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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/157

10:00 a.m., November 22, 1991

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	L. E. N. Fernando
Che P.	Zhang Z.
	G. C. Noonan
T. C. Dawson	Q. M. Krosby
	B. Szombati, Temporary
	G. H. Spencer
R. Filosa	N. Kyriazidis
M. Finaish	A. F. Mohammed
	J. A. Solheim
H. Fukui	N. Tabata
E. Goos	
J. E. Ismael	
A. Kafka	J. C. Jaramillo
J.-P. Landau	
A. Mirakhor	
L. B. Monyake	
D. Peretz	P. Wright
G. A. Posthumus	Z. Trbojevic
C. V. Santos	
	R. Marino
A. Végh	

L. Van Houtven, Secretary and Counsellor
B. R. Burton, Assistant

Also Present

African Department: M. Katz, R. C. Williams. Central Asia Department: H. Neiss, Director. Southeast Asia and Pacific Department: K. Saito, Director. Central Banking Department: M. Guitián, Associate Director. European Department: M. Russo, Director; J. Artus, Deputy Director; J. Odling-Smee, Deputy Director; M. C. Deppler, Deputy Director; G. Anayiotos, J. J. Hauvonen, P. C. Hole, I. Kapur, V. R. Koen, D. C. Ross, J. F. van Houten. Exchange and Trade Relations Department: T. Leddy, Deputy Director; A. Basu, H. M. Flickenschild, M. G. Gilman, B. Horvath, S. Kanesa-Thasan, H. J. G. Trines. External Relations Department: S. J. Anjaria, Director. Fiscal Affairs Department: V. Tanzi, Director; A. A. Tait, Deputy Director. IMF Institute: R. E. Daumont. Legal Department: F. P. Gianviti, General Counsel; R. H. Munzberg, Deputy General Counsel; H. Elizalde, R. B. Leckow. Middle Eastern Department: S. H. Hitti, M. D. Knight, A. Ouanes. Research Department: D. T. Coe. Secretary's Department: C. Brachet, Deputy Secretary; J. W. Lang, Jr., Deputy Secretary; A. Jbili, M. J. Primorac. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; D. Gupta. Western Hemisphere Department: E. S. Kreis. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. M. Abbott, P. Bonzom, L. E. Breuer, M. B. Chatah, C. D. Cuong, L. Dicks-Mireaux, B. R. Fuleihan, M. Galán, A. Gronn, J. M. Jones, M. Nakagawa, D. Powell, S. von Stenglin. Assistants to Executive Directors: G. Bindley-Taylor, B. Bossone, J. H. Brits, Chen M., J. A. Costa, S. B. Creane, Deng H., H. Dogrin, T. P. Enger, N. A. Espenilla, Jr., S. K. Fayyad, A. Giustiniani, S. Gurumurthi, M. E. Hansen, K. M. Heinonen, O. A. Himani, R. Meron, F. Moss, M. Mrakovcic, J. A. K. Munthali, L. F. Ochoa, E. H. Pedersen, R. K. W. Powell, S. Rouai, S. Shimizu, D. Sparkes, C. M. Towe, J. W. van der Kaaij.

1. ARTICLE IV CONSULTATION CYCLES - TEMPORARY CHANGES

The Chairman recalled that at the recent discussion of the work program (EBM/91/153, 11/13/91) Directors had endorsed his proposal on temporary changes in Article IV consultation cycles in principle, pending contact on the matter with their authorities. Since then, there had been broad acceptance by the membership of the need for those temporary changes to cope with current work load pressures.

A few Directors had expressed concern about the effects of the proposed changes on a small number of countries, but their concern had been met in ways that were fully consistent with the principles established during the discussion of the work program, with the exception of one case that had inadvertently been classified as a new program country and another in which the consultation mission that had been scheduled for early November had been delayed at the request of the staff, the Chairman remarked. Accordingly, a revised table reflecting the change for the case that had been misclassified and additional information on tentative consultation dates would be circulated shortly. The temporary changes in the consultation cycles would be in effect from November 22, 1991 to November 20, 1992. He hoped--but did not expect--that he would be able to propose an earlier return to the Board's normal surveillance procedures. Directors could facilitate that return by their decisions on the Fund's administrative budget. In addition, recruitment operations would be accelerated with a view to enabling the Fund to continue its usual surveillance practices. In any event, the Board would review the situation before November 20, 1992.

Mr. Posthumus wondered whether the staff paper that would form the basis for the Board's review in one year's time could be issued well in advance. Executive Directors should use flexibility in the coming year in considering changes to countries' Article IV consultation cycles; for that reason, he had not asked for a change in the consultation cycle for one of his countries, for which he could have made a case for flexibility. Otherwise, the chance that the temporary policy would continue in force would only increase.

The Chairman noted that the third paragraph of his statement at EBM/91/153 constituted a commitment to be flexible.

The Executive Directors concluded their consideration of temporary changes in Article IV consultation cycles.

2. U.S.S.R. - RECENT DEVELOPMENTS AND FUND ACTIVITIES

The Executive Directors considered a statement by the Chairman on political and economic developments and Fund activities in the U.S.S.R. since his previous statement to the Board on November 6, 1991.

The Chairman's statement read as follows:

Starting with political changes, the main development is the formation of a new Government in the Russian Federation with Mr. Yeltsin as Prime Minister and Mr. Burbulis as First Deputy Prime Minister. Economic and financial policy is the responsibility of Mr. Gaidar, and social policy is the responsibility of Mr. Shokhin, both of whom are Deputy Prime Ministers. The members of the team of policymakers around Mr. Gaidar seems to have known each other for some time, and many of them have been working closely together since the coup to produce the framework of the economic reform program that Mr. Yeltsin has adopted and which he announced on October 28.

I shall return to the details of the program itself later. But it is worth noting now that the new Russian Government attaches priority to economic reform rather than to building up interrepublican economic relations. Partly as a result--but also because some other republics have difficulty with various draft interrepublican agreements that supplement the main Economic Community Treaty--progress in settling interrepublican relations has been slow. Although the Treaty has been signed by the leaders of ten republics--all except Azerbaijan and Georgia--it has not yet been ratified by any Parliaments. The ratification process is being held up by uncertainties as to whether agreement can be reached on key "supplementary agreements," including those on a banking union, fiscal and budgetary coordination, and external debt servicing. There is considerable mistrust between republics, and the main areas of disagreement involve the division of power--for example, voting rights in the Banking Union--and assets and liabilities. By contrast, they seem to find it easier to agree on economic objectives such as price stability and price liberalization, even though few of them are striving in practice to attain these objectives.

It is too early to say where interrepublican relations will end up. The agreement in principle on November 14 by seven republics, including Russia, to a new political union might suggest a continued willingness to stick together. But agreements in principle are not regarded as binding, and the Ukraine was notably absent from the meeting. On balance, especially in view of the position of the new Russian Government, it seems safe to say that the trend toward separation is continuing.

Economic developments

There have been no major developments on the economic side since I last reported to Executive Directors, except with respect to the debt issue. Output continues to fall, inflation is certainly rising, and shortages persist. The consolidated state budget deficit is large: depending on the definitions and assumptions that are used, figures of between 15 percent and 25 percent of GDP in 1991 can be obtained. Money and credit growth is rapid, although real balances and real credit outstanding have fallen. One significant development has been the change in the current account from a deficit in 1990 to a surplus in 1991, but this surplus has been achieved only as a result of a major import compression that has deprived the economy of important inputs. The external payments situation has been aggravated by the withdrawal of short-term credits, and it is now precarious.

I know that a number of Executive Directors have asked for more written information about economic developments. I am therefore circulating with this statement a paper on recent economic developments which includes some of the quantitative data that the Fund has gathered, and the text of the communique that was issued upon the conclusion of the agreement with the G-7. 1/

Agreement with the G-7

The most important economic development is the November 21, 1991 agreement on debt issues between the G-7 on the one hand and the U.S.S.R. and the republics on the other. The main features of the agreement have been reported in the newspapers, but allow me to note a few of them. Eight republics have entered into an agreement to honor the liabilities of the U.S.S.R. on a joint and several basis. The possibility that the other four--Azerbaijan, Georgia, Uzbekistan, and the Ukraine--might join the agreement later remains open. The eight republics have also agreed, among other things, to introduce macroeconomic stabilization policies in consultation with the Fund. In particular, they have said that they intend to adopt and implement during the first quarter of 1992 comprehensive and ambitious macroeconomic and structural adjustment programs taking into account the Fund's recommendations. They will also seek to maintain free interrepublican trade, and they accept the need for a full disclosure of economic information.

1/ Reproduced in Annex I and Annex II.

In return for the commitments made by the republics, the G-7 Governments stand ready to support a package of three measures: a deferral of principal payments on medium- and long-term official debts contracted before January 1, 1991; the maintenance of short-term credits by their export credit agencies; and possible emergency financing in the form of a gold swap facility. There will be phasing of the gold swap and the possibility of terminating or reducing the other measures, dependent in part on the fulfillment by the republics and union of their commitments.

The commitment by the eight republics to agree on their economic programs with the Fund during the first quarter of 1992 presents us with an enormous challenge. With eight programs to prepare, the staff will be almost starting from scratch, except in Russia, in the sense of collecting economic data for the republics, establishing relationships with the key policymakers, and agreeing on economic programs with them. Nonetheless, there are some factors that will help the staff. First, the Fund has the strong endorsement and support from the G-7. Second, the Fund already knows something about how the system as a whole works from the joint study on the economy of the U.S.S.R. and subsequent work. Third, the fact that Russia intends to introduce its own reforms provides a strong economic incentive--although, unfortunately, a political disincentive--for other republics to emulate. Fourth, the staff can concentrate mainly on the fiscal side, because in the short term it would be unrealistic for the republics to attempt to introduce separate currencies. Despite these favorable points, it will be necessary to devise simple but crude programs that can be put in place in the required time scale, rather than something more sophisticated. Far from being a drawback, this approach could actually be what the situation requires: subsequent programs can introduce more sophistication as institutions and economic understanding develop in the republics.

The Fund will have to work closely with other international organizations on these programs. In particular, I hope that the World Bank will play a leading role in advising on price liberalization and interrepublican trade issues.

Even with simplified programs and help from the World Bank and other institutions, the task is daunting. Moreover, we cannot at this stage be sure that there is a willingness to cooperate with the Fund in devising appropriate programs, despite the commitment the republics have entered into this week. Nevertheless, I am determined that the Fund should do the best job that it can.

Recent Fund activities

As I explained to Directors on November 6, 1991, three separate missions started work in Moscow on November 11: two technical assistance missions, largely diagnostic in character--one from the Central Banking Department and one from the Statistics Department--and a general economics mission from the European Department. The two technical assistance missions are due back next week, and it would be more appropriate for me to report on their findings on a subsequent occasion. The general economics mission will remain in Moscow, with a changing composition, for some time.

The missions' main objectives were to collect material and conduct consultations for an Article IV-type review; to provide advice to the groups working on interrepublican agreements; and to discuss its economic program with the new Russian Government. Some progress was made on all three objectives, although the slowdown in discussions on interrepublican agreements meant that there was not much the mission could contribute at this stage. Most time was spent on the Russian program. The mission met senior members of the economics team and was impressed by the clarity of their thinking and the general coherence of their economic program, which embraces macroeconomic stabilization, price and exchange rate liberalization, and a greatly reduced role for the state. Further work needs to be done on the details before we shall know whether the specific fiscal, monetary, and other instruments available to the authorities are capable of delivering the desired policy outcomes, and whether an adequate social safety net will be in place. One area of concern to the mission was the risk to interrepublican trade if Russia went ahead with its reforms unilaterally without trying to persuade other republics to emulate it. The mission has already expressed its concerns on this point to the authorities.

A two-man team from the Treasurer's Department arrived in Moscow this week to collect data for the Union and individual republics for making quota calculations, including most immediately for the Baltic republics. A team from the Institute has also just started work there. Over the last two weeks there have been senior staff from seven Fund departments (Central Banking, Exchange and Trade Relations, European, IMF Institute, Legal, Statistics, and Treasurer's) in the U.S.S.R., and our missions have also included representatives of the OECD, the World Bank, the Bank for International Settlements, Eurostat and four Western central banks, as well as consultants.

Finally, two important meetings with other financial institutions have been held to discuss the coordination of technical assistance to the U.S.S.R. I met with the heads of institutions in Brussels on November 11, and members of the European Department attended the regular meeting on coordination of work in Eastern Europe and the U.S.S.R. in Luxembourg on November 19. There was general agreement that there should be a greater exchange of information about technical assistance activities between institutions. There was also agreement in principle on the establishment of a training institute in Vienna at which all institutions would offer courses. Further meetings are planned, and I expect that a future meeting of the heads of institutions might discuss a possible code of conduct.

From my preceding remarks you will perceive that the Fund is in the midst of a major effort. Many staff members have had to change plans, travel on short notice, and adapt to new jobs. I would like to pay tribute to the spirit of commitment with which the staff is reacting to this formidable challenge at a time when it was already overburdened. To speed up the review of the medium-term budget outlook and the approval of the supplementary budget, papers on both these subjects will be circulated today.

Mr. Mirakhor wondered whether the trend to separation was picking up momentum and when the question of separation might be decided.

The Chairman responded that a revolution was under way in the U.S.S.R., which meant that developments occurred at an irregular pace. Those who had worked for the maintenance of the Union were demoralized. It was his subjective assessment that the point of no return had been passed, as all the signs pointed to separation. The forthcoming referendums on December 1, 1991 in Ukraine and Uzbekistan might accelerate that process.

Mr. Al-Jasser wondered whether political events were influencing the programs that the Fund was contemplating. The Chairman had mentioned that fiscal measures would be the first priority. Fiscal policy could be miniaturized to each county or city. The Chairman had not referred to the coordination of monetary policy, the currency, or the central bank that each republic would have as a sovereign state or a conglomerate of sovereign states.

The Deputy Director of the European Department replied that fiscal policy was already being conducted essentially at the republic level only. There was no significant fiscal authority for the Union. The civil servants keeping the accounts of the Union Government could not act in any substantive way without the agreement of the republics and the receipt of money from them. Monetary policy was still the constitutional responsibility of the U.S.S.R.'s new central bank, which was politically weak and unable to resist political pressure from the republics to extend credit to finance deficits through the central banks of the individual republics--banks that had emerged out of the former network of regional branches of the U.S.S.R.'s state bank.

Recent developments in the Russian Federation suggested that the Russian Government would soon take over Russia's monetary policy and, perhaps, that of the Union as a whole, the Deputy Director continued. The staff had held many discussions with representatives of the Russian Government on whether it was in Russia's interest to try to make the existing monetary system work on a union-wide basis or to institute its own system. The Russian Parliament had that day been talking about trying to take over monetary policy for the Union as a whole, but such decisions were changed frequently. There was still some semblance of central monetary policy, but not much, and it was becoming increasingly weak.

He could not judge the prospects for political and military union, the Deputy Director of the European Department said. However, it was his impression that the Union was stronger in that sphere than in the economic sphere, because the army supported the Union and seemed to be controlled, to some extent, at the Union level.

Mr. Mirakhor remarked that he was concerned about the Fund's recommendation that the republics not establish their own central banks and currencies, given that fiscal policy was being managed at the republic level. There were no disadvantages other than possible implications for the U.S.S.R.'s external debt. If the trend was toward separation--as the Deputy Director had indicated--little in the way of Union-level fiscal policy would be expected. He therefore wondered whether the staff was considering the contingency of independent central banking systems and currencies for the republics.

Mr. Al-Jasser wondered whether the assumption by the Russian Federation of the central banking role and monetary policy for Russia, and possibly the Union, constituted a divergence from the economic treaty that had been signed--although it was still a shell--and the supplementary agreements that were being contemplated. With respect to the comments by the Chairman on the agreements that had been reached between the G-7 Deputies and the eight sovereign states, the maintenance of short-term credit and a possible short-term bridge loan had been mentioned. However there had been no indication of any assurances having been made--or that they could credibly be made in the future--and of the terms for those new credits vis-à-vis all countries that were trying to help, not just the G-7. The gold swap facility had been alluded to, but the summaries of the agreement that had been released the previous day noted that the G-7 had excluded that possibility.

The Chairman noted that the communique issued by the G-7 and the eight republics had been circulated. The G-7 was pledging their own contribution. For the G-7, and, indeed, for all nations, the security for any credit extended would be the improved quality of the policies that the republics would be able to implement; therefore, the communique contained a paragraph about adopting policies defined in consultation with, and recommended by, the Fund. The G-7 was committed to support the deferral of principal payments on medium- and long-term official external credits provided that such policies were implemented. The agreement was designed to meet an emergency. It would certainly contribute to the normalization of the situation.

Mr. Dawson remarked that part of the uncertainty arose from the fast pace at which change was occurring. The Russian central bank's assumption of monetary policy was likely to have implications that would provoke a reaction from the republics. He wondered why the two-person mission from the Treasurer's Department was calculating a Soviet quota. Although there was the legal reality of an application by the U.S.S.R. pending, there was an element of fantasy in that mission, particularly because--at least as he understood the rules of the Fund--the quota was being calculated on the basis of 1980 data. The Treasurer's Department mission should avoid getting embroiled in what could be a political controversy. The republics would object to the Fund's work on the membership application for an entity that many of them viewed as defunct.

The Chairman responded that the members of the Treasurer's mission had been briefed on the political realities. However, they also had other responsibilities to fulfill, namely, gathering the data required for the calculation of quotas for the Baltic republics.

Mr. Peretz wondered whether the Chairman or the staff had any information on economic reform in republics other than the Russian Republic. He also wondered what plans the Fund had with respect to the four republics that had not signed the agreement the previous day--particularly Ukraine, which was quite an important republic.

Mr. Végh recalled that at the time the joint study on the U.S.S.R. had been presented in December 1990, and the first discussion on the matter of special association had taken place, many Directors had pointed out that a minimal test of cooperation would be the official provision of figures on the gold reserves. He wondered whether furnishing those data would still be considered a test of cooperation.

Mr. Goos wondered whether the Deputy Director of the European Department could elaborate on the reform plans and policies of Russia itself and assess the general direction in which Mr. Yeltsin's plan was heading.

The Deputy Director of the European Department explained that the Fund had not been insisting on the maintenance of a single currency. Rather, it was advising that, should a republic want to have its own currency, it should plan and prepare carefully for it and create the institutions and acquire the knowledge so that the quality of the currency would not be undermined from the day it was introduced. A new currency could not be introduced overnight. Therefore, the staff was approaching the immediate need for macroeconomic policies and economic reform on the assumption that the single currency might continue for a while.

As to the consistency of the Russian approach to monetary policy with the Economic Community treaty, he did not have full information about the direction the Russian authorities' monetary policy would take, the Deputy Director said. If they decided to cooperate with the Economic Community treaty, which envisaged a banking union--that is, a monetary union with a single central bank--and if they were able to reach an agreement with the other republics on voting rights that would give Russia its due economic weight, which was what Russia wanted and the other republics did not, the Russian authorities would essentially control monetary policy, but within the context of the EC treaty. However, should the Russian authorities take complete control of the central bank, their action would be incompatible with the EC treaty.

The communique itself made no reference to new credits, except for the gold facility, the Deputy Director observed. It was concerned essentially with old credits. The commitments asked of the republics related to the existing debts. The only thing that was relevant to any new credits was the commitment on policies that the Chairman had explained.

With respect to the question about the calculation of quotas for the Soviet Union, the Chairman had noted that the Treasurer's team had also been in Moscow to calculate quotas for the Baltic republics, the Deputy Director of the European Department recalled. Any calculations of quotas for the Baltic republics must anticipate any possible configuration of new republican arrangements; in other words, the methodology to be adopted--and that methodology still had to be determined--should be such that it could be applied to whatever configuration of republics might emerge. It was therefore essential that the Treasurer's Department should be in Moscow to collect union-wide data and the disaggregated data, which, in some cases, were only available there and not in the republics' capitals.

Mr. Dawson commented that if one took the 1980 published data for the U.S.S.R., the numbers were substantially above any theoretical graduation level, so that, in addition to the issue of how to divide up those numbers should the union be dissolved, there would remain a problem of how to determine what the numbers should, in reality, be. The changes over the past ten years, or even over the past two years, had been such as to make historical calculations in a sense more unreal than they had been for any case of a country ever joining the Fund.

The Chairman observed that the exchange rate was a principal factor.

Mr. Peretz said that he agreed with the Chairman that, even using 1980 data, the exchange rate employed would make a significant difference to the quota calculations. Once the United States had ratified the quota increase, 1980 data would not have to be used.

Mr. Dawson commented that 1985 data were also likewise unrealistic. As Mr. Landau had suggested, even 1986 data were unreal.

Mr. Landau said that 1985 data might be easier to collect than 1980 data.

Mr. Finaish wondered what forms of coordination, if any, were in place to avoid a duplication of efforts now that the Fund was providing technical assistance in addition to the World Bank, other international institutions, national authorities, and individual central banks.

The Deputy Director of the European Department responded that the staff did not have much solid information about the plans of the individual republics other than Russia. Until the staff visited the republics, it could not ascertain the strength of political support for price liberalization. Price liberalization and privatization were the two best-known reforms. Macroeconomic stabilization was less well understood, partly because the republics had no role in the formulation of macroeconomic policies.

Ukraine and three other republics had not signed the agreement with the G-7, the Deputy Director observed. An extensive Fund mission would travel to Ukraine in December 1991. It was a key republic, partly because of its size, but also because of its determination to be more independent--a move that risked the disruption of interrepublican economic relations, especially between Ukraine and Russia. The staff planned to present the case to Ukraine and the other three republics that if Russia went ahead with reforms, it would be in those republics' own interests to emulate those reforms rather than try and resist them--in other words, to liberalize their own prices simultaneously in more or less the same way and to stabilize their own economies at more or less the same time. If they did not, the trade and payments tensions between the republics would be great. Ukraine would be forced into cutting off many trade links--an approach it should try to avoid. The Ukrainian authorities' receptiveness to that line of reasoning was not yet known.

As to the Russian program, the new Government had been in office only a few days when the staff had arrived, the Deputy Director recalled. The Russian authorities had not gone beyond the general framework that they wanted to put into effect. The quantification of that framework had only just begun. Even at the beginning of the current week, they had not been ready to produce any calculations of the budgetary implications; those calculations would take another one to two weeks. The broad outline, not the details, was fairly clear. The authorities wanted to liberalize most prices and let them move to market-clearing levels immediately. At the same time, they wanted to keep the prices of a number of commodities regulated, particularly the main energy inputs--oil, maybe coal, and natural gas--bread, vegetable oils, and a few other items; the prices of those commodities would be raised to world prices in steps, perhaps spread over two or three years. The Russian authorities also wanted to liberalize the exchange rate, but it was not clear when they would do so. They had already issued a decree liberalizing imports. Their position on exports was unclear; Mr. Yeltsin had issued a decree the previous weekend that had seemed not to fit some other parts of the program, but it might not be the final word. A substantial reduction in the budget deficit--even after allowing for the contributions to central union level expenditure--was planned. Sometimes the Russian authorities discussed the need for Russia to finance the entire union budget, because reaching an agreement with the other republics on the shares that they would finance might be impossible. They would likely draw back from that position when they did the calculations and realized how difficult it would be to finance even their own share, which was approximately 60 percent.

Russia was still uncertain about the institutional arrangements needed to support monetary policy, the Deputy Director of the European Department remarked. Once the institutional issues were settled, the Russian authorities wanted to operate a reasonably tight monetary policy.

Mr. Goos wondered whether the staff was assured that the authorities were moving generally in the right direction, or whether there were any major flaws in the design of the economic reform program.

Mr. Posthumus remarked that eight programs for eight republics was a challenging task. He asked the staff to comment on how much time it would take to draw up those programs.

The Chairman noted that time was, indeed, a constraint in obtaining the commitment of the eight sovereign republics to economic policies approved by the Fund. It was hoped that those economic policies could be agreed before the end of March 1992. The Fund would concentrate its efforts on the eight republics that had signed the agreement with the G-7, but it would visit all the other republics before the end of 1992. An overview of the situation was needed, as were contacts in all parts of the country, in order to be sure that the Fund's assessment of the situation in general was correct.

The Deputy Director of the European Department noted that, when visiting the other four republics, the staff would offer advice consistent with that discussed with respect to Ukraine. The more republics that implemented similar policies at the same time--especially policies to liberalize prices and control fiscal deficits--the more successful the whole endeavor would be, because of the interactions between the economies.

With respect to flaws in the Russian program, as the Chairman had mentioned in his introductory remarks, the impact of the pro-Russia policy on interrepublican relations was a concern; the Russian attitude--that there was no time to reach agreements with the other republics on various matters, and that, instead, it was important for Russia to proceed and let the other republics look after themselves--could put great strain on some of the interrepublican economic links. Discussions were continuing, and the situation was one of considerable flux.

The Russian authorities had published figures on the gold reserves and were discussing them with the staff, the Deputy Director of the European Department said. There had initially been some skepticism in the West about whether the figures were correct, because the market had a different view. The staff had no independent evidence of their validity. At first sight, it was not obvious that the market had a better view than the authorities, and the staff was inclined to accept the authorities' figures. The problem always had been that no one had known which authorities had held the gold. The republics that had gold mines were withholding some of the production from the Union Government, but the amount withheld was not generally known.

Mr. Fukui wondered whether it was the Fund's policy to give priority to the design of programs for the eight republics that had signed an economic treaty and the G-7 statement over the republics that had not yet joined that economic treaty.

The Deputy Director of the European Department replied that the Fund was sending missions to all 12 republics. The precise functions of those missions would differ slightly, depending on whether or not the G-7 was asking the Fund to provide policy advice to them. In practice, the Fund would be giving exactly the same kind of advice to all the republics.

The Chairman noted that there was a high degree of coordination with other institutions in the provision of technical assistance to the republics. During the Fund's missions to the U.S.S.R. in November 1991, in addition to seven departments of the Fund, there were representatives of the OECD, the World Bank, BIS, Eurostat, and four European central banks. In Bangkok, he had held a meeting of senior officials of other international organizations to organize that coordination. He had participated in another meeting in Brussels on November 10, 1991. On November 20, 1991, there had been a meeting at the staff level in Luxembourg to coordinate work in Eastern Europe and in the U.S.S.R. It was generally agreed that there should be a broad exchange of information about technical assistance activities among the institutions. However, the greatest risk in the whole assistance effort was not that of duplication, but rather the risk of not being able to get the job done, given the immensity of the task.

With respect to the matter of training high-level macroeconomic specialists and monetary officials, the Government of Austria had offered to create an institute in Vienna and would help with housing and operating costs, the Chairman remarked. Four other organizations would participate on an equal footing. It was hoped that a relevant institution could be functioning as soon as possible. Several meetings had been planned. A code of conduct for cooperation, namely, a set of rules to ensure that the work of the staffs of the member organizations went smoothly, was being negotiated.

The Executive Directors concluded for the time being their consideration of recent developments and activities concerning the Fund and the U.S.S.R.

3. ISRAEL - 1991 ARTICLE IV CONSULTATION; AND RELATIONS WITH GATT - CONSULTATION WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Directors considered the staff report for the 1991 Article IV consultation with Israel (SM/91/191, 9/11/91; Cor. 1, 11/15/91; and Sup. 1, 11/19/91). They also had before them a background paper on recent economic developments in Israel (SM/91/199, 9/25/91; and Sup. 1, 10/25/91) and a statement by the Fund representative to the 1991 Consultation of the GATT Balance of Payments Committee with Israel (EBD/91/310, 11/21/91).

Mr. Posthumus made the following statement:

> The surge of immigration that began in 1990 and is expected to continue in the next few years presents Israel with a challenge to open the country's economy, not just its borders. It also presents Israel with a great opportunity to involve both the established population and the new immigrants in the growth process. My authorities are aware that to absorb this wave of immigration they have to change course in their economic policies. Rather than be one of the main economic actors itself, the Government will set the stage for the private sector to carry the growth process. Liberalization of markets for goods, services, and capital; privatization of government enterprises; deregulation; and price stabilization are the targets of a policy that has evolved in recent years. The authorities are intent on making its full implementation a matter of greater urgency.
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> Economic growth in 1991 has, for the second year, been driven by the influx of immigrants--primarily from the U.S.S.R. Some 380,000 immigrants arrived in 1990 and 1991--contributing 8 percent of the almost 10 percent population growth rate in these two years. Economic activity was temporarily halted during the first

quarter of this year, owing to the Middle East crisis. Even so, the expected GDP growth rate of 5.5 percent will be slightly over last year's rate, reflecting a higher level of aggregate domestic demand. Domestic demand rose primarily because of a rapid expansion in construction and an increase in public expenditure. But while domestic demand accelerated, exports suffered a setback leading to the reversal of the current account balance from surplus to deficit. Exports of goods and services are projected to decline in 1991 by 2.5 percent, mainly because of the shortfall in receipts from tourism as a result of the Middle East crisis.

Notwithstanding the large increase in housing prices, inflation in 1991 is expected to remain within the 15-20 percent interval that has been experienced over the past five years. As a result of demand pressures for housing that have built up during the past year and a half, housing prices have spiralled. Over the past 12 months, the Consumer Price Index (CPI) has risen by 19.4 percent, but excluding the housing component of this index, the figure is 16.5 percent. The CPI for October, 0.4 percent, shows a decline in the housing component, suggesting that housing prices have peaked. A wave of expectations for an adjustment of the exchange rate that was reflected in speculative purchases of foreign exchange may have been prompted by the temporary acceleration of inflation during the second quarter. The Bank of Israel responded by allowing short-term interest rates to rise to defend the exchange rate and signal monetary restraint. The firm stance of the central bank appears to have paid off, as private purchases of foreign exchange have subsided.

As I mentioned at the beginning of my statement, the authorities are intent on deregulation and liberalization of the economy. At present markets can be ranked in increasing order of regulation and inflexibility: financial markets, external trade, goods markets, and the labor market. This ranking reflects both the institutional resistance to reform and the degree of progress that has been made since the introduction of the Stabilization Program in 1985. My authorities fully realize the particular importance of removing the rigidities in the labor market to increase employment and secure long-term growth. At the same time, they are well aware of the slow progress in this respect. Accordingly, the dialogue with the social partners will continue, in order to phase out the automatic wage adjustment mechanisms and change the minimum wage law.

In deregulating financial markets, further progress has been made with the introduction, earlier this month, of a set of measures in the foreign exchange and capital markets. These measures are intended to accelerate the process of opening up Israel's financial markets by removing administrative restrictions on deposits, property, and capital inflows and outflows. These restrictions have interfered with the money markets and hampered the economy's growth potential. They will be replaced by market-based policy instruments. The new measures will bring Israel further into line with other industrial countries and will strengthen links with international markets. This reform is particularly important in view of the country's financing needs over the next few years. While these measures serve to increase the efficiency of the financial markets, they also make it necessary to add to the monetary policy instruments at the disposal of the central bank. These changes will enable the monetary authorities to cope with problems arising from unusually large capital inflows and outflows and from movements on local money markets.

My authorities attach great importance to the introduction of a three-year budget framework. The 1992 budget and policy statement has already been presented to the Knesset in this new framework, with the elimination of the fiscal deficit by 1995 as the main quantitative target. Increased public expenditure related to the absorption process of the immigrants has led to a widening of the fiscal deficit in 1991 to 6.7 percent of GDP. This deficit is expected to narrow to 6.2 percent in 1992, then to 3.2 percent in 1993, and 2.2 percent in 1994. My authorities' estimates vary from the staff's mainly because they exclude from their definition of the deficit net lending by the Government, which they do not consider an expenditure.

The authorities will step up the privatization process during the next three years. A special ministerial committee on privatization has taken a number of specific decisions. Israel Chemicals, the biggest government-controlled conglomerate, will be sold; a first tranche is expected to go on the market before end-1991. Government holdings in "Bezek," the Telecommunications Corporation, will be reduced to less than 30 percent. The preparations for selling the bank shares held by the Government will be completed; the immediate target is to sell the shares of at least two of the four banks by end-1992.

The absorption process entails a current account deficit in the medium term, because immigration has an immediate impact on domestic demand, whereas its contribution to output comes only later, and the investments required in the absorption process exceed those that can be financed out of national savings in the medium term. The external debt will inevitably grow, although at a lower rate than at the beginning of the 1980s. My authorities agree with the medium-term outlook presented by the staff but wish to point out that the staff's analysis is made in terms of gross external debt--a definition that does not take into account the foreign currency reserves of the central authorities and the banking system's assets abroad. In view of the substantial extent of the latter, the "gross" definition rather overestimates the degree of indebtedness. My authorities also wish to note that the three-year budget presents a change in priorities in favor of investment in infrastructure as against public construction. This shift should justify some increase in foreign debt.

As noted earlier, since 1985 the annual inflation rate has been on the order of 15-20 percent. The exchange rate of the sheqel is linked to a basket of currencies. Since the beginning of 1989, the sheqel has been allowed to fluctuate within a certain band. This band, which was first set at 3 percent on either side of the central rate, was subsequently widened to 5 percent. At the same time, the central rate itself has been adjusted a number of times; however, notwithstanding pressures on the authorities, the exchange rate has not been used in order to improve competitiveness. As such, the exchange rate policy has contributed to moderate inflation. The authorities' stance is to use the exchange rate as a nominal anchor for price stabilization.

Extending his remarks, Mr. Posthumus said that two-and-a-half years had passed since the previous Board discussion of a staff report for an Article IV consultation with Israel; according to the new schedule, it would be two more years before the Board would hold such a discussion again. Although that schedule was acceptable on a temporary basis, the interval between consultations was lengthy. Therefore, it was important, not only for Israel, but also in all bicyclic and 24-month cases, that a special consultation be held if external developments warranted it.

The Acting Chairman noted that the policy on supplementary consultations remained in effect.

Mrs. Krosby made the following statement:

The central feature of the contemporary Israeli economy is the absorption of the surge of immigration that is now under way. The staff representative from the European Department could perhaps shed light on whether or not this immigration from the U.S.S.R. would change radically over the next year. As Mr. Posthumus notes in his opening statement, this immigration presents Israel with a challenge "to open the country's economy and not just its borders." The stabilization policy adopted in the latter half of the 1980s has put Israel in an improved, but still far from ideal, position to cope with this historic challenge.

The thrust of supply-side policy has been to reduce the intervention of the state in the functioning of the economy. Deficits and debt have been brought under better control. There is a broad unfinished agenda of fiscal consolidation and structural reform that needs to be pursued with determination if the economy is to maintain its balance and its vitality as it seeks to absorb an anticipated 25 percent increase in its population. We are concerned that in the post-stabilization period there has seen a slackening in the required policy determination.

Some policy accommodation to the cyclical downturn was undoubtedly appropriate. However, the policy discussions summarized in the staff report suggest that there is some complacency among the authorities about the need for firm financial discipline. This shows up particularly in the discussions of inflation, where the authorities are fairly clearly resigned to accepting the current range of 15-20 percent inflation. On page 12 it is reported that in the previous two years "monetary policy aimed at the lowest interest rates that were consistent with the major monetary aggregates growing in line with an inflation rate of around 15 percent." This approach sounds like a monetary policy willing to run inflation risks to stimulate activity. The subsequent exchange market pressure and monetary tightening this year confirm the impression that monetary policy had turned overly aggressive.

The immigration wave that is now building will transform the Israeli economy. It will shift the center of gravity for economic policy. The wealth of human capital that the immigrants bring with them will need to be matched with supporting tangible and financial capital. The economic case for a major, but temporary, increase in investment beyond the immediate savings capacity of the internal economy is straightforward. Increased public spending, both on the current and the capital accounts, will be needed to support the absorption of the immigrants. This much is clear-cut. But the rationale for an historic adjustment should not be used as justification for a general relaxation of policy. Vigilance will be needed to insure this relaxation does not occur.

The broad contours of the authorities' strategy appear to be appropriate. The "direct absorption" approach enunciated by the authorities is attractive. While providing financial support through an "absorption basket," the general approach is designed to foster private initiative and minimize government involvement. Likewise, the anticipated expansion of overseas borrowing shows an appropriate phasing between public and private demands on capital markets. Public sector requirements would be front-loaded, but as immigrants are integrated into the work force, private investment would come to the fore, and public sector deficits would recede.

While we agree with these contours, we have doubts about the details. The summary on pages 14-15 of the staff report of the budgetary impact of immigration-related expenditures indicates that there is substantial scope for extensive and expensive government involvement in the settlement process, despite the intention that government involvement would be minimized under the "direct absorption" strategy. As it has been implemented, the housing construction and mortgage lending programs are already raising budgetary outlays beyond programmed levels. Inclusion of temporary wage subsidies can easily lead to inflated budget costs and distorted labor markets. Increased lending for high-risk investments and government participation in new nonmilitary businesses suggest a substantial government involvement in the allocation of jobs and investment. The Government's increased contingent liabilities will expose public finances to significant risks, as was demonstrated by the banking failures of the early 1980s. Could the staff elaborate a little more on how the authorities intend to circumscribe their involvement in the immigrant absorption process?

The anticipated bulge in government spending and borrowing seems to be coming through quickly and strongly. The trend is worrisome. The 1991 jump in the deficit of the Central Government to 10 percent of GNP from 5.5 percent in 1990 is large, even allowing for the qualification of shifting to a new fiscal year and taking into account differences between national and Fund accounting definitions. Large as this projected deficit is, it seems to rely on optimistic projections for privatization receipts equivalent to 2.0 percent of GNP. In all likelihood, this objective will not be attained. Whether or not net lending is recorded as part of the government deficit, at 3 percent of GNP it does indicate a large role for the state in channeling funds to the private sector. In his opening statement, Mr. Posthumus indicates that the public sector deficit will taper off substantially in 1993 and 1994. We hope this proves to be the case, but we believe the authorities should take a cautious approach now to early increases in borrowing, whether at home or abroad, in the event that immigration and growth do not materialize as expected.

We would encourage the authorities, in their understandable preoccupation with the problems of immigrant settlement, not to be deflected from the further progress necessary in structural reform. Lagging reforms of labor market practices need to be given a high priority if the full productive potential of the expanded labor force is to be achieved. Financial and capital market reform still have a long way to go. As the staff report makes clear, many existing distortions are a legacy of schemes for forced funding of the Government. Financial reform and deficit control will have to go hand in hand if the strategy of "direct absorption" is to be successful. Trade reform has made a good deal of progress, and we would be interested in any additional information the staff might have regarding a timetable for complete elimination of all import licensing requirements.

The Israel authorities face major challenges in managing their economic transformation. My authorities, along with those of many other Fund members, take a keen interest in this process. In the staff report, which was drafted and circulated in September, it is noted that the Israeli authorities had expressed an interest in returning to the annual consultation cycle. As a first step, they had asked to re-establish the original timetable for bicyclic consultations. This change would have involved interim consultations early in 1992 and full consultations early in 1993. The staff, noting that the economic difficulties of immigration justified frequent surveillance, stated that, at the time of the next full consultation, they intended to recommend return to an annual cycle of consultations. We would have warmly supported such a recommendation. It is unfortunate that, under the temporary changes in consultation cycles, Israel will be shifted to a 24-month cycle. The result will be that, instead of having had two additional consultations with Israel by early 1993, our next consultation will now not occur until the end of 1993. The Israeli case would seem to fit the circumstances contemplated in the third paragraph of the Managing Director's statement on the consultation cycle. We believe it would be fully in keeping with that paragraph for Israel to remain on the bicyclic consultation cycle and would ask for the Board's approval.

Mr. Kyriazidis made the following statement:

Although there are many concrete reasons to be optimistic about the long-term future of the Israeli economy, the country is at a difficult crossroads. A delicate balance must be struck over the medium term between the need, on one side, to contain demand pressures and, on the other, to enhance the response of the supply structure of the economy.

The significant achievements of Israel's adjustment efforts begun in 1985 have survived to this day--in itself an important result. However, the process of adjustment cannot yet be regarded as complete and consolidated. There is a great deal of risk at a time when the economy is entering a prolonged phase of strong demand pressures and growth. In fact, in the absence of an adequate policy framework, the resurgence of high inflation and large financial imbalances carries with it a potentially disruptive risk that could compromise Israel's successful transition to a path of sustainable development.

The solution to this problem depends on the authorities' full recognition of these risks and on whether their intention to avert them is strong enough. Until mid-1991, their policy track record was not reassuring, because their monetary and fiscal policy stance had been relaxed considerably. Moreover, their argument that the social costs of disinflation were too high when there was no social consensus to make combatting inflation a top priority is a reason for serious concern. We are glad to see that some changes in the Government's attitude have taken place in the last few months, especially in the monetary policy, and we strongly hope that new attitude will be further reinforced. It is essential that inflation be brought down substantially, though gradually, and that the medium-term policy framework be designed with this clear objective in mind.

This chair endorses the staff appraisal and associates itself with the staff's recommendations. On monetary policy, we appreciate the authorities' resolve to abandon the interest rate pegging they had pursued until mid-1991. This decision restores an important instrument to fight inflation to the monetary authorities' armory. In this connection, we also welcome the Government's recent move to expand the Bank of Israel's authority over open market operation instruments and reserve requirements. It would seem, however, that the response of the bank lending rates to the central bank's signals is quite slow and weak due, to a large extent, to the oligopolistic structure of the banking system. Also, preferential treatments remain for interest rates on government bonds. To enhance the efficacy of monetary policy, it is important that the reform in the financial market address these two problems soon.

As to fiscal policy, we appreciate the Government's decision to frame the annual budget proposal within a medium-term plan. We regret, though, that such a wise decision has not been taken as an opportunity for the authorities to signal with the 1992 budget their determination to a follow a tight budget policy--one that would certainly continue to accommodate social investment needs related to immigration, but would also aim to rationalize drastically the budget structure, expand the revenue base, and cut non-priority and distortional expenditures. The staff's recommendations do not seem to have been strong enough and well enough articulated in this respect, and the proposed 1992 budget proposal seems to move in exactly the opposite direction to the one indicated in the medium-term plan.

With respect to the labor market, one can expect significant results from the climate of cooperation between the social parties. Given the extreme importance of a flexible wage structure for improving the supply response of the economy, however, ways should be found to give adequate representation at the wage negotiations to the unemployed segments of the work force to reduce as much as possible the market insider-outsider inconsistencies.

We were pleased to read in Mr. Posthumus's statement his closing remark about the authorities' intention to use the exchange rate as an anti-inflation instrument. This intention is reassuring. We are somewhat puzzled, however, by the difference between Mr.Posthumus's and the staff's assessment of the actual objectives of the exchange rate policy. The staff argues that "the central rate was devalued when deemed necessary to bolster competitiveness"; Mr. Posthumus states that "the exchange rate has not been used in order to improve competitiveness." It would be interesting to know how these two positions can be reconciled. Moreover, until the authorities' financial stance remains consistent with a 15-20 percent inflation rate, the exchange rate will have to be periodically adjusted if competitiveness is to be preserved. An exchange rate that acts as a nominal anchor will only be possible when the authorities show full commitment to a low-inflation policy stance.

As the staff has very well put it in its appraisal, in Israel "the consensus about immigration should be exploited to push ahead with structural reforms which, in more normal times, would be prevented by one group or another." This consensus is, indeed, a great opportunity that the authorities should not risk missing. Many important moves have already been made, as the progress achieved on trade, financial, and labor policies shows. Much, however, remains to be done along the lines indicated by the staff, and we would urge the authorities to take further decisive steps in this direction.

Mr. Landau made the following statement:

The Israeli economy is now facing a shock of exceptional magnitude with the arrival of a new wave of immigrants. As underlined in the staff report, it is both a demand and supply shock with different impacts in time. The challenge, then, is to minimize the lag between the increase in demand and the supply response to keep transition costs under control and bring the economy on the path of strong and continuous growth, together with a sustainable external balance. This task might prove all the more challenging for the authorities because the economy is still prone to inflation and subject to many rigidities.

In this context, we agree with the many recommendations of the staff report: the key to success lies in a strong increase in investment. Let me deal briefly with the four main issues involved. First, investment in the business sector will depend heavily on expected profitability. As the experience of the past two years has shown, this expectation could be compromised by real wage rigidity. In effect, in 1990-1991 too large a part of labor productivity gains were nonetheless absorbed by wage earners, without a sufficient increase in profits. This turn of events might be the result of some kind of "inflationary illusion" and a mistaken assessment by the parties to wage bargaining of the rise in relevant prices--a gap of around 7 percent appeared between the consumer and producer price indexes, which led to both a decrease in real consumer wages and an increase in real producer wages. But this evolution also illustrates the lack of flexibility in the labor market. The staff is right, then, in stating that "the consensus about immigration should be exploited to push ahead more structural reforms which, in more normal times" would prove difficult. Failure to do so, as far as the labor market is concerned, would bring the danger that the immigrants would experience long periods of unemployment and that inflation would accelerate. In this framework, a reform of wage indexation systems might prove appropriate.

Second, the inflation situation has not been stabilized. At the level of 15 percent to 20 percent, the risk of sudden acceleration is ever present. Making the reduction of the inflation rate an objective of monetary policy, as recommended by the staff, might be difficult, however, in a context of strong demand pressure. But everything should be done to prevent it from exceeding the present level. Monetary policy should be tightened to the extent required, and the authorities should not shy away from increasing interest rates when necessary to maintain or strengthen their credibility. I agree with the staff that the exchange rate has a role to play in the stabilization process; by not systematically accommodating the inflation differential--and thus accepting some real exchange rate appreciation--the authorities would help to alleviate demand pressure, reduce import costs, and influence wage expectations. As stated by Mr. Posthumus in his opening statement, the exchange rate must and will play a role as a nominal anchor.

The third critical issue is the one of foreign indebtedness. There is, theoretically, a good case for some increase in the foreign debt in the face of the present shock to the Israeli economy. It could and should be used to finance investments that would later generate future growth and internal savings. However, as underlined by the staff, uncertainty about the amplitude and speediness of the supply response would deserve caution. The authorities should not find themselves in a situation where the combination of slower than anticipated growth and quick increase in foreign debt would trigger a dangerous and unsustainable dynamic.

My last remark includes a question for the staff. Meeting with the needs for integrating such a number of immigrants implies many direct and indirect costs for the Government and the economy--education, training, adaptation, and infrastructure development costs. Is there a precise assessment of what these costs will amount to? How are they going to be met? Can we rely purely upon the "direct absorption approach," and leave the economy to adjust itself after having given direct support to the immigrants? Is there going to be some more specific intervention of governments or local authorities, and what would be the impact on public finance and the overall financial strategy? I would certainly appreciate some comments by the staff in this regard.

Mr. Wright made the following statement:

I agree with other speakers about the central importance to policy in Israel posed by the massive immigration. The immediate increase in domestic demand and the public expenditures associated with this immigration have the potential to add significantly to inflationary pressures over the next few years. The challenge for the authorities is to stimulate the supply-side response and capitalize on the high skill levels of the immigrants, but to do so in a way that does not add to domestic demand pressures in the short term.

A rise in inflation, or even its persistence at current levels, would be inimical both to the needed expansion of capacity and the assimilation of additional labor. The authorities must, therefore, maintain strict control over fiscal policy. It is encouraging that the authorities are contemplating a less dirigiste approach than in the past, but it is hard to avoid the impression that they are still reluctant to trust the market. The paper describes the expected sharp increase in housing costs, transfer payments to new arrivals, training, and special employment measures. These expenditures seem broadly appropriate, but it is essential that they are targeted efficiently. I am not convinced that direct spending by government on housing and mortgage lending is efficient, and I would hope that any subsidies to wages of new employees will only be temporary and will be targeted to provide genuine additionality.

I recognize the importance attached by the authorities to ensuring adequate housing for new arrivals, but the paper reveals a considerable and, I would say, unwarranted reluctance to rely on market forces to ensure that resources are allocated more efficiently and on the appropriate time scale.

To the extent that these expenditures impose a fiscal burden, they should be offset to the greatest extent possible by savings in public spending, increased efficiency, and reductions in subsidies elsewhere. In this context, I welcome the move to medium-term budget planning, which will help in monitoring the projected deficit. However, I was concerned to see in the supplementary note that the September budget proposal for 1992 does not provide for the same degree of fiscal restraint as the staff had recommended, and that in practice, several of the provisions are expected to encounter resistance in the Knesset. Although the across-the-board real cuts in expenditure of government departments are not expected to reach the Defense Department, it is at least welcome that defense spending continues to fall as a proportion of GDP.

Excessive growth in real wages of those workers in employment will contribute to inflationary pressures and restrict the growth of employment among new arrivals. For this reason, labor market flexibility is of particular importance. Wages need to respond flexibly both to labor supply conditions and to productivity. Low inflation will be essential to this process. If the already relatively high inflation rate is allowed to continue or rise further, relative price signals will increasingly become confused with general price rises and have a deleterious effect on the speed and efficiency with which the new labor is assimilated. In particular, the public sector should not be insulated from any downward pressure on the overall level of real wages associated with immigration.

On monetary policy, I am most concerned that the authorities have in the past adjusted interest rates with the aim of setting a target for inflation as high as 15 percent. Inflation has now reached about 20 percent, and the authorities should not shy away from raising interest rates further if this should prove necessary. I was encouraged to hear of moves in this direction during October, but like Mrs. Krosby, I am unclear so far about the authorities' genuine resolve in this area.

I am also concerned about the past practice of adjusting the exchange rate to offset inflation differentials with trading partners and thereby protect competitiveness. I strongly support the staff in urging that the exchange rate should not be automatically adjusted in this way. Rather, competitiveness should be protected through containing the growth in domestic labor costs. I was pleased to see Mr. Posthumus's comments on this point in his opening statement. The past practice of depreciation, together with the subsidized arrangements for insulating domestic producers from the consequences of inflation differentials, will have contributed significantly to inflation. I would say in this connection that in the measurement of the competitiveness of the traded goods sector, the real effective exchange rate adjusted by the wholesale price of manufactured goods seems to me to be much better than adjusting for the consumer price index, which has become distorted by the high growth in housing costs. Looking at the relevant line in Chart 2 of the staff report, there does seem to have been a significant competitive devaluation since 1989, notwithstanding Mr. Posthumus's reassurance and the reversal of this policy in the second half of last year. Perhaps the staff could comment on this interpretation and offer some more reassurance on the precise stance that the authorities are now adopting on exchange rate policy.

The recent moves toward reform of the money and capital markets will to some extent facilitate more efficient monetary policy. However, like others, I remain concerned at the wide differential between deposit and lending rates and other manifestations of a heavily distorted financial market structure. I agree with the staff that financial reform must be speeded up and that these restrictions and distortions should be eliminated as soon as possible.

As to the proposed decision, in the absence of any firm timetable for the elimination of the remaining exchange restrictions, which are very damaging to the effectiveness of financial policy, I support the staff recommendation not to grant approval under Article VIII.

The Deputy Director of the European Department said that, with respect to possible changes in immigration projections over the next few years as a result of developments in the U.S.S.R., the staff's immigration projections depended largely on the Israeli authorities' own projections, which were based on inquiries that they received through their offices in the U.S.S.R. and elsewhere. In their view, push factors were important in a longer-term sense and always tended to be present between the U.S.S.R. and Israel, owing to the difference in living standards and various social factors. The precise timing was influenced more by developments affecting pull factors in Israel than by developments in the U.S.S.R., although changes there could affect the timing, as had happened earlier in 1991, when the Soviet regulations changed and caused immigration to accelerate. The Israeli authorities were concerned that the failure of the economy to take advantage of the immigrants' skills and to expand at the rates projected to be necessary to absorb them would discourage immigration. The projected arrival of 1 million immigrants over the coming five years depended more on the achievement of those goals in Israel and less on events in the U.S.S.R.

The new licensing procedure for imports from regions other than the United States and the European Community was essentially a recording procedure; licensing was automatic, the Deputy Director explained. When the new tariffs that had been introduced to replace licenses were reduced to the low target levels set for the mid-1990s, the remaining licensing procedures would likely be dropped.

Attempts were being made to reduce the scale of public sector involvement in housing, but the issue was highly politicized, the Deputy Director noted. The Finance Ministry's views differed from those of the Housing Ministry. In the budget for 1992, it was assumed that housing starts would be lower in 1992 than in 1991, although expenditure would actually be about the same--maybe even slightly higher--because of the continuation of existing construction projects. Over the longer term, the expenditure on immigration would diminish with the decline in immigration. However, there were no immediate plans to make major reductions in direct expenditure on immigration.

As to precise estimates of the costs of intervention to finance immigration, the budgetary figures were set out in Table 2 of the supplement to the staff report, the Deputy Director commented, which showed that the costs had continued to rise. There had also been a change in composition, with a move toward more expenditure on housing. Initially, expenditures had concentrated on direct absorption, which meant the provision of an initial sum of money to immigrants and the payment of associated costs for them when they first arrived. There were various schemes for wage subsidies and training programs, some of which were operated at the local level and did not necessarily cost much. The costs of all those were included in the totals given in Table 2.

The authorities' exchange rate policy had given priority to maintaining competitiveness, but not to seeking to improve it, the Deputy Director said. The authorities had therefore placed less emphasis on using the exchange rate as a nominal anchor in recent years. In October the authorities had firmly resisted market pressures for a depreciation. A shift in policy might be occurring; however, it was too early to say--one should not base any conclusion solely on that one event.

With respect to whether there had been an attempt to engineer a real devaluation over the past few years, the Deputy Director of the European Department remarked, the quality of the wholesale price data that underlay the real effective exchange rate series in Chart 2 was not high; for that reason, the consumer price index data that was more reliable, although less economically meaningful, had been added. Moreover, the debate in Israel about the appropriate level of the real exchange rate had not dwelt on the past two years exclusively; instead, it had focused on the whole period since the 1985 stabilization. A real appreciation had taken place from the end of 1986 to early 1988. The authorities--the Bank of Israel in particular--were under heavy pressure from exporters and others to reverse that appreciation. Although there had been wide fluctuations in the real exchange rate, there had not been a strong trend in the series based on wholesale prices since the 1985 stabilization to the extent that this particular data series could be relied on.

Mr. Goos made the following statement:

I fully endorse the analysis and recommendations outlined in the staff appraisal. There is one aspect, however, which I found peculiar, and that is the staff's warning on page 22 of the staff report not to be "too ambitious" in bringing down inflation and, instead, to pursue a gradual approach to price stabilization. Unless I have misread that part of the appraisal, this advice appears quite innovative or at least astonishing, especially in view of the inflation rate that is hovering around 20 percent. Some clarification by the staff on this issue might therefore be helpful.

The importance of the staff's core recommendation that the authorities "contain the inflationary and balance of payments pressures...while attempting at the same time to speed up the increase in supply..." can hardly be overstressed. It is reminiscent of advice that was extended to Germany in the context of the discussion of the most recent Article IV consultation. Israel's economic problems are not unlike the challenges currently facing Germany's economy. In fact, like Israel, my country had to tackle an immense exogenous shock resulting from large additions to the West German population and from a host of profound structural problems that it inherited in the new eastern states. As a result, my authorities have to struggle with extraordinary budgetary demands and with inflationary pressures that are rather exceptional in the German context.

I certainly do not wish to overstress this comparison, nor do I want to engage in a discussion on the appropriateness of German economic policies. But I think it is fair to say--and this comment might provide some encouragement to the Israeli authorities--that my authorities have fully embraced the Fund's policy advice with fairly satisfactory results to date in the maintenance of domestic and external stability.

Against this background, I am glad to note from the supplement to the staff report that the central bank has recently tightened the monetary policy stance and increased interest rates. I certainly hope that this move is not a one-time event but, instead, signals a fundamental change in the orientation of monetary policy toward what it is supposed to achieve, and what it can achieve best, namely, the restoration of domestic price stability and the maintenance of external viability. The futility of the previously expansionary thrust of monetary policy in support of growth-related objectives was clearly underlined by the observed increase in the rate of inflation, the strong surge in import demand, and the balance of payments pressures. I therefore hope that the authorities will be able to stay their new stability-oriented course, which I believe would be greatly facilitated if the widespread indexation mechanisms were eliminated--sooner rather than later. At the same time, I wonder whether a significant slowdown in the rate of inflation is feasible in view of the rather ambitious targets that are set for overall economic growth--on the order of 6-7 percent.

The success of monetary policy hinges critically on the support of firm fiscal policies. In this respect, I would merely associate myself with the views expressed by the staff and previous speakers. But maybe I should emphasize that a much stronger front-loaded approach would have been advisable to bolster confidence in the authorities' adjustment strategy and in the viability of their medium-term consolidation strategy. The appropriateness of the envisaged path of consolidation is arguable. There, too, the Government would be well-advised in view of the uncertainties and the downside risks surrounding future economic developments--and here I again refer to the rather ambitious rate of growth--to aim at more ambitious consolidation goals or to achieve a more sustainable deficit in a shorter time period than is being envisaged.

I think that the staff has made an important point in stressing that the authorities should seize the momentum of the consensus that exists now about immigration to push vigorously ahead with adjustment and reform. I deliberately mention adjustment, not reform only.

Ms. Szombati made the following statement:

During the past two years, Israel's performance has been strongly affected by an immense wave of immigration that has generated not only a rapid recovery in growth and productivity, but also excessive domestic demand pressures. The staff points out that elimination of these pressures will require a supply-side response that can only be expected in the longer term, so that demand restriction will be needed to maintain macroeconomic stability in the meantime. I broadly agree with the staff's appraisal and policy recommendations for both the short and medium term, especially in the fiscal and monetary areas. The staff is correct to note that the authorities' accommodative financial policies run the risk of spiralling inflation and that both fiscal and monetary policy actions to restrain domestic demand are called for. Given the urgency of the situation, the 1992 budget's weaker than expected curtailment of nonimmigration expenditures is particularly disappointing.

The continued high inflation rate and strong pressure on the balance of payments reflect the rigidities and distortions that hamper the economy's absorption of the large numbers of immigrants arriving in the country. The staff correctly points out that increasing the investment rate will be crucial to this absorption process. I would add, however, that an acceleration of structural reforms will also be necessary to permit these additional human resources to be utilized rapidly and efficiently as a factor favoring economic growth.

Progress in the privatization of public enterprises is essential not only for reducing the Government's involvement in the absorption process, but also in other important areas, such as resource allocation, the pricing mechanism, and job creation. We welcome the Government's privatization efforts and urge the authorities to create the mechanism and regulations needed to expedite the privatization of public enterprises. Expansion of the private sector will increase competition and job creation and accelerate the absorption process. Reducing the share of the public sector will also help lower fiscal expenditures for transfers and subsidies to domestic production. Rigidities remain to be eliminated in the labor market despite the recent abandonment of direct government interventions in the area of job creation. To make the larger private sector more sensitive to wage costs and labor efficiency, greater flexibility in employment and wage contracts will be required and necessitate reforms to discourage the unions from taking bargaining positions that are not justified by the market.

Let me turn now to the financial sector, which Mr. Posthumus' statement ranks first in terms of inflexibility. As the staff documents point out, the financial system is segmented, with a large share concentrated in government hands, and is subject to extensive government regulation that distorts the allocation of resources. We welcome the recent renewal of liberalization efforts that have removed most foreign exchange controls and some administrative restrictions. These measures will help reduce the distortions in the domestic money markets and encourage the capital inflows required to satisfy Israel's sizable need for external resources. So far, however, there has been no progress with privatization, which would greatly aid in correcting the lack of competition that is a major shortcoming of the financial sector. I would like to know what steps the authorities are planning in this area.

Finally, the continuation of trade liberalization to open up the country to world markets is vital for improving competitiveness and efficiency. We commend the authorities for their recent important initiative that replaced nontariff barriers with tariffs, but we still feel that much remains to be done. We urge Israel to continue its trade liberalization by eliminating the distorting import taxes as soon as possible and by reducing the high transitional tariffs applied to "third" countries.

Mr. Solheim made the following statement:

The Israeli economy is at a critical juncture, and the application of a steady policy is essential to ensure sustained favorable developments. The major economic-political issue facing the authorities is how to integrate successfully, over the course of a few years, the influx of immigrants expected to amount to about one fifth of the current population.

To absorb such a large influx of manpower, it is essential for the authorities to create an environment that will generate a flexible supply response. The staff notes that the opportunity provided by the consensus on immigration should be exploited to push ahead with structural reforms. I would add that this possibility for change is not only an opportunity, but a necessity. Like the staff and Mr. Posthumus's comments in his opening statement, I welcome the liberalization efforts of the authorities. Promoting well-functioning markets by removing rigidities, particularly in the labor market, is essential for the creation of employment opportunities. In this context, the relatively high educational standard of the immigrant population should favor the expansion of the economy's productive capacity.

The reorientation of economic policies, with the promotion of markets and the changed role between the public and private sector, must, however, be followed up with a firm macroeconomic policy stance, providing a stable framework for private sector decisions by bringing down inflation and keeping domestic demand in check. It is essential that the investments being made be profitable to ensure Israel's future ability to service its increasing external debt.

A key to this strategy is adherence to the objective of eliminating the fiscal deficit by the middle of the decade. Given the aim of absorbing the increase in the labor force largely within the private sector, the authorities should regard this deficit reduction as a minimum requirement and rather err on the side of caution in implementing fiscal policy.

Finally, a liberalized financial market will require adequate supervision and a flexible, but firm monetary policy stance to ensure consistently positive real interest rates. On this point, I note the measures--listed in the supplement to the staff report--adopted by the authorities to liberalize the financial market. However, I would like to hear the staff's view on whether these measures will significantly contribute to stronger competition in the banking sector, with a consequent reduction in interest margins. Moreover, what is the scope for further deregulation to stimulate competition, including access by foreign banks?

Mr. Noonan made the following statement:

Since I am in broad agreement with the staff appraisal and the comments of earlier speakers who supported the staff position, I have confined my remarks to a few queries on Israeli attitudes to high inflation and on the medium-term path toward fiscal consolidation.

As to inflation, I share the concerns already expressed. The authorities seem unable, or unwilling, to reduce the rate of inflation below what is a relatively high level. The staff identify "a greater willingness to tolerate high inflation in Israel than in its major trading partners." I am puzzled why that should be the case--and particularly why that tolerance should persist.

At the present time, the authorities have to cope with a flood of immigrants. To facilitate their absorption into the economy, and particularly into the workforce, there is an obvious need to increase the supply potential of the economy. Indeed, it is claimed that priority is being given to that objective. That should imply the encouragement of savings and productive investment. Part of my puzzlement at the Israeli authorities' apparent tolerance of their high inflation rate arises because they must be well aware of the distortionary and adverse impact that a continuing high rate of inflation has on savings, consumption, and the pattern of investment. Consequently, I have to conclude that they must be especially sensitive--more sensitive than other authorities--to some of the social costs that they perceive to be attached to a reduction in the rate of inflation. I would be interested in learning a little more about these sensitivities that may help to explain Israel's greater tolerance of relatively high inflation rates and the maintenance of index-linking mechanisms that tend to support these high rates.

For instance, I wonder what the role of asset appreciation is under conditions of high inflation in determining this tolerance. The housing market is dominated by owner-occupied housing. Transactions in such a market would be largely financed by mortgages. Once a household acquired a property with mortgage finance in conditions of continuing high inflation, it would seem that in practically all cases they would benefit from uncovenanted increases in their net worth and in their real disposable incomes. That could give many households--and voters--a vested interest in a continuing high rate of inflation. Lest there be any misconceptions, I should make clear that my comments are not criticisms of owner-occupiers but of high inflation and how it can create features of the insider-outsider model in the housing market.

The provision by the Government of interest-free loans for up to 50 percent of the price of a property must strengthen the benefits of becoming an insider household. That point is made quite apart from the reservations of other chairs, which I share, about the impact of the Government's massive interventions in the housing market on a desirable market-determined balance between the supply and demand for housing.

As regards the medium-term path toward fiscal consolidation, others have already emphasized how critically important it is for Israel to bring the fiscal position under control. The establishment of a medium-term budget framework is a positive step in this process. However, little information has been provided either in the supplement to the staff report or in Mr. Posthumus's statement on the medium-term budget framework and how the goal of a balanced budget within four years is to be achieved, especially when set against the background of the 1992 budget. We wonder whether the Government has put in place, or plans to put in place, limits on the growth of expenditures or has firm plans for cutting back or phasing out certain expenditures. It would also appear from the divergent path of real wages in the public sector, with an increase of 3 percent in the first half of this year compared with the private sector, in which real wages declined by 6 percent, that a more coherent policy on public sector pay increases should be part of the effort at fiscal consolidation. In our view, some of the savings should also be sought in improved efficiency in the public sector, including the public enterprise sector and through a substantial scaling back of regulations and controls. Such regulations and controls not only contribute to serious economic distortions but clearly add to the costs of government. Perhaps the staff or Mr. Posthumus could clarify how the Government plans to contain expenditures over the medium term.

Mr. Spencer made the following statement:

I agree substantially with the staff appraisal and the thrust of earlier comments--that is, to maintain firm financial policies and encourage a faster supply response through broad-based liberalization measures, especially in the labor market.

I would like to emphasize the need for further strong measures to free up the financial system. Even allowing for the recent moves listed in the supplement to the staff report, the financial system is still characterized by a bewildering maze of controls and regulations, which necessarily impose a wide range of ad hoc taxes and subsidies on various sections of the economy. This system must necessarily impose efficiency costs on the economy, but in the situation that Israel now faces, with the prospect of a sustained period of high investment and growth, it is doubly important that distortions be minimized to ensure an efficient allocation of financial--and, hence, capital--resources.

In addition to improving the quality of investment decisions, further financial deregulation would also have various other advantages, one of which would be the enhancement of the monetary policy mechanism. Given the present monetary policy framework, concern about its efficacy merits further comment. On page 12 of the staff report, it says monetary policy aims at the lowest interest rates consistent with the money aggregates growing in line with inflation around 15 percent. The exchange rate is then free to fluctuate within margins, with occasional devaluations to maintain competitiveness.

In this context, I was wondering how--if I were the new governor of the central bank--would I actually make this policy work? In particular, how would I avoid an acceleration of inflation over the next couple of years, let alone achieve a reduction from the present level. First, I am not sure what interest rates are telling me because, with all of the various distortions, I am not sure what the effective interest rate level is. From Table 36, I can take my pick of anything from 12 to 70 percent. Second, I do not see that the money base or the money aggregates will be much of a guide for policy, because the ongoing deregulation must be shifting the demand for these aggregates by significant amounts. I noted in the table on the money base, in particular, that the M3 base had been falling steeply in real terms over several years, even though inflation has been trundling along at 15 to 20 percent.

The exchange rate seems to offer a better prospect as some sort of solid guideline for policy. As the Deputy Director of the European Department mentioned, the recent experience in October may suggest a change in approach, but history would suggest that exchange rate management consists of a fairly ad hoc arrangement of ongoing devaluations to maintain competitiveness--not much of a credible anchor at this point in time. In the circumstances, the preferred strategy may be some sort of predetermined sliding exchange rate target along the lines of the Mexican regime. Such an approach may provide a more credible nominal anchor in this situation. In the light of those observations, I would appreciate staff comments on what approach should be preferred not only to contain inflation, but also to reduce it.

Mr. Tabata said that it was his understanding that the staff had recommended the elimination of the accelerated depreciation allowance referred to on page 3 of the supplement to the staff report. Although they admittedly led to a distortion of the tax system, tax allowances could be useful, given some aspects of the Israeli economy--for instance, the substantial upsurge in immigrants--to help put the economy on a relatively high growth path and to expand production capacity on the supply side. The staff report had mentioned the need for private industry to expand; in the event, the accelerated depreciation allowance should be continued. The selective application of the allowance could also benefit the development of strategic industries. In Japan, after the oil price increase in the early 1980s, the accelerated depreciation allowance had been applied to investments in capital equipment for energy conservation or machinery embodied with highly sophisticated techniques. He would appreciate the staff's comments.

Mr. Marino made the following statement:

Israel's overall macroeconomic performance during the period under consideration has been characterized by a resumption of growth, an inflation rate that has been hovering around 15-20 percent in the post-stabilization period, an increase in the fiscal deficit, and a sharp contraction in the balance of payments surplus. Israel has been subject to both transitory and permanent external shocks that help explain to a large extent these macroeconomic developments. Nevertheless, the policy mix adopted by the Israeli authorities has also made an important contribution to recent developments.

With respect to structural adjustment, important initial steps have been taken. However, as Mr. Posthumus highlights in his opening statement, more efforts are needed to foster a supportive environment for the private sector--one in which the private sector can be the driving force of sustained growth, with low inflation and a viable external position, particularly in view of the surge in immigration.

In effect, Israel's main challenge over the coming years will be the absorption of a large number of immigrants while improving and strengthening its stabilization effort. In our opinion, two factors will contribute to achieve a successful stabilization: first, a major overhaul in nondefense related investment; and second, the removal of important remaining institutional rigidities to increase the flexibility of labor markets. In this context, we will focus our statement on three basic topics: first, on the adverse macroeconomic effects produced by distorted financial markets; second, on the importance of labor market flexibility, particularly in the face of a shock to the labor market; and third, on the need to restore price stability.

Israel's authorities have already implemented important measures aimed at liberalizing the financial sector. However, as the staff report points out "the financial system in Israel continues to be characterized by a concentrated banking system, by widespread indexation of financial assets and liabilities, and by government regulations which segment credit and deposit markets and constrain interest rates." These characteristics tend to perpetuate inflation, foster inefficiency in the allocation of financial resources, have an adverse impact on domestic savings, and may produce regressive redistributional wealth effects arising from subsidies and constraints on interest rates. These institutional characteristics may be potentially more damaging under current conditions because of the investment needed to absorb immigrants. Under conditions of financial repression, the financial system cannot perform well its basic task of channeling savings to investors.

Many of the new immigrants are highly qualified people. To utilize fully these valuable new resources to boost real growth, labor markets have to be able to respond flexibly. In this connection, we would encourage the authorities to adopt wage guidelines that link wage increases to improvements in productivity rather than to consumer prices.

We encourage the authorities to make every effort to reduce the inflation rate. Tight monetary policy can play an important role in containing inflationary pressures, supported by a steady decline of the fiscal deficit. Nevertheless, in this context we would appreciate some elaboration from the staff or Mr. Posthumus as to the reason why inflation, after having decelerated so sharply in the mid-1980s, has hit a floor at around the 15-20 percent level.

Israel faces a shock of historic magnitude. The challenge will be to seek ways to use the huge immigration in the most productive and least disruptive way. Allowing markets to respond flexibly and the support of the international community will certainly contribute to a smooth transition.

The Deputy Director of the European Department, in response to the question whether Israel should have a less ambitious growth target to reduce the rate of inflation, remarked that the growth target was more a scenario about the possibilities that could emerge with the projected amount of immigration. The scenario was not overambitious. It involved rising unemployment for the next three to four years, indicating that immigration would not be fully absorbed in the short term. There might be some element of ambition in the amount of investment required to achieve such a high growth rate. Nevertheless, one would expect considerable extra investment to be forthcoming in view of the opportunities that existed and the high rates of return that were achievable, given the additional labor and the increase in demand represented by the immigrants.

In the short term, the immigrants' impact was on the demand side, the Deputy Director noted. There was a large exogenous demand-side shock. Mr. Goos's analogy between Israel and Germany was relevant. Germany had likewise found it difficult to offset the inflationary pressures coming from that sort of a shock in the short term, and it would be unreasonable to expect Israel to do much better than Germany in that respect. In fact, the staff had been heavily criticized by the Israeli authorities for suggesting that any reduction in inflation was at all feasible at a time when the first priority was to absorb the immigrants.

As to foreign participation in banking, there were two issues: whether foreign banks could operate in Israel, and whether foreign ownership of Israeli banks would be contemplated, the Deputy Director remarked. There were limitations on access by foreign banks to the Israeli market; at present, only representative offices were allowed. However, the staff had been told that foreign banks had not expressed much interest in Israel because it was a small market. One never quite knew which came first--the willingness or lack of willingness of the banks, or the restrictions on doing business in Israel.

The Government favored selling shares in Israeli banks to foreigners with certain limitations, but some of the committees of the Knesset were opposed, the Deputy Director said. Specific details on bank privatization still had to be settled. Foreign ownership of a minority of shares might possibly be permitted, or one of the smaller banks might be opened to foreign ownership.

The recently announced liberalization measures would not have much impact on competition in the banking sector, the Deputy Director commented. Nevertheless, the staff welcomed those measures not only for their own sake but also as evidence that the authorities intended to continue their liberalization efforts. The authorities approached liberalization in a rather cautious way, preferring to go step by step and see what the results of each step were before taking the next step.

The reasons for the Israelis' continuing tolerance of inflation included the view expressed by Mr. Noonan that the institutions in the housing market were a factor, the Deputy Director remarked. The institutions in the economy generally, especially indexation in one form or another, protected people from inflation and, therefore, made them less concerned about it. Moreover, Israel's recent history of high inflation had not undermined society and may have caused Israelis to be slightly more tolerant of it than other countries.

The staff had not yet received an English translation of the document on the authorities' medium-term budgetary plans and the arrangements that they had put in place to achieve their targets for 1994 and the intervening years, the Deputy Director stated. The staff had not received a proper report on its main contents either.

With an inflation rate of 15-20 percent, some changes in the nominal exchange rate would obviously have to be made from time to time, the Deputy Director said. The choice between the step changes of the sort that the authorities had been adopting and some sort of rule or sliding mechanism was complicated and had to take account of a number of factors, not least the way in which expectations were formed in that economy. The staff did not have strong views on which was the more appropriate approach, although it recognized that there were some advantages to a sliding rule type system.

The accelerated depreciation allowances in Israel were generous, the Deputy Director commented. All investment expenditures could be deducted in the first year--an unusually generous provision. That sort of distortion--

especially between the cost of capital and the cost of labor--was of questionable value at a time when the top priority was to absorb the rapidly growing labor supply. In addition, investment efficiency had not been especially great, judged by capital productivity figures and other indicators; therefore, there were good reasons for moving toward an economic depreciation system, while continuing to encourage investment.

The authorities' overall policy stance had been a contributing factor in the maintenance of the 15-20 percent inflation rate, the Deputy Director of the European Department remarked. The authorities seemed to have been content to have an inflation rate of that kind. Their position had changed a little, depending on the business cycle. Immediately after the 1985 stabilization, they had been a little surprised that inflation had not come down more. They had tried to lower it further at that stage, without success. When the economy had moved into a recession in 1988 and 1989, the authorities had become concerned about the recession and so had eased up on monetary policy.

Mr. Wright noted that Table 4 contained quite a plausible scenario, with modest growth in productivity, but with some not insubstantial increase in unemployment. He wondered whether inflation was likely to be contained or whether there was a real risk of it rising over the medium term. He also wondered whether the operation of the exchange guarantee/exchange rate assurance scheme compensated exporters for differential inflation, which was not offset by a depreciation of the exchange rate. Several Directors had argued for a more stable exchange rate policy, but it would appear that such a policy might increase the associated fiscal costs if the stabilization of the exchange rate did not have an immediate effect on reducing inflation. Stabilizing the exchange rate itself would have some fiscal benefits in terms of exports and imports.

Mr. Noonan said that he wondered whether the disappointing return on investment could be attributed to the large housing element in the building and construction component.

The Deputy Director of the European Department responded that, when he had referred to the disappointing productivity investment, he had been thinking of not just the past year or two when housing investment had been high, but the longer run, when housing investment had not been especially strong.

A gradual decline in inflation--the approach suggested by the staff--was consistent with that medium-term scenario, the Deputy Director commented. Unemployment would, in fact, rise and put downward pressure on real wages to help contain inflationary pressures.

On the exchange rate guarantee scheme, the fiscal cost depended on whether or not the premiums were set at the right level--a variable under the control of the authorities, the Deputy Director of the European

Department said. The proper assessment of the impact of different exchange rate policies on a given premium level would necessitate a comparison of the situation in which the exchange rate was changed frequently with one in which it was changed infrequently. The average lag between the change in the exchange rate and the change in prices would likely be much the same, or at least the average level of subsidy for a given premium would probably be the same. The level of subsidy had been heavy, but it had decreased in recent years.

Mr. Posthumus said that, by definition, the absorption of the new immigrants--particularly the demand for housing and employment--meant that growth would occur. The authorities recognized that absorption could not be accomplished by the Government itself, as it had done in previous immigration waves of a smaller size. For the economy to do it would require the restructuring, liberalization, and other measures that had been mentioned in the course of the Board's current discussion.

As to financial policies generally, the stabilization effort had not slackened, and there was no complacency or lack of financial discipline, although a preliminary examination of the figures might indicate otherwise, Mr. Posthumus remarked. The Deputy Director of the European Department had given part of the answer. Since the 1985 stabilization effort, which was a clear indication that Israel would no longer accept a high inflation rate, the authorities' attempts to lower inflation progressively had not worked. The authorities were baffled by the failure to reduce inflation, but they were not complacent. The authorities had deregulated the financial markets as much as had been politically feasible; that deregulation would likely be accelerated with the measures of November 7, 1991.

In his opening statement, the final sentence dealing with exchange rate policy had been taken from the three-year budget and financial policy document that he had only recently received and that was not in English translation, Mr. Posthumus stated. The comment in his opening statement that the authorities had not tried to improve their competitive position through the exchange rate policy should be read in a somewhat longer-term context. There had been [illegible] rovement in Israel's competitive position after it had deteriorated following the previous exchange rate adjustment. To some extent, the exchange rate policy resembled the policies in effect in Europe during the initial stages of the European Monetary System, when a number of countries had to realign their exchange rates periodically and only gradually had reached the point at which, even though their authorities had not taken any explicit decision, there were no further changes in the exchange rates included in the mechanism. There had been considerable discussion in Israel about the introduction of a policy to devalue the real exchange rate annually to improve the competitive position, and strong pressure to implement such a policy had been exerted on the Bank of Israel. In October 1991, there had been speculation about a forthcoming exchange rate devaluation, but the Bank of Israel had repudiated that approach.

He agreed with the comments of the Deputy Director of the European Department on the privatization of banks, Mr. Posthumus remarked. In addition, the authorities had said that the largest bank would be privatized, and a prospectus was being written preparatory to a stock offering. Privatization remained an objective of the Israeli authorities, although privatization initiatives were proceeding more slowly than some of his authorities would like to see.

The Acting Chairman made the following summing up:

Directors concurred with the views of the staff as expressed in the appraisal. Directors observed that the surge of immigration presented the authorities with a major challenge. The immediate tasks ahead were to stimulate the supply response of the economy--capitalizing on the high skills of immigrants--and to keep the transition costs of immigration under control. Speakers generally were concerned that the Israeli authorities were too complacent with respect to inflation and financial discipline. At the same time, Directors urged the authorities to proceed with the structural reforms necessary to reduce the rigidities in the labor and product markets as well as in the financial systems; they therefore welcomed the Government's intention to reduce state intervention in the economy.

Directors were concerned that inflation had remained in a 15-20 percent range since 1986. The increased tolerance for such a high rate of inflation was worrisome. In this context, Directors noted the importance of the inertial elements, including wage rigidities, oligopolistic markets, and the role played by the loosening of monetary and fiscal policies. A steady decline in inflation through more restrained fiscal and monetary policies and increased labor market flexibility were seen as prerequisites for sustained stronger economic growth.

Directors observed that national wage agreements had made a useful contribution to wage restraint in recent years, but that widespread rigidities in the labor market had limited their effect on labor costs. Directors believed that the system of wage determination should be made more flexible; in that connection, minimum wage legislation should be revised and public sector wages reformed. Such measures have become particularly important in view of the need to absorb the sizable increase in the labor force from immigration.

Directors welcomed the adoption of a medium-term budget framework. However, in light of the large deficit budgeted in

1991 and its limited narrowing proposed for 1992. the already high level of government indebtedness, and the heavy overall tax burden, they urged the authorities to consolidate the fiscal position quickly and vigorously. This consolidation could be facilitated by a reduction in spending rigidities, increased public sector efficiency, and an acceleration of the process of privatization.

Directors pointed out that the tightening of monetary policy since the middle of 1991 was appropriate, and it should be sustained into the future. In this context, they supported the authorities in using the exchange rate to moderate inflationary pressures, while relying on improvement in labor market flexibility and productivity gains to ensure the medium-term competitiveness of the economy. They urged the authorities to eliminate the remaining distortionary taxes and subsidies applicable to foreign trade and payments as soon as possible.

Directors noted that interest rate spreads had come down, but were still high by international standards. They welcomed the recent steps to liberalize financial markets and encouraged the authorities to persist in their efforts to reduce market segmentation, simplify the regulatory structure, phase out preferential interest rates on government borrowing, and increase competition, both by admitting foreign competitors and by privatizing domestic banks.

Directors noted the weakening of the balance of payments in the course of 1991. They urged the authorities to move quickly and forcefully in implementing comprehensive structural reforms to facilitate the productive absorption of the immigrant labor force and increase the share of domestic savings in the financing of investment. Such measures, combined with prudent fiscal, monetary, and incomes policies, would enhance economic efficiency, encourage productive investments, and strengthen the viability of the external position.

With respect to the next Article IV consultation, Israel has been placed on the 24-month cycle on a temporary basis. Should external developments call for an earlier consultation, the matter would be brought to the attention of Directors.

The Executive Board took the following decision:

The Executive Board approves the recommendation by the Committee on Liaison with the CONTRACTING PARTIES to the GATT with regard to the guidance statement for the Fund representative attending the GATT consultation with Israel on November 26, 1991 as set forth in EBD/91/310, Supplement 1 (11/22/91).

Decision No. 9864-(91/157), adopted
November 22, 1991

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/156 (11/15/91) and EBM/91/157 (11/22/91).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/49 through 91/58 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/91/271 (11/15/91) and EBAP/91/272 (11/18/91) and by an Assistant to Executive Director as set forth in EBAP/91/273 (11/15/91) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/91/275 (11/21/91) is approved.

APPROVED: May 19, 1992

LEO VAN HOUTVEN
Secretary

Recent Economic Developments in the U.S.S.R.

1. Output, incomes and prices

The economic situation of the U.S.S.R. has continued to worsen. In the period January-September 1991, GDP is estimated to have declined by 12 percent. Industrial output fell by some 6 percent. Crude oil production decreased by 10 percent; domestic consumption fell by a much smaller amount, while exports of oil fell sharply by 40 percent. The 1991 grain harvest (excluding the Baltics) is projected at a level 25 percent lower than in 1990 with state procurements down even more sharply, implying that a growing share of grain output is being traded through the parallel distribution channels. Completed housing construction was down 18 percent.

Wholesale prices increased by 117 percent in January-September 1991 compared to the equivalent period last year and by 164 percent, September-to-September. The corresponding increases for retail prices were 70 percent and 100 percent, implying growing net subsidies. Household money incomes (mostly wages) increased in line with retail prices.

2. Fiscal developments

In 1991, there has been a serious deepening of the consolidated state budget deficit from its 1990 level of around 8.5 percent of GDP. Present indicators suggest that the deficit in 1991 could amount to 15-25 percent of GDP, depending on assumptions about inflation and the treatment of asset indexation following the 1991 price reform. 1/

Revenue has fallen significantly on all fronts mainly because of the decline in tax bases due to falls in output, trade, and the share of the state sector. At the union budget level, where revenue has fallen by more than 50 percent compared with 1990, the situation has been aggravated by the withholding of revenue by republics. Moreover, anticipated revenues from privatization, which had been earmarked to finance the social safety net and enterprise adjustment, did not materialize.

As regards expenditures, several factors have contributed to their relative buoyancy, including large price subsidies despite the April 1991 price reform, large compensating payments at both the union and republic levels, support for ailing industries, and growth of social programs and

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1/ Factors increasing uncertainty about the 1991 outcome include the shift in budget administration to the republics, the lack of reporting by many republics to the center, and the removal of certain functions from the budget to earmarked funds. The mission in Moscow is working, inter alia, on refining these estimates.

pensions. The domestic cost of foreign debt service has also risen significantly. The 1991 deficit is to be completely financed by recourse to banking system credit.

3. Money and credit

Both total credit and monetary assets are estimated to have risen by around 65 percent in the first three quarters of 1991. This compares with estimated retail price inflation of around 100 percent. Credit to government, which until the end of 1990 represented about two-thirds of total credit, expanded by 58 percent from January-September 1991. Approximately half of the credit expansion is accounted for by partial compensation by government to deposit-holders following the April price reform. Credit to the rest of the economy grew by nearly 70 percent in January-September.

Narrow money grew at roughly the same rate as broad money. The State Bank of the U.S.S.R. has increased the interest rate schedule by several percentage points compared with 1990. However, real interest rates remain strongly negative. Moreover, the Gosbank schedule is indicative only, and republics have in fact granted earmarked credits with nominal interest rates as low as 0-2 percent a year.

4. External developments

The external position continues to deteriorate. In the period January-September 1991 total exports and imports fell 30 percent and 45 percent, respectively. The payments situation is critical. The liquid reserves of the Vneshekonombank (VEB) are virtually depleted and it has started to prioritize its payments obligations. It has stopped all payments on imports already received and payments to its foreign subsidiaries. In the absence of further financial assistance, it would probably have to stop servicing the debt it has guaranteed. The foreign exchange position of the VEB has been made more difficult by the increase in the number of transactions which escape the official channels. In addition, the use of existing credit lines has been delayed in some cases by the uncertain legal status of the debtor and by the republics' inability to agree on what goods to import.

Exchange rate developments have been characterized by increasing distortions resulting from the different rates applicable to different transactions. Thus, the commercial exchange rate which is used for the surrender of about 70 percent of export receipts and for centralized imports, has continued to be rub 1.7 per U.S. dollar. The exchange rate used for tourist transactions was depreciated from rub 32 to rub 47 per U.S. dollar at the end of October. The interbank market rate--which usually follows closely the black market rate (currently at rub 70-80 per U.S. dollar)--depreciated sharply to rub 110 per U.S. dollar following the recent announcement of Mr. Yeltsin about future price liberalization. This market continues to comprise only a small part of the transactions.

U.S.S.R. Recent Economic Indicators

(Percent change unless otherwise specified)

	1988	1989	1990 Jan.-Sept.	1991 Est. 1/
		(Percentage changes)		
Real NMP	4.4	2.5	-4.0	-13.0
Household money incomes	9.2	13.1	16.9	96.8
Consumer prices	0.6	2.0	5.3	102.5 2/
Broad money 2/	14.1	14.8	17.5	60.0
Households' real balances 2/	10.8	12.7	8.6	-13.5 3/
Oil production	--	-2.7	-6.1	-10.5
Oil exports 4/	4.8	-10.0	-13.1	-40.0 4/
Exports (value)	-1.5	2.4	-11.2	-30.3
Of which: CMEA	(-4.2)	(-2.6)	(-19.5)	...
Imports (value)	7.1	10.9	-2.0	-45.2
Of which: CMEA	(2.3)	(2.0)	(-2.0)	...
		(In percent of GDP)		
Consolidated state budget deficit	9.2	8.5	8.5	...
		(In billions of U.S. dollars)		
Current account balance in convertible currencies 5/	1.6	3.9	-2.6	1.0
External debt 6/	43.0	54.0	55.4	...

Sources: Joint Study: data provided by the union authorities; and Fund staff estimates.

1/ Percentage change from the corresponding period of 1990, unless otherwise indicated.
2/ End-period change on 12 months earlier.
3/ End-August on End-December.
4/ In volume terms.
5/ Excluding gold.
6/ Contracted or guaranteed by Vneshekonombank.