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IMMEDIATE ATTENTION

EB/CGATT/84/3

May 14, 1984

To: Members of the Committee on Liaison with the CONTRACTING PARTIES to the GATT

From: The Committee Secretary

Subject: Consultations with the CONTRACTING PARTIES to the GATT - Hungary, India, Israel, and Yugoslavia

The attached memorandum concerning preparation for forthcoming consultation with the CONTRACTING PARTIES on their consultation with Israel is submitted for consideration by the Committee. Consultations are also being held with India, Hungary, and Yugoslavia, but no statement by the Fund is expected for India and Yugoslavia because these are consultations under the simplified procedures agreed by the CONTRACTING PARTIES. The statement on Hungary for the guidance of the Fund representative is being circulated separately to members of the Committee (EB/CGATT/84/2, 5/14/84).

The staff report for the 1984 Article IV consultation with Israel (SM/84/99, 5/2/84 and the recent economic developments paper, SM/84/103, 5/8/84) is scheduled for consideration by the Executive Board on June 1, 1984. In general, the timing of the GATT consultation is fixed taking into account the Fund mission and consultation discussion schedule. In most cases, this has allowed the Fund representative to the GATT consultations to have the benefit of a recent Executive Board discussion on that country. The unusual sequence of meetings in the present instance (i.e., the GATT consultation with Israel being scheduled ahead of the Fund consultation) is in part due to the fact that the GATT consultation with Israel was initially planned for the week of October 10, 1983 but had to be postponed. In order to avoid undue delay, the GATT CONTRACTING PARTIES have rescheduled it at the earliest feasible date. GATT meetings for this purpose are generally held only two or three times a years.

Under the circumstances, it is felt desirable to adhere to the agreed schedule in a spirit of collaboration with the GATT. In order that the Fund representative to the GATT consultations may have the benefit of the views of the Executive Board in the light of the recently issued staff report for the 1984 Article IV consultation with Israel, the attached guidance statement would be brought to the agenda of the Executive Board on Wednesday, May 16, 1984.

Accordingly, in the absence of objection from a member of the Committee by close of business tomorrow, Tuesday, May 15, 1984, the memorandum will be deemed approved by the Committee for submission to the Executive Board for its approval.

Att: (1)

Other Distribution:
Members of the Executive Board

May 14, 1984

To : The Chairman of the Committee on Liaison with the CONTRACTING PARTIES to the GATT

From : The Director
Exchange and Trade Relations Department

Subject: Consultations with the CONTRACTING PARTIES to the GATT

The Fund has been invited to consult with the CONTRACTING PARTIES in connection with their consultations with Hungary, India, Israel, and Yugoslavia, to be held in Geneva during May 21-25, 1984. The Managing Director has recommended that this invitation be accepted, and that Mr. Shailendra J. Anjaria, Chief, Trade and Payments Division, be designated to represent the Fund during the consultations. This recommendation was approved by the Executive Board on April 27, 1984 (EBD/84/122).

In accordance with the procedures set out in EBD/56/102 (8/29/56), the latest Recent Economic Developments papers on Hungary, India, and Yugoslavia, and Supplementary Background Information on Yugoslavia, have been transmitted to the CONTRACTING PARTIES. It is expected that the Recent Economic Developments paper on Israel will be transmitted shortly.

It is expected that the CONTRACTING PARTIES will request the Fund's view with respect to Hungary and Israel. The statement on Hungary is being issued separately. With respect to Israel, it is recommended that, in reply to such request, the Fund representative should be guided by the statement set forth below.

Israel

The pace of growth of the Israeli economy slowed markedly in the last two years, to about 1 percent per year in 1982-83, compared to a growth of over 3 percent in 1980-81. During much of 1983, the imbalances in the Israeli economy deepened, with the external resource gap widening further and inflation rising. From the autumn of 1982, economic policy had focused on reducing the inflation rate by decelerating the growth of key nominal magnitudes, including the exchange rate and controlled prices. This policy did not succeed in significantly reducing inflation--over the year to September 1983, consumer prices increased by 128 percent, compared with 131 percent in the preceding 12-month period--partly because of institutional rigidities and deeply ingrained inflationary expectations, but also because of a deepening in the economy's real imbalances.

In the face of a rapidly deteriorating external position, and a mounting demand for foreign currency, the shekel was depreciated moderately in real terms in August 1983 and more substantially in October 1983. The second depreciation was accompanied by a basic change in exchange rate policy to ensuring maintenance of the real effective rate; at the same time, budget subsidies were cut back substantially and steps taken to begin reducing other expenditures. This heralded a change in the immediate focus of policy from reducing inflation to strengthening the balance of payments--which the Government has indicated that it intends to carry forward in 1984, when it is aiming to secure a reduction of about US$1 billion in the external goods and services deficit, primarily through a substantial reduction in the budget deficit.

As in the two previous years, aggregate demand--which increased by 5 percent--grew substantially faster than output during 1983. This reflected strong rises in both private consumption (7 percent) and public consumption (8 percent); fixed investment was also buoyant. The shift in pricing policy in October 1983 led to a release of repressed inflation--in the six months from September 1983, consumer prices rose by more than 120 percent and, by March 1984, stood more than 240 percent higher than a year earlier. Since real wages are adjusted incompletely and with a lag through indexation, real earnings fell by 15 percent in the fourth quarter, after having risen substantially earlier in the year. This sharp fall in real wages, combined with an erosion of the real value of the public's financial asset holdings in the fourth quarter of 1983 due to a collapse in the stock market, led to a turndown of domestic expenditure and output and a rise in unemployment.

The budgetary situation weakened markedly during 1983/84. The policy of tackling inflation in the first half of the fiscal year was responsible for higher price subsidies and increased outlays under an exchange rate insurance scheme; domestic defense costs and public sector wages also rose in real terms. Despite a number of measures to strengthen the budget from August 1983--including cuts in various programs--the deficit continued to widen in the second half of the fiscal year, due in part to a decline in both tax and nontax revenues. For the fiscal year as a whole, the budget deficit widened by the equivalent of 8 percentage points of GNP, to 26 percent of GNP. About one half of this deficit was financed by credit from the Bank of Israel. This monetary financing contributed importantly to a 9 percent real increase in the public's liquid financial assets during 1983. The public's holdings of total financial assets, by contrast, fell by 30 percent in real terms during 1983, reflecting the sharp fall in values on the Israeli stock market.

Israel's external goods and services deficit rose from US$4.7 billion in 1982 to US$5.0 billion in 1983, with a decline in defense imports (mostly financed by aid) more than offset by a further sharp rise in nondefense imports. As receipts from private and official transfers also fell slightly, the overall deficit on the current account rose by US$0.5 billion in 1983 to reach US$2.6 billion, or nearly 11 percent of GNP (compared to 9 1/2 percent in 1982 and 6 1/2 percent in 1981). The devaluations of August and October 1983, and subsequent exchange rate policy, have returned the real value of the shekel to around the level of September 1982; there are signs of improvement in the trade deficit in the second half of 1983 and early 1984. Gross external debt minus the foreign assets of commercial banks is estimated to have increased by US$1.4 billion, or 6 percent, in 1983 to US$22.3 billion (92 percent of GNP). The short-term component of debt declined marginally in 1983 to 14 percent of total debt; 70 percent of total debt was long-term, mainly at concessionary interest rates. Debt service remained unchanged at 22 percent of current receipts in 1983.

Although in 1977 most restrictions on payments and transfers for current international transactions and multiple currency practices were eliminated, new restrictions have been introduced, and some old restrictions reintroduced, as the external position has deteriorated more recently. The 3 percent import levy introduced in June 1982 and originally intended to lapse on April 1, 1983, was extended first to April 1, 1984 and then through March 31, 1985, though the rate of levy was reduced to 2 percent effective from April 6, 1983, when a levy on the purchase of foreign exchange by the public equivalent to 1 percent of the value of all transactions was introduced. On June 1, 1983, a noninterest bearing 15 percent deposit for one year on a range of imports was introduced, equivalent to a tax approaching 10 percent at average interest rates during the second half of 1983; this deposit scheme was renewed for a further six months on December 1, 1983. As from April 1, 1983, a travel tax on Israeli citizens traveling abroad was reintroduced. Exporters continued to benefit from the exchange rate insurance scheme introduced in July 1981: net payments under the scheme were estimated at US$435 million in 1983 (8 percent of exports). The 2 percent surcharge on proceeds from the sale of domestically traded securities by residents and nonresidents, as well as on the proceeds from foreign-traded securities by residents introduced in June 1982, remains in force. In the face of continued sizable purchases of foreign currency by Israeli residents, foreign currency controls were tightened in both November 1983 and January 1984.

Given the imbalances in the Israeli economy, the current policy strategy aims appropriately at improving the balance of payments substantially through a sizable reduction in the budget deficit. The Fund hopes that the authorities, by further strengthening the adjustment effort, will be able to return to a more liberal exchange and trade system in the near future.