40.8	...

1/ Provisional estimates.

2/ Excluding direct defense imports.

3/ Deflated by consumer price index.

4/ Based on the standard index (using consumer prices) developed in connection with the Information Notice System; fourth quarter over fourth quarter.

5/ GNP figures in U.S. dollars reflect the overvaluation of the shekel in recent years, particularly in 1982 and 1983; the percentages therefore arguably understate somewhat the underlying position.

6/ Gross external liabilities.