SUR/95/110

Office Memorandum

MASTER FILES
ROOM C-525 **0460**

September 22, 1995

To: Members of the Executive Board

From: The Secretary

Subject: The Acting Chairman's Summing Up at the Conclusion of the 1995 Article IV Consultation with Israel - EBM/95/88 (9/15/95)

Attached is the text of the summing up. Executive Directors may wish to be aware that the last sentence in the first paragraph on page 2 was amended in light of comments made by several Directors at the end of the Board meeting on September 15, 1995. The sentence reads, "They warned, however, that if further fiscal restraint were not forthcoming, the authorities would be faced with the choice between allowing further exchange rate appreciation--with the attendant risks of a further widening in the current account deficit--or accommodating capital inflows, with the likelihood of increasing inflation."

Att: (1)

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SUR/95/110

September 22, 1995

The Acting Chairman's Summing Up at the Conclusion of the
1995 Article IV Consultation with Israel
Executive Board Meeting 95/88 - September 15, 1995

Directors commended the Israeli authorities for the policies that had led to the impressive rate of economic growth since the large wave of immigration began in late 1989, and for the successful absorption of most of the new immigrants into the domestic economy, while at the same time reducing the overall unemployment rate. They also welcomed the fact that growth prospects had been enhanced by the peace process. Directors observed that, although compared with past trends, there had been a favorable fiscal turnaround in recent years, the decline in private saving meant that stronger efforts at fiscal consolidation were still needed.

Directors expressed some concern about the recent overheating of the economy, particularly as manifested in a substantial widening of the external current account deficit that was accompanied by a marked decline in private savings. While Directors considered that the current account deficit did not pose an immediate financing problem, they emphasized that the present level of the deficit could not be sustained and that its early reduction was required.

Directors considered that the key policy challenge in the period ahead was to strengthen the level of domestic savings. Given the uncertainties surrounding private savings behavior, Directors emphasized that fiscal policy would need to play a crucial role in that effort. In this context, they considered that a more ambitious fiscal effort than presently envisaged was needed, and that public expenditures would need to be tightly controlled, particularly in the realm of public sector wages and employment. As regards 1996, Directors stressed that the budget should aim at significantly increasing national savings. This was required not only for balance of payments reasons, but also to reduce Israel's level of public debt, to meet the Government's future pension obligations, and to prepare for any future reduction in unilateral transfers.

Directors welcomed the changes that had been made in the direction of reforming the pension system, but noted that--barring further reform--the pension system would impose a heavy burden on future budgets. Some Directors criticized the present plans for pension system reform as being inadequate and called for more comprehensive reforms, including moving toward a fully-funded pension system for public employees.

Noting the disappointing price performance in 1994, Directors stressed that the overriding objective of monetary policy must be to meet the

- over -

Government's inflation target in 1995 and to lay the basis for a further decline in inflation. In this context, Directors cautioned against a premature reduction in interest rates.

Directors generally considered that the diagonal exchange rate band system had served Israel well. However, they observed that the recent implementation of monetary policy had been complicated by a surge of short-term foreign borrowing by Israeli companies. While the Bank of Israel had successfully sterilized these inflows to date, the cost of such sterilization could not be overlooked. Directors noted that these considerations made it all the more necessary that more of the burden of macroeconomic stabilization should be transferred to fiscal policy through the implementation of a more restrained fiscal stance. Some Directors noted the limits for monetary policy to attain simultaneously both the inflation and the exchange rate objectives, especially in the face of large capital inflows. They encouraged the authorities to reassess exchange rate policy, including making greater use of the more appreciated part of the exchange rate band. They warned, however, that if further fiscal restraint were not forthcoming, the authorities would be faced with the choice between allowing further exchange rate appreciation--with the attendant risks of a further widening in the current account deficit--or accommodating capital inflows, with the likelihood of increasing inflation.

Directors were of the view that aggregate demand policy in Israel needed to be complemented by a reinvigorated supply side approach. Regretting that the privatization process had stalled, they supported the Government's recently proposed option scheme and urged its early implementation. In particular, they urged a faster pace of bank privatization.

Directors welcomed the opportunity to review recent economic developments in the West Bank and Gaza Strip and to assess the progress being made in institution building. They also welcomed the Fund's increased involvement in providing technical assistance to the Palestinian Authority in the areas of fiscal policy, monetary and financial management, and the improvement of the macroeconomic statistical base. They considered that the main emphasis of a development strategy for the West Bank and Gaza Strip should be outward oriented and private sector led, particularly in view of the large investment and employment needs. Moreover, they attached the highest importance to the establishment of sound and transparent public finances in the West Bank and Gaza Strip.

It is expected that the next Article IV consultation with Israel will take place on the standard 12-month cycle.