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SM/83/68
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

June 14, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Israel - Staff Report for the 1983 Article IV Consultation

The following corrections have been made in SM/83/68 (5/4/83):

Page 3, line 6: for "32 per cent" read "29 per cent"

Page 14, 1st full para., lines 3 and 4: for "26 per cent" and "32 per cent" read "24 per cent" and "29 per cent"

Page 16, 1st full para., penultimate line: for "32 per cent" read "29 per cent"

last line: for "25 per cent, an average" read "22 per cent, below the average"

2nd full para., last line: for "40 per cent" read "37 per cent"

Page 24, Table 6: for "Debt service...and services 3/" read "Debt service...and services 4/"

corresponding figures, columns 1-5: for "26.0, 25.9, 25.0, 31.8, 32.0" read "23.8, 23.9, 23.5, 29.3, 29.0"

Page 24, Table 6: for "Debt service...current receipts 4/" read "Debt service...current receipts 5/"

corresponding figures, columns 1-5: for "18.9, 19.5, 19.1, 23.7, 24.0" read "17.7, 18.3, 18.2, 22.3, 22.0"

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Page 24, Table 6, footnote 4: for "Exports of goods...official transfers."
read "Excluding banks'...investment income."

footnote 5: reads "Exports of goods...official transfers."

Page 25, Table 7, columns 1-4, line 3: for "31.8, 32.0, 28.0, 25.0"
read "29.3, 29.0, 26.0, 22.0"

line 4: for "23.7, 24.0, 22.0, 20.0"
read "22.3, 22.0, 21.0, 18.0"

line 7: for "31.8, 36.0, 38.0, 40.0"
read "29.3, 33.0, 36.0, 37.0"

line 8: for "23.7, 27.2, 29.0, 31.0"
read "22.3, 25.0, 27.0, 29.0"

footnote 1: for "Excluding investment income"
read "Excluding banks' investment income"

footnote 2, line 1: for "(excluding investment income)"
read "(excluding banks' investment income)"

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

SM/83/68
Corrected: 6/13/83

investment. 1/ The long-run decline in the share of investment in GNP has already eroded the economy's growth potential. But with investment continuing to exceed domestic savings, the external deficit has remained high, and has recently widened. Accordingly, the gross claims of debt service on the country's exports of goods and services rose to an estimated 29 per cent in 1982.

1. The acceleration in inflation

Inflation accelerated very markedly in the past decade, particularly after the initiation of more expansionary policies in late 1977. The inflation rate jumped to 50 per cent in 1978 as the expansion in demand ran up against capacity and manpower constraints much sooner than expected. At the same time, there was the tendency for the inflation rate to become more rapid the longer it persisted. This was so because, as inflation persisted, both the degree of indexation and the frequency of adjustment increased. This was particularly evident for wages and financial assets. First, the reluctance of wage earners to accept declines in their real incomes led to a greater degree of indexation and more frequent adjustments in nominal wages. In fact, the overall wage agreements negotiated resulted in increases in real wages. Second, expectations of continuing or accelerating inflation stimulated shifts toward assets protected from inflation. Both these responses magnified the effects of the underlying demand imbalances and resulted in progressively higher rates of price increase.

Inflation jumped to the triple-digit range in 1980, reflecting a lagged response to the second round of oil price increases, the sharp expansion in demand during 1977-79, and continued large increases in real wages. As long as the exchange rate moved to offset the inflation differentials between Israel and the rest of the world, the excess demand was reflected in domestic price increases. After mid-1981, when this was less and less the case, a larger proportion of the excess demand was shifted abroad. Inflation moderated slightly, while balance of payments pressures increased. Quarterly developments in the inflation rate indicate a deceleration which lasted until mid-1982 after which the rate of price increases accelerated again to about the record levels achieved in 1980/81.

The real demand pressures that have been at the basis of the inflationary process have been broadly accommodated by the growth in the monetary magnitudes. The progressively larger budget deficits in recent years have required increasing recourse to net money creation. And the widespread indexation of financial assets, including foreign exchange-indexed assets, has meant that monetary growth has been largely beyond the direct influence of policy. As inflation accelerated so did the shifts out of nonlinked shekel financial assets, and by end-1981 these comprised only about 20 per cent of a broader monetary aggregate (M4).

1/ An analysis of the impact on the economy of high and accelerating inflation is contained in the recent economic developments paper.

2. Wage developments

An important element in the underlying imbalance has been the behavior of real wages. Indicators of the growth in real wages show that, over the past decade, real wages per employee have risen far in excess of productivity (Chart 1). Between 1974 and 1982, real wage costs per employee increased by 15 per cent, compared with a decline of 4 per cent in real net national product per employee, adjusted for the decline in the terms of trade.

Until 1980, the indexation adjustment affecting cost of living allowances took place twice yearly; subsequently it has been on a quarterly basis. Until October 1979, the degree of indexation was 70 per cent. This was replaced by a formula which varied the degree of adjustment between 80 per cent and 90 per cent depending on the quarterly inflation rate. The fact that wages were not fully indexed might have reduced real wages; however, this has not been the case as other aspects of the wage negotiations have often proceeded on the basis of excessively high estimates of the rate of prospective inflation. In addition to the indexed allowances, there have been at least two other types of agreements. At the national level, the agreement between the Employers' Federation and the Histadrut has generally focussed on the real wage. Except for 1980, when the acceleration in inflation to the triple-digit range was not anticipated fully, this process has generally assured increases in real wages. At the sectoral, industrial, or plant level there have been the diverse wage agreements which have led to considerable differences in relative wages.

Trends in unit labor costs have been broadly similar to those in real wages. Over the period 1974-82, real unit labor costs rose by 21 per cent, with a rapid increase in the second half of the 1970s being only partially offset by declines in 1980 and 1981. These trends in unit labor costs have added to pressure on profit margins, reduced the rates of return on capital, and affected the demand for labor.

Low and stagnant labor productivity remains an important obstacle to reversing the upward trend in unit labor costs. Only agriculture has continued to experience strong gains in productivity. Business sector labor productivity has grown only very little since the mid-1970s. The gains totaling about 3.5 per cent that did result in 1981 and 1982 reflected a "shake-out" of labor, and have neither restored the balance necessary nor altered the underlying factors that resulted in the relative stagnation during much of the 1970s.

3. Balance of payments and competitiveness

Two factors explain the recent deterioration of the balance of payments: depressed external markets and a loss in competitiveness. Indicators of competitiveness show that Israel's competitiveness began to of exports to European markets, and some shift had taken place between Europe and the United States as the destination for exports. The transition had involved costs and in the process exports had suffered in 1982.

To alleviate some of the uncertainties on exporters a new insurance scheme against exchange risks had been established for exporters effective July 1, 1981. The scheme resulted in a loss of US$60 million in 1981 and US$200 million in 1982. While it was not intended to constitute a subsidy for exporters, the scheme has offset some of the erosion in competitiveness that resulted from the gradual reduction in subsidized directed credits for exports. The losses incurred by the insurance scheme were indicative of the appreciation of the real exchange rate that had been experienced, particularly in 1982.

The authorities stressed the difficulty of restoring competitiveness through changes in the nominal exchange rate as long as the consequent effects on the inflation rate remained unacceptable. The actual deterioration had, in any case, been limited, and was certainly much less than implied by the calculations based on differential movements in unit labor costs. It had not offset the competitive gains experienced by Israeli exporters during much of the 1970s. The authorities also pointed out that large changes in the structure of Israel's exports had been achieved in recent years with greater specialization in products of sophisticated technology. This made it difficult to compare changes in competitiveness over time. Nevertheless, the authorities recognized that future developments in exports needed particular attention, and that flexibility would be exercised in implementing the current policy if the recent developments in export performance were to continue into 1983.

b. External debt

Israel's external debt increased sharply in 1982 from 88 per cent to about 96 per cent of GNP, reflecting the increased current account deficit. While official concessional borrowing rose sharply, there was also greater reliance on private borrowing through banks. This followed a period of two years when the debt/GNP ratio stabilized at levels below those reached in the late 1970s. Israel's external debt has traditionally been large by international standards, reflecting the dominance of government debt, much of it in the form of direct loans from foreign governments and publicly placed bonds on concessional rates of interest. At end-1982, about two thirds of total external debt was the liability of the Government, with 91 per cent of this debt on a long-term basis and the remainder in the form of medium-term loans. The debt service problem reflects mainly private sector borrowing from abroad, the share of which in the total rose to 29 per cent at end-1982 compared with an average of about 23 per cent in the preceding three years.

The relatively greater reliance on private borrowing in 1982 reflected almost entirely debt incurred by the banking system. Such borrowing rose by US$1.5 billion in 1982, of which about half was short term of less than one year's maturity. At end-1982, the short-term component of Israeli total external debt constituted about 16 per cent, compared with an average of 11 per cent in 1979-80 and 13 per cent in 1981. The authorities explained that the increase in the short-term liabilities of commercial banks was explained by special factors arising from changes in the system of export credits. The Bank of Israel had transferred the operation of export credit to commercial banks and ceased the practice of discounting foreign currency export credits by commercial banks. This change meant that the foreign resources required to meet export credit demands affected commercial banks' net foreign asset positions rather than that of the Bank of Israel. The authorities stressed that the changes in the banks' liabilities did not represent a shift in the private sector's demand for foreign borrowing. They had, in fact, reduced ceilings on private short-term foreign borrowings through the banking system at end-1981, for purposes other than export credits.

Nevertheless, there has been a sharp increase in the net debt service ratio. Debt service as a percentage of exports of goods and services rose from an average of about 24 per cent during 1979-81 to about 29 per cent in 1982; net of interest receipts from abroad, this ratio rose from about 19 per cent to 24 per cent. The increase was mainly due to higher interest payments.

c. Trade policies

Israel's import system continues to be guided by the Free Imports Order of 1978 and is virtually free from licensing and quantitative restrictions. The major changes since the last consultation have included some additions to the restricted list of imports to meet specific domestic protection objectives, and the recent introduction of an import levy. During 1981 and 1982, 28 import categories were added to the list of restricted imports estimated to account for less than 3 per cent of total non-oil imports. The levy of 3 per cent on the c.i.f. value of all imports subject to the value-added tax, introduced on June 15, 1982, was part of a package of measures to demonstrate the authorities' commitment to spread the sacrifices associated with the Lebanon war. While the authorities stated that this measure would substitute, in part, for the deceleration in the nominal depreciation of the shekel, they are determined not to tackle the growing pressures on the balance of payments by resorting to import restrictions. The import levy was intended to be a temporary measure for the fiscal year 1982/83 only. It has recently been extended, but the authorities have stated that they would abolish it not later than the end of the 1983/84 fiscal year. Exporters are being compensated for the levy by rebate arrangements. Israel continues to reduce duty rates on imports from the EC in line with her commitments to the Communities; value-added tax rates are being raised. Israel's exports to the Communities are already exempt from import duties. The exchange risk insurance scheme, introduced in July 1981, was not intended to be a subsidy to exporters, although net payments to exporters had resulted since the introduction of the scheme. In the long run the scheme was meant to be self-financing.

On other trade matters, the authorities stated that Israel's exports to Egypt had virtually ceased after mid-1982, when the Egyptian authorities stopped issuing import licenses for imports from Israel. They hoped this trade would resume again in the near future.

III. The Economic Outlook for 1983 and Beyond

The economic outlook for future years depends critically on the extent to which the authorities are able to reduce domestic absorption and shift resources to the traded goods sector. Official forecasts for 1983 project private consumption to rise by 1.4 per cent or significantly less rapidly than in the preceding two years. This will imply a decline in real private consumption per capita. Civilian public consumption is projected to rise by less than 1 per cent while gross domestic investment is expected to rise considerably more rapidly than in recent history, by 9 per cent in real terms. The increase in real domestic demand again exceeds the forecast real increase in GDP of 2 per cent. The authorities are hoping that the policies already in place, will result in a deceleration in the inflation rate to 80 per cent in 1983 measured as the average increase in the CPI over 1982.

Achievement of these forecasts will not be easy and will depend on the extent to which real private and public consumption can be restrained or reduced, and a turnaround in the external current account obtained. Important determinants will be the behavior of real wages, moderation of excess demand pressures from the budget, and the stance of exchange rate policy. The authorities are projecting that the estimated decline in real wages in 1982/83, which will result from the current wage agreement, will be consolidated and built upon during the remainder of 1983. Assuming that the budget is implemented as introduced, the budgetary deficit will be reduced in proportion to GNP, although there will be a sharp increase in net central bank credit to the Government, and a greater contribution to reserve money creation than obtained in 1982/83.

Developments in the external trade account will depend critically on the stance of exchange rate policy, and whether a further erosion of competitiveness is allowed to result in 1983, as well as on the intended restraint in domestic absorption. The scenario sketched for 1983 by the authorities may well be on the optimistic side, particularly in light of past slippages in government expenditures and in the behavior of public employment and real wages. The danger is, again, that private and public consumption will rise faster than officially forecast with some further squeezing of investment. If this were to occur, the more rapid growth in domestic demand would place renewed pressure on the balance of payments.

Preliminary calculations of financial developments indicate that, if the balance of payments for 1983 evolves as forecast by the authorities, and the growth in domestic liquidity is restrained in line with the projected growth in GDP and officially forecast inflation of 80 per cent, the implied growth in domestic credit will be very stringent.

Assuming the budget financing need is met as implied by the 1983/84 budgetary forecast, the residual available for private credit will imply a sharp reduction in real terms. It seems likely therefore that the growth in domestic credit will be greater than implied by this set of calculations, and the resultant deficit in the balance of payments will also be greater.

The authorities' medium-term projections for the balance of payments and for the evolution of their external debt position indicate relatively rapid external adjustment and a sharp reversal of the recent increase in the proportion of debt service payments to exports of goods and services. The authorities stressed that these projections should be understood as targets for policy. They noted that the balance of payments and external debt were particularly difficult to forecast as they depend critically on the international cycle and on the availability of long-term capital inflows. The authorities project the external deficit on goods and services account to decline from US$4.9 billion in 1982 to US$4.6 billion in 1983 and to be at about this level in 1986. This implies a return to the rapid rates of export volume growth that were experienced in the 1970s. As a proportion to projected GNP, the deficit is expected to decline considerably more rapidly reflecting the authorities' assumption of aggregate growth rates of 6-7 per cent after 1983. Correspondingly, the debt service expressed as a percentage of goods and services is projected to peak at 29 per cent in 1983 and then decline in 1985 to about 22 per cent, below the average that prevailed in 1980/81.

The staff believes these projections to be ambitious particularly with respect to the projected sharp recovery in export performance and in aggregate growth. On the basis of a more cautious reading of present trends and policies, the external deficit on goods and services could widen in 1983 to US$5.3 billion and to exceed US$6 billion by 1985. Such a deterioration would result in a marked worsening of the debt service ratio to perhaps 37 per cent by 1985.

IV. Staff Appraisal

The authorities view inflation as the major problem for economic policy, and their economic strategy is designed to reduce the monetary element in the inflation rate by acting on the nominal variables. They intend the effects on real output and employment to be minimal, that is they are not prepared to accept the inevitable consequences in the short run for employment and consumption of policies aimed at sharply reducing domestic demand. However, the pressures on the balance of payments reflect the growing underlying real imbalances, and unless these are reduced the pressures will continue.

The underlying imbalance in the Israel economy has worsened in recent years, not least because of the rapid rise in real wages, which has not only increased domestic absorption but also reduced competitiveness. The external deficit on the civilian current account expanded

Table 5. Israel: Monetary Survey

(In millions of Israel shekels)

	End third quarter	Flows during year		Real percentage increase	
	1982	1981	1982 1/	1981	1982 1/
1. Net domestic assets	280,532	81,699	129,032	7.7	-2.5
Domestic credit	263,483	74,479	123,087	5.7	-1.2
Public sector	(87,305)	(27,884)	(40,413)	(22.4)	(-2.0)
Private sector	(176,178)	(46,595)	(82,674)	(-1.1)	(-0.8)
Nongovernment bonds	17,049	7,220	5,945	41.9	-19.2
2. Net foreign assets	-24,244	-8,502	-19,136	--	--
3. Other items, net	1,400	-5,182	15,281	--	--
4. Total (1+2+3)	257,689	68,015	125,178	2.0	2.4
5. M_1 and unlinked time deposits	36,826	9,785	17,807	2.2	2.0
6. PATAM deposits	164,538	40,924	81,782	-1.8	4.7
7. Savings schemes and linked deposits	56,325	17,306	25,589	13.6	-3.5
8. Total (5+6+7)	257,689	68,015	125,178	2.0	2.4
			1980	1981	1982
Memorandum items:					
Directed credit as a percentage of total credit to the private sector			44.2	38.0	32.3 1/
Nonlinked assets as a percentage of liquid assets (M_4)			17.2	19.7	24.0
Liquid assets (M_4) as a percentage of total financial assets			36.4	30.0	22.8

Source: Bank of Israel.
1/ To third quarter.

Table 6. Israel: Indicators of Debt Service Burden

	1979	1980	1981	Est. 1982 1/	Proj. 1983 1/
		(In millions of U.S. dollars)			
Principal repayments	839	957	1,071	1,100	1,200
Net debt service	1,410	1,803	1,813	2,077	2,325
Debt service 2/	1,946	2,345	2,346	2,780	3,080
		(In per cent)			
Interest on debt as a percentage of exports of goods and services 3/	15.2	15.7	13.5	18.3	18.8
Net debt service as a percentage of exports of goods and services 3/	18.9	19.9	19.4	23.8	24.2
Debt service as a percentage of exports of goods and services 4/	23.8	23.9	23.5	29.3	29.0
Debt service as a percentage of current receipts 5/	17.7	18.3	18.2	22.3	22.0

Sources: Bank of Israel, Annual Report, 1981; and data supplied by the Israeli authorities.

1/ Staff estimates and projections based on the national budget for 1983.
2/ Excludes liabilities of Israeli banks operating abroad.
3/ Excluding receipts of investment income.
4/ Excluding banks' receipts of investment income.
5/ Exports of goods and services (excluding banks' receipts of investment income) plus private and official tranfers.

Table 7. Israel: Illustrative
Analysis of Medium Term Debt Scenario

(In billions of U.S. dollars)

	Est. 1982	Projections 1983	1984	1985
Israeli authorities				
Goods and services deficit	4.9	4.6	4.2	4.5
Debt outstanding (net of foreign assets of commercial banks)	20.8	23.0	24.3	25.0
Debt service as a percentage of exports of goods and services 1/	29.3	29.0	26.0	22.0
Debt service as a percentage of current receipts 2/	22.3	22.0	21.0	18.0
Possible variant				
Goods and services deficit	4.9	5.3	5.3	6.2
Debt outstanding (net of foreign assets of commercial banks)	20.8	23.7	26.1	28.5
Debt service as a percentage of exports of goods and services 1/	29.3	33.0	36.0	37.0
Debt service as a percentage of current receipts 2/	22.3	25.0	27.0	29.0

Sources: Israel, Central Bureau of Statistics, Monthly Bulletin of Statistics; National Budget for 1983.

1/ Excluding banks' investment income.
2/ Exports of goods and services (excluding banks' investment income) plus official and private transfers.

Israel - Basic Data

Population (1982)		4.021 million	
GNP in 1982 (market prices)		IS 528,261 million	
		(In per cent of GDP)	
Origin of GDP in 1982 (at factor cost)			
Agriculture, forestry and fishing		7.0	
Industry, mining, and quarrying		21.0	
Construction		6.0	
Finance trade and services		25.0	
Other		41.0	
Gross domestic product		100.0	
	1980	1981	1982 1/
	(Annual percentage change)		
National accounts			
Use of resources (constant prices)			
Private consumption	-3.2	10.5	6.8
Public consumption 2/	1.7	2.8	7.7
Gross investment	-17.4	-1.0	6.3
Total domestic demand	-5.4	6.3	6.9
	(In per cent of GNP)		
Budget aggregates (fiscal years)			
Expenditures	68.2	72.6	90.0
Of which: defense	24.7	22.7	30.6
Revenues	53.2	49.7	63.6
Deficit	15.0	22.9	26.4
	(Real percentage change; end of period)		
Monetary developments			
Liquid financial assets (M4)	6.4	-5.6	-1.0
Financial assets of pulbic	16.5	14.6	30.7
Domestic credit	-6.0	5.7	-1.2 3/
	(Annual average percentage change)		
Prices and employment			
Consumer prices	131.0	116.8	120.4
Wholesale prices	135.1	122.7	125.7
Unemployment rate (in per cent)	4.8	5.1	5.0
External position			
Current account deficit 4/ (as a per cent of GNP)	5.5	5.5	9.8
Debt outstanding (in billions of U.S. dollars)	16.7	18.2	20.8
Debt service (as a percentage of current receipts)	19.5	19.1	23.7

1/ Provisional data.
2/ Excluding direct defense imports
3/ To third quarter
4/ Excluding official transfers
5/ Exports of goods and services (excluding receipts of investment income), plus private and official transfers.