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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/114

10:00 a.m., December 18, 1996

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Decision Taken Since Previous Board Meeting

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman

Executive Directors

A.A. Al-Tuwaijri
M.-A. Autheman
T.A. Bernes
B. Esdar
H. Evans

D. Kaeser
A. Kafka

K. Lissakers
H. Mesaki

A.V. Mozhin

M.R. Sivaraman

E.L. Waterman
J. de Beaufort Wijnholds

Zhang Z.

A.G. Zoccali

Alternate Executive Directors

S.M. Al-Turki

T. Turner-Huggins, Temporary

J. Shields
J.C. Martinez Oliva, Temporary
L.J.F. Erasmus, Temporary
Y. Patel, Temporary
D. Gotz-Kozierkiewicz

D.A.A. Daco, Temporary
J. Hamilius, Temporary
B.S. Newman
S. Fukushima, Temporary
M. Daïri

Y.Y. Mohammed
H.B. Disanayaka
R.P. Watal, Temporary
B. Andersen
J. Guzmán-Calafell
J.-H. Kang

A. Barro Chambrier
B. Konan, Temporary
S. Joyosumarto
Han M.
Zheng H., Temporary
J. Leiva

R.H. Munzberg, Secretary
W.S. Tseng, Acting Secretary
P. Cirillo, Assistant

Also Present
European I Department: M. Russo, Director; M.C. Deppler, Deputy Director; E.V. Clifton, H.M. Flickenschild, F. Scacciavillani. European II Department: K.A.-M. Westin. External Relations Department: C. Hellemaa. Fiscal Affairs Department: N.A. Chalk, P.S. Heller, H.H. Zee. Legal Department: F.P. Gianviti, General Counsel; W.E.Holder, Deputy General Counsel; J.L. Hagan. Middle Eastern Department: E. Maciejewski, M. Zavadjil. Policy Development and Review Department: J.T. Boorman, Director; J. Ferrán, Deputy Director; K.J. Langdon. Research Department: M. Mussa, Economic Counsellor and Director; P. Isard. Secretary's Department: K.S. Friedman, A. Mountford. Treasurer's Department: D. Williams, Treasurer; F.M. Lakwijk, A. Muttardy, O. Roncesvalles, T.M. Tran, M.A. Wattleworth. Western Hemisphere Department: E.S. Kreis. Office of the Managing Director: S. Sugisaki, Special Advisor; J.A.Quick, Personal Assistant. Advisors to Executive Directors: M.B. Alemán, M. Askari-Rankouhi, J.A. Costa, S.S. Farid, P.M. Fremann, A. Guennewich, K.M. Heinonen, G.M. Iradian, A. Levy, M.F. Melhem, O. Otazú, O. Sein, L.B.J. van Geest, V.Y. Verjbitski. Assistants to Executive Directors: W.F. Abdelati, P.I. Botoucharov, M.A. Brooke, M. A. Cilento, A.L. Coronel, B. Grikinyté, D.S. Hakura, R.J. Heinbuecher, O. Himani, J.P. Leijdekker, D.G. Loevinger, A. Lucenti, F. Mercusa, D. Merino, I. Moon, H. Ogushi, L. Palei, L. Pinzani, G.P. Ramdas, S. Rouai, S. Simonsen, A.G.Yakub.

1. SPECIAL ONE-TIME ALLOCATION OF SDRS—DRAFT OF PROPOSED FOURTH AMENDMENT OF ARTICLES OF AGREEMENT

The Executive Directors considered a staff paper on the draft of a proposed fourth amendment of the Articles of Agreement providing for a special one-time allocation of SDRs (EBS/96/183, 12/2/96).

Mr. Wijnholds made the following statement:

The staff has prepared a solid legal text which incorporates the three guiding principles of the proposed amendment. These are, first, to provide for a special allocation of SDRs based on a common benchmark ratio of cumulative allocations to present quotas; second, that this allocation is of a one-time character, and; third, that this does not affect the Fund's power to allocate SDRs in case of a long-term global need to supplement reserves.

Now, it is up to the Board to finalize its work on the amendment. I would say that there are three areas where details need to be filled in. First of course, is the amount. I am looking forward to a rapid agreement on this center piece of the amendment, and hope that we can move forward in the same cooperative spirit which prevailed at our last meeting on this matter.

The second issue is the treatment of new members, including the special case of Serbia/Montenegro. I think that the staff rightly proposes to extend the principle of equity to future members. This appropriately reflects the spirit of the amendment, as well as removing the possibility of a similar issue arising again. As I could make up from the draft amendment, this required rather intricate legal formulations, and I commend the staff for coming up with an elegant proposal.

The third area in which details need to be filled in concerns the treatment of members with overdue obligations to the GRA. On this issue, I would like to offer some more detailed comments.

The staff is right to propose as an initial suggestion that the benchmark ratio would be applied to the quotas of members in arrears under the Eighth General Review. After all, this comes closest to the text of the Interim Committee's communiqué, which talked about "a common benchmark ratio of cumulative allocations to present quotas" (my emphasis). At the same time, I think it is clear that the Committee leaves it up to the Board to fill in the details, and that the phrase "present quotas" should not be interpreted as an implicit stipulation by the Committee on the treatment of members with overdue obligations. Therefore, I find myself again siding with the staff, when it presents two alternatives.

The first alternative is to allocate SDRs to members in arrears on the basis of their quotas under the Eighth Review. As the General Department is separate from the SDR Department, these members' arrears in no way restrict their participation in the allocation (neither, by the way, do their arrears in net SDR charges). Granted, the size of their allocations would be modest, as the ratio of their cumulative allocations to the Eighth Review quotas is high (although for one member with arrears, the allocation would be quite large). Still, as matter of principle it seems inappropriate that members with arrears are eligible to receive extra resources from the Fund.

The second option would be to apply the benchmark to the proposed Ninth Review quotas for these members. This has some intuitive appeal, as it conforms to the principle of equity and as such fits well into our consensus. However, it would seem to send a perverse signal on our stance toward overdue obligations in a cooperative institution.

As neither option seems completely satisfactory, I would like to suggest a third alternative. That is, to treat members with arrears like future participants. These members would be excluded from participation now, but could participate retroactively and for the full amount after clearing their arrears. In this way, some central principles underlying the Fund's arrears strategy (including the cooperative elements) would be combined with the main principle of this amendment, i.e. that of equity. This option would require two slight revisions in the draft text.

The first revision would be to establish a link between a member's standing in the GRA and their participation in the special SDR allocation. The idea behind this is consistent with the conclusion of a Board discussion on July 27, 1989. At that time, Directors ended a discussion on the arrears strategy with noting that "Another measure being considered by the staff relates to the possibility of withholding SDR allocations for members with arrears in the General Department." As such a provision would require an amendment of the Articles, it was not pursued further at that date. I would suggest that we bring this back on the table, and consider a modification of the draft amendment which would exclude members with arrears in the GRA from this allocation.

To complement this, I would suggest a second revision which states that if a member clears its overdue obligations, it could retroactively participate in the equity allocation, on the basis of its proposed quota under the Ninth Review. I think this is an adequate reflection of the fact that once arrears are cleared, these members are no different from others, and should thus be treated along the same principles of 'equity' as current and future members.

In comparison with the two other alternatives on the table, I think the above approach both increases the stick (i.e. no receipts of SDRs when overdue) as well as the carrot (full retroactive participation after clearing arrears). I would very much appreciate staff's comments on the legal feasibility of my suggestions.

The Chairman recalled that the focus of the current discussion should be on the language of the draft amendment and not the size of the special allocation.

The General Counsel made the following statement:

It might be useful if I could address some suggestions that have been made concerning, in particular, the treatment of participants in arrears to the General Department. First of all, however, I should explain how this instrument was prepared. Our understanding was that, except for the criteria that would lead to this equity allocation, in every other respect the principles governing the SDR Department were to be observed. In particular, the SDRs to be created under this allocation would have exactly the same features as any other SDRs—for example, they would be unconditional assets. Similarly, the rules governing the relationship between the SDR Department and the General Department would also be observed. So it is on that basis that we have prepared this instrument. As I will explain in a moment, the suggestion that was put forward by Mr. Wijnholds would depart from that principle.

The first question with respect to members in arrears was whether there should be a reference to the current quotas—namely, those under the Eighth Review, since they have not been able to increase their quotas—or whether there should be a reference to the future quota to which they may accede once they have settled these arrears.

We have relied, at least as a matter of presumption, on the language of the Interim Committee communiqué—that is, we would refer to current quotas: in other words, the quotas that would be in force as of the date when the proposal is transmitted to the Board of Governors. We realize that it would be possible to refer also to the Ninth Review, but there would be some questions to be raised here. The first one would be that the proposal made for these countries to increase their quotas has been extended from time to time, but there is no commitment that it will be extended forever. One could therefore be in a situation where the amendment is eventually adopted and the quota increase under the Ninth Review is not yet effective for some members, and perhaps would never become effective. So there is a question here as to whether it is possible to offer an allocation based on a quota that potentially could never become effective.

A second problem is that, if it were to be done, there would be a question of comparability of treatment at the time the allocation is made. Let us suppose that these countries eventually become able to complete the quota increase under the Ninth Review in a few years from now and that, in the meantime, there is another quota increase. While other members would not benefit from the current quota increase for the allocation, these countries would, which would be a different treatment.

One possibility that we considered was a compromise; namely, give those members an allocation based on the Eighth Review, and make the balance of the allocation available when they complete the increase under the Ninth Review. It is a possibility, but we then run into the same problem: what if the offer for a quota increase under the Ninth Review is not extended and lapses? These members would not be able to complete the quota increase andto receive their full allocation. While anything is possible, we presume that we would refer, as a safer approach, to the Eighth Review, although we recognize the possibility of using the Ninth.

Mr. Wijnholds is proposing a different approach to the problem of members in arrears. I understand there would be two aspects. The first one is that these members in arrears—members that have not, therefore, completed the quota increase in the Ninth Review—would not participate in this SDR allocation; when and if they complete the quota increase, they would receive what Mr. Wijnholds has called a retroactive allocation of SDRs. I would not say "retroactive," because the allocation would not be retroactive—it would take place at that time. A retroactive allocation would mean that the SDRs would be deemed to have been created years before they were actually created.

The approach, first of all, raises the same technical problems as the compromise I mentioned; namely, what if these members do not complete the quota increase under the Ninth Review? Do they still, nevertheless, participate in the allocation? What is more important here, however, is the impact of this proposal on the relationship between the SDR Department and the General Department. I would not say it is not legally feasible in an amendment of the Articles, but why has it not been done before? This issue has been around for many years: as Mr. Wijnholds clearly points out, in 1989, when there was a discussion of the arrears strategy in the Fund, it was suggested that SDR allocations be withheld from members in arrears to the General Department. Eventually, when the Third Amendment was adopted, no such provision was included in the Articles. When the Third Amendment was discussed, that is, after the 1989 discussion, it was concluded that there should be no interference of the strategy on arrears in the General Department with the rules governing the SDR Department. Not only could SDR allocations still be made to members in arrears in the General Department, but voting rights—and this is important—in the SDR Department would not be subject to suspension because of arrears in the General Department. So there was a conscious decision to continue the principle of separation.

Where does the principle of separation come from? Is it so important? After all, maybe it could be disregarded in the future. It comes from the idea that, when the SDR Department was invented, the Fund as a manager and an administrator of the SDR Department should avoid any appearance or suspicion of conflict of interest with its functions as creditor in the General Department. In the General Department, the Fund has liabilities and the Fund has claims. In the SDR Department, allocations do not create liabilities or claims for the Fund. When the Fund allocates these SDRs, these SDRs are really claims and liabilities among the participants, not vis-à-vis the Fund. Therefore, the SDRs should not be perceived in any way as an asset, let us say, created by the Fund or a liability of the Fund.

In the Articles, the separation between the two departments is so fundamental that it appears and is repeated in a number of provisions. Article XVI sets forth the principle of separation both with respect to the operations and transactions in the SDR Department and the General

> Department and with respect to the assets and liabilities of the SDR Department and the General Department. Moreover, under Article XXIII, Section 2, a breach of obligation outside the SDR Department cannot justify a suspension of the right to use SDRs and a breach of obligation in the SDR Department cannot justify a declaration of ineligibility to use the Fund's general resources. Therefore, under the structure of the Articles, the separation between the two departments was intended to avoid depriving a member of its rights, including allocations, in the SDR Department because of arrears or other failures to fulfill obligations in the SDR Department. In other words, the Fund was not supposed to use its powers in the SDR Department to enforce its rights in the General Department.
>
> Therefore, while using the "carrot and stick" approach by making an SDR allocation conditional upon discharge of arrears in the General Department may be legally feasible in the context of an ad hoc allocation under an amendment, Directors should bear in mind the importance of maintaining the principle of separation between the General and SDR Departments. If that principle is ignored in this case, should the Board not also be prepared to withhold general allocation to members in arrears to the General Department? Should it not consider allowing the Treasurer to use SDRs to discharge liabilities to the General Department, which currently is not possible?

Mr. Wijnholds said that he retracted the use of the word "retroactive," since it was not a legally sound concept. While the separation of the two departments was clearly understood by all Directors, the proposal to link—in some way—the two departments was legally feasible and had been considered in the past. In the suggestion outlined in his preliminary statement, such a link would be quite minor, since the particular case under discussion was a one-time allocation. As a result, Directors would need to decide whether it was more important to preserve the complete separation of the two departments or to avoid the possibility of members in arrears obtaining unconditional financing through an SDR allocation.

Mr. Newman asked whether the special allocation of SDRs could be used to offset some of the outstanding obligations of a member to the General Resources Account, and, if so, what the consequences of such a use would be.

The General Counsel responded that the Fund would deduct from the allocation the amount overdue in the SDR Department, such as interest; however, arrears to the General Department would not be charged automatically to the allocation. It would be for the member to decide whether or not to use the allocation to clear those arrears.

Mr. Newman remarked that, in the case of arrears to the SDR Department, the effect would be neutral, because the SDRs would have been created to finance the interest arrears, and one set of SDRs would effectively replace another set. At the same time, if a member used a special allocation to pay a portion of arrears in the General Department, those SDRs would then return to the Fund and be used initially as financing as any other Fund liquidity is used.

Ultimately, those SDRs would return to net SDR holders, which would then have the contingent liability in the event that the country resumed additional arrears in SDRs. If the Fund were liquidated, it would be the net holders who would bear the risk of any default on SDR obligations.

The General Counsel responded that the eventual liability of any deficit in the SDR Department was on participants.

Mr. Waterman said that he agreed with Mr. Wijnholds's proposal, and that he would accept some infringement on the principle of the separation of the SDR and General Departments if the result were balanced and sensible.

Mr. Daïri considered that, particularly in the context of the upcoming Board discussion on governance, the Fund should respect its own rules as laid out in the Articles.

The Chairman noted that he attached particular importance to following the Fund's rules; however, the Articles could be changed to accommodate the wishes of the members.

Mr. Evans said that he agreed with Messrs. Waterman and Wijnholds. While the principle of the separation of the two departments was important, another principle—the unity of the Fund as an institution—was also important. As currently drafted, the amendment would allocate SDRs to members in arrears and those SDRs would be used to pay off those arrears. However, in cases in which those arrears were smaller than the SDR allocation, the members in arrears would receive additional SDRs—in effect, rewarding members in arrears. That could be regarded by outside observers as a strange manner in which to conduct business. As a result, the Board should consider accommodating Mr. Wijnholds's suggestion.

Mr. Daïri believed that it would be inappropriate if a so-called equity allocation led to the exclusion of some countries.

Mr. Sivaraman stated that, while appreciating the concerns of Messrs. Evans, Waterman, and Wijnholds, the analysis presented by the General Counsel was compelling, particularly with respect to subparagraph (c) on page 2 of the staff paper, which says that for members that continue to have overdue obligations to the General Resources Account at a specified date and are unable to consent to and pay for their increase in quota, the quotas under the Eighth General Review should be considered. It would not be appropriate to segregate those members in arrears; as a result, the staff's suggestion was acceptable, particularly as it was consistent with Article XVIII, paragraph 2(b).

Mr. Mohammed made the following statement:

> We have no problems with the proposed draft of the Fourth Amendment providing for a one time allocation of SDRs without compromising the Fund's power to allocate SDRs in case of a long-term global need.
>
> Based on the compelling argument of the General Counsel concerning preserving the principle of separation between the SDR Department and the General Resources Department, I cannot support the proposal of Mr. Wijnholds for excluding participants with arrears in the General Resources

Account. Instead, I support the staff's proposed treatment. I also support the staff in the proposed treatment of future participants.

Mr. Kafka made the following statement:

> The staff present us with the text of the long-promised—or threatened—amendment establishing a special allocation of SDRs for those members whose net cumulative allocation falls below a specified benchmark. We are prepared to recommend approval of this amendment to the Board of Governors, although we are not enamored of the idea. Our doubts stem from our fears that approval of the amendment could undermine the procedure established by our Articles for the allocation of SDRs. We have said this on several occasions and there is no point in repeating it.
>
> We welcome the clear statement in the text of the paper that the special allocation is a one-time one; and the assurance that it does not affect the Fund's power to allocate SDRs in case of a finding of long-term global need to supplement reserves.
>
> There are three main areas where we have to make decisions. First, the amount to be allocated. We have an open mind but, before formulating an opinion, would like to listen to our colleagues.
>
> Regarding future participants, for reasons of equity, the staff propose, and we support, adjustments of the agreed benchmark ratio, in line with the downward changes that have occurred since the specified date in the total quotas of existing participants and upwards in proportion to the changes in the total net cumulative allocations made after the specified date.
>
> Regarding members with overdue obligations to the General Resources Account and despite the danger of sending a perverse signal in respect of overdue obligations, for simplicity's sake, we could apply the benchmark to the Ninth—or even Eleventh—review, if the fourth amendment should enter into effect after completion of the 11th review.
>
> We would also be prepared to consider Mr. Wijnholds' ingenious alternative proposals.
>
> We shall comment as we go along on specific aspects of Schedule M.

Mr. Mesaki made the following statement:

> It is quite significant that we reached a consensus at the September Board meeting on a special SDR allocation through an amendment of the Articles based on the Managing Director's proposal. I hope that we can reach a final agreement by swiftly agreeing upon the total allocation amount.
>
> As to the draft of the fourth amendment of the Articles of Agreement, I have no problem accepting it.

I understand some Directors suggest including some lines in the draft to emphasize that this is strictly a one-time allocation, but while I reaffirm my understanding that this is a one-time allocation, I myself do not see a compelling need to include such additional lines because the current draft, as does the commentary, already addresses the issue.

On the treatment of the countries in arrears, I am somewhat hesitant to support Mr. Wijnholds's stick and carrot approach. While it is an interesting suggestion, I believe that allocating SDRs based on the quotas under the Eighth Review is appropriate. For future participants, I agree to the staff's proposal.

I would like to take this opportunity to reiterate my authorities' view that, in order to facilitate domestic support, we should make an effort to reach agreement simultaneously on the SDR allocation and the Eleventh General Review of Quotas.

Mr. Esdar made the following statement:

I will try to be brief as the proposal prepared by the staff provides a very good basis for our discussion.

I welcome the clear wording of the staff paper along the lines of our earlier agreement. It is important to point out very clearly the purpose of the "one-time allocation," namely to deal with the equity problem by harmonizing the ratio of cumulative net allocations to quota ratios and to prevent the impression that this allocation could be regarded as a kind of general allocation of SDRs. However, while we welcome that this was made very clear in the staff report, we wonder whether it should not also be integrated by an appropriate wording in the amendment of the Articles.

We, therefore, would like to propose to include an additional sentence in the text of the amendment of Article XV which explicitly explains this objective: The wording might be as follows: "These provisions provide for a one-time allocation of SDRs to enable all participants to participate fully in the SDR Department. They do not provide a basis for periodic harmonization of cumulative net allocation-to-quota-ratios."

With respect to future new members or participants we basically agree with staff's proposal. However, in our view, we should set a certain time frame—say three to six months—in which new members could declare their participation in the SDR department to take advantage of the equity allocation. I do not see any rationale in holding such an option—which, by the way, provides benefits for members—indefinitely open.

For countries currently in arrears vis-à-vis the Fund we support an allocation on the basis of their quota following the eighth review. To refer to the quota shares under the ninth review would be premature and in light of the arrears status, it would also not be acceptable.

On the procedure for the Federal Republic of Yugoslavia we agree with the proposal by the staff.

Finally, I would also like to suggest a rewording of the general text which will be the basis for the report to the Board of Governors. Instead of referring to a "catch-up with prior allocations" when explaining the rationale of the amendment on page 2, Chapter 2, first paragraph, I would prefer to explain the rationale of the amendment by stating that the objective would be: "for equity reasons to allow members to participate fully in the SDR system."

Mr. Daïri made the following statement:

We welcome this discussion and thank the staff for the draft amendment as well as for the clarifications provided this morning. We also appreciate the Managing Director's efforts to achieve an early agreement on this important issue.

Our position in today's discussion will be preliminary; we shall reserve our position until all elements of the proposal are presented for discussion. It is the Board's responsibility to reach an agreement on all elements well before the interim committee meetings, and we encourage it not to leave any aspect, most notably the benchmark for the special allocation, for consideration by the interim committee, otherwise the Board would fail its responsibilities as a decision-making body.

During our last discussions on the issue of SDR allocation, we indicated that in the spirit of compromise we were ready to support a special allocation of SDRs with the following conditions:

First, the existing mechanism of Article XVIII must be preserved.

Second, the amount of the allocation should not be lower than SDRs 26.6 billion.

In our discussions of the proposed fourth amendment of the Articles of Agreement we shall be guided by these two principles, in particular, we call for an early agreement on a benchmark ratio of cumulative allocations to quotas of 33 percent. We would like also to seize the opportunity of the fourth amendment to include other pressing issues that require modification of the Articles, in particular the issue of the basic vote.

We can support the staff proposals with regard to the treatment of future participants in the SDR Department and the case of the Federal Republic of Yugoslavia (Serbia, Montenegro).

With regard to countries in arrears, our preference is for a mechanism under which the ninth review of quotas is used. We do not support the postponement of SDR distribution for countries in arrears as proposed by Mr. Wijnholds. We are of the view that the principle of separation of the General and SDR Departments should be strictly safeguarded.

Finally, Article XVIII, Section (e), stipulates: "A participant shall receive allocations of SDR made pursuant to any decision to allocate unless:

(i) the governor for the participant did not vote in favor of the decision;

(ii) the participant has notified the Fund in writing prior to the first allocation of special drawing rights to be allocated to it under the decision.

I would like to ask the staff why only the second condition was included in the proposed Schedule M, paragraph 5.

The present drafting suggests that, contrary to general allocation where a country has to vote against the decision to be able to forego its share of SDRs under the present proposal, a country would be able to forego its share ever if it voted in favor of the special allocation. Could the staff comment on the reasons for this differentiation and its practical consequences?

Mr. Kaeser made the following statement:

We thank the staff for their draft of a fourth amendment of the Articles of Agreement allowing a special allocation of SDRs to solve the equity problem in SDR allocations and support it. We agree with the proposal that this should be performed as a one-time allocation of SDRs, based on a common benchmark ratio of cumulative allocations to present quotas, and that no permanent mechanism for periodic harmonization of cumulative net allocation-to-quota ratios be established.

The equity problem stemmed from a significant increase in the number of member countries. If one wants to avoid in the future that this issue reemerges, the case of future members should be taken into account. We therefore agree that future participants should also be able to benefit from a special allocation of SDRs. In achieving this, however, comparability of treatment between existing and future participants should be sought. In this respect, the proposed amendment seems to offer a satisfactory solution.

As regards members in arrears, we can support Mr. Wijnholds's suggestion to treat them like future participants and to allow them to participate ex post and for the full amount after they have cleared their arrears. Another solution would appear to us as somewhat surrealistic. Some colleagues fear that we might violate the law. I think that we would not violate, but adapt it to new circumstances and considerations.

I know that we do not have to talk about numbers today. Therefore, I will limit myself to express the deep satisfaction of reporting the progress made on the issue of a special allocation of SDRs. This is a poor example of the cooperative spirit which should characterize the work of the Board. I thank especially the developing countries, which made a major compromise to clear the way for the Fourth Amendment. I hope that the industrial countries will demonstrate the same spirit of compromise.

Mr. Zhang made the following statement:

I would like to thank the staff for preparing the comprehensive legal text of the operational treatment of Special Allocation of SDRs.

I would agree that in principle, this amendment draft reflects the spirit of the Decision made by the last Interim Committee on the SDR special allocation, that the Article XVIII should be preserved, the special allocation should be a one-time allocation in addition to the general allocation pertaining to Article XVIII and that this allocation would result in the harmonization of ratios of members' cumulative allocation to their quotas.

I also agree with the principle of equal treatment of future new members in this amendment.

As for allocation for members with arrears, we can go along with the staff suggestion. Our preference is that the benchmark ratio for these members will be applied to their proposed Ninth Review of Quotas.

As we discussed yesterday at luncheon, we shall not discuss the SDR allocation today. I agree with it. I certainly look forward to a rapid agreement when we return to the issue. However, I would like to remind the Board that the Managing Director indeed made a proposal of a 33 percent benchmark ratio on June 20 which many Directors support.

Mr. Newman made the following statement:

The staff's proposed SDR equity amendment appears to address satisfactorily the key issues which Directors have raised in the past. The special allocation would be a one-time allocation. It would in no way affect the operation of the other SDR provisions, particularly the criteria for a general allocation based on a finding of global need, and it would be based on a uniform benchmark.

We recognize that there is a broad support for a uniform benchmark as the preferred means of determining the overall size and distribution of the special allocation and that it could serve as the basis for an acceptable arrangement. However, we believe that a final decision should be postponed until the Board considers in greater detail the overall size of the special allocation. We may find that an alternative distribution of the allocation along the lines of the earlier U.S./U.K. proposal could facilitate agreement and thus prove preferable. While we are not discussing the amount of the special allocation in detail today, I would reiterate our previous view that it should be modest.

As Mr. Wijnholds notes in his statement, the staff proposals would provide a special allocation to members that are not fulfilling their obligations to the Fund. It is our understanding that, as a practical matter, a special allocation to countries with arrears on SDR charges would have no material effect since the new SDRs would simply replace the additional SDRs previously created to finance the overdue SDR charges and the member would still have outstanding interest obligations. However, a special allocation to a country with overdue quota-based obligations would send the wrong signals regarding our arrears strategy and could adversely affect the willingness of net SDR holders to accept additional SDRs. In these circumstances, we would support Mr. Wijnholds' proposal that a country with arrears should not receive any special allocation until its overdue obligations are cleared.

With regard to Mr. Esdar's suggested amendment, while I am sympathetic to the intent, I would appreciate the staff's comments, particularly on whether the approach is consistent with the rest of the Articles, which are operational in content rather than providing policy statements

Mr. Esdar noted that Articles other than Article I had policy implications as well.

Mr. Martinez Oliva made the following statement:

We find the language proposed by the staff for the special allocation of SDRs broadly satisfactory. What this chair had in mind since our earlier discussions is that the existing mechanism of Article XVIII should be preserved and that the equity amendment should not create a new mechanism for further equalization of ratios of SDRs to quotas in the future. In this regard, our impression is that the draft amendment attached to the staff paper responds to these concerns. We would, nonetheless, like to hear further comments on this issue from the staff.

We can also go along with the proposal of extending the principle of equity to future members, including the special case of Serbia-Montenegro, along the lines proposed in the staff document. This is consistent, in our view, with the spirit of the amendment; that is, allowing all members to receive an equitable share of cumulative SDR allocations.

Finally, concerning the treatment of countries that continue to have overdue obligations to the General Resources Account as of the specified date used for calculation purposes, while we find reasonable the staff proposal of using their quotas under the Eighth General Review, given that those would be the quotas in effect as of the specified date, we still have some sympathy for Mr. Wijnholds's proposal. Accordingly, we are ready to examine further this option if the legal language consistent with such a proposal is drafted by the staff for a future discussion.

Mr. Andersen made the following statement:

I welcome this opportunity to discuss issues related to an amendment of the Articles of Agreement that will allow for the one-time special allocation of SDRs agreed upon in September, leaving aside for the time being the question of the size of the allocations. Having been asked by the Interim Committee to finalize our work on the amendment before the next meeting of the Committee, I look forward to a discussion on the size of the benchmark in the not too distant future.

There is indeed an important issue of timing, but still this chair believes that there would be substantial benefits in also considering whether there are issues in relation to work in other fields where changes of the Articles are clearly needed. Both a review of the Articles and the passing of amendments in national parliaments is a cumbersome process, and it could indeed have some merits dealing jointly with initiatives which would require parliamentary approval.

With these remarks, I can be brief on the two main issues for today's discussion, the treatment of new members and the treatment of members with arrears to the Fund. For new members, I fully support the views presented by the staff as well as their proposal, and on the treatment of members with overdue obligations to the General Resources Account, I welcome the considerations of Mr. Wijnholds in his excellent preliminary statement, and can fully associate this chair with the views of Mr. Wijnholds, as well as with his suggestion on how to treat members with arrears. I too was attracted by the "carrot and stick" characteristics of the suggestion, and I invite the staff to come up with a proposal that would make it legally feasible and, at the same time, not do damage with respect to our principles to the extent possible. By an amendment of the Articles, we are changing the rules of law governing this institution, and I hope it will be possible to come up with an elegant proposal.

Mr. Zoccali made the following statement:

The consensus reached for addressing the so-called equity issue through an amendment of the Fund's Articles that would provide for a one-time special allocation of SDRs based on a common benchmark ratio (of cumulative allocation to present quotas) rather than on a finding of "long-term global need" for reserve supplementation is a clear demonstration of the unique cooperative spirit which guides the decision-making process in this institution.

The proposed draft amendment of the Articles of Agreement and the introductory note that would become the official commentary of the amendment provide an appropriate legal description of the consensus reached, thereby facilitating an agreement by the time of the Interim Committee's next meeting.

We welcome the staff's proposed inclusion of a reference in the first sentence of Article XV for the purpose of emphasizing that allocations made on the basis of "long-term global need" will continue to be made in accordance with the provisions of Article XVIII. But it has to be recognized that even this adaptation fails to refine, even minimally, the criteria for collective decision-making on future allocations. We would not favor other inclusions which would have the effect of deemphasizing the Fund's powers to make allocations on the basis of "long-term global need" or of highlighting the apparent inconsistency with the existing obligation of participants in Article XXII to make the special drawing right the principal reserve asset in the international monetary system.

Having said this, there is little to add to the staff paper and Mr. Wijnholds useful preliminary statement. His proposal regarding the treatment of members in arrears as future participants after their clearance is ingenuous. The staff's reply this morning concludes that such an approach is legally feasible but raises a potential break with a long-standing separation between the General Resources and Special Drawing Rights Departments in Article XVI and others. Nonetheless, we would be amenable to exploring this novation further provided that it does not alter in any way the Fund's power to make general allocations of international liquidity, or weaken the reserve asset characteristics of the SDR.

Regarding the draft text of the fourth amendment, I have two minor presentational points. First, footnote 3 in page 3 lists as exemptions to the downward correction in the special allocation for new participants the quota increases after the specified date. It states that "additional" quotas of new members and increases of quotas under the Ninth Review that entered into effect after the specified date will not be taken into account. The word "additional" seems confusing and perhaps even redundant. Second, cross-referencing footnotes 3 and 4 in page 3 with item 4(a)(i) and item 4(b) of schedule M, respectively, could facilitate the reading of the new schedule M.

Finally, it is our hope that the same cooperative spirit that has taken us thus far will also prevail when deciding the level of the benchmark, which remains the unsettled centerpiece of the amendment, keeping in mind that the Managing Director's proposal would meet only a minimal part of the unsatisfied demand for official reserves "to hold."

Mr. Barro Chambrier made the following statement:

I welcome this opportunity to discuss the guiding principles of the Fourth Amendment of the Articles of Agreement, regarding the special allocation of the SDRs.

I am pleased that as requested by the last Interim Committee, this amendment does not affect the Fund's existing provisions to allocate SDRs on the basis of a finding of a long term global need to supplement reserves as and when that need arises.

The amount of SDRs that should be allocated to existing participants would be an amount that would raise their net cumulative allocation to a level corresponding to a specified benchmark ratio.

I agree with Mr. Daïri that it is incumbent to the Board when the time arises to get the compromise on the level and on the overall size of the special allocation.

I find no difficulty with the choice of a specified date that will not affect the size of the special allocation.

For members that continue to have overdue obligations to the GRA, I could go along with the staff proposal that preserve the principle of separation among departments. I would also favor that the benchmark ratio for members in arrears would be applied to their proposed Ninth Review quotas or even the Eleventh Review as suggested by our Dean rather than their actual quotas under the Eighth Review.

Finally the provision for a special allocation after the specified date for future participants appear reasonable, given the equity reason to achieve a uniform treatment between existing participants and future participants.

Mr. Guzmán-Calafell made the following statement:

During our previous Board discussion of a special SDR allocation, we expressed that notwithstanding our firm believe that a general allocation under the Articles of Agreement is fully justified, in a spirit of compromise we would be willing to support an amendment to the Articles to allow for a one time allocation of SDR's, provided a number of conditions were met. Our position on this issue has not changed and thus I do not see the need to repeat it today. I wish to note, however, that it is our view that the draft amendment prepared by the staff provides a reasonable basis for progress on this matter.

We have expressed in the past that we need to be assured that any amendment to the Articles in no way affects the principles underlying Article XVIII. Thus, we welcome the proposed modification to the first sentence of Article XV. We also look forward to the language to be used in the Communiqué of the Interim Committee in this connection. On the other hand, the staff's proposal addresses adequately the concerns related to the one time nature of the allocation, and we have no objections to the suggested provisions for special allocations for future participants and the Federal Republic of Yugoslavia. On the issue of those members that continue to have overdue obligations to the General Resources Account, and after listening to the staff's explanation, we sympathize with the need to preserve the principle of separation among the different departments of the Fund, and, therefore, we prefer an approach along the lines suggested by the staff, with the benchmark ratio for these countries applied to their proposed Ninth Review quotas.

Mr. Evans made the following statement:

While we are discussing the general topic of amending the Fund's Articles, I must emphasize the importance we attach to updating the Fund's role in the area of capital flows, which we should address in 1997. I support, in general, the proposed amendment to the Articles. I can go along with Mr. Esdar's suggestion, subject to hearing further views about the appropriate location of such a suggestion. As I said earlier, I sympathize with Mr. Wijnholds's proposed amendment, and I hope we can find some way of accommodating it. You will not be surprised if I echo Mr. Newman's comments on the size and distribution, including his remarks on the earlier U.K.-U.S. proposition.

Recalling the seminar on the SDR earlier this year, I quote from the Fund's Annual Report that one of the conclusions of the seminar was the prospect of the SDR being established as the principal reserve asset. In the current international monetary system, that seems unlikely, so I think we might want to use this opportunity to be more transparent about the position of the SDR by deleting the last clause of Article VII, Section 7, which states that each member undertakes to collaborate with the Fund to make the SDR the principal reserve asset in the monetary system.

Mr. Sivaraman made the following statement:

We have no problem in going along with the proposals made by the staff, which are broadly in line with what was decided by the Governors in regard to the special allocation, especially that it will not shut the door to a future general allocation. I do not know whether the amendment that is being sought to be made in paragraph A of Article XV with the additional phrase, "in accordance with the provisions of Article XVIII," is only intended to reemphasize the provisions of Article XVIII, or whether it is at all necessary.

As regards the allocation formula itself, I did not want to refer to it, but since some of my colleagues have referred to it, I would support achieving uniformity in the rate of SDR allocation to quota, as suggested by the Chairman.

Regarding the size, I would reserve comments until later when we discuss this issue.

Mr. Bernes made the following statement:

Clearly, we have come a long way from the 1994 Annual Meetings in Madrid, and I think the discussion today and the excellent paper which the staff has prepared should allow us to conclude this exercise within the time frame established by the Interim Committee. We can certainly support the broad thrust of the draft which the staff has provided. I would just make two comments, one with respect to provision for new members, which we think is appropriate to be addressed.

With respect to countries in arrears, I would favor Mr. Wijnholds's proposal, not only for the reasons which he has clearly articulated, but also the important point that Mr. Evans made, that is, I think it would be inexplicable to the outside world that the countries that openly flout their obligations and show total disrespect for this institution would be seen to benefit from an allocation which would allow them to, in part or in whole and in effect, eliminate their arrears.

Mr. Daco made the following statement:

First, let me formulate the hope that we achieve a rapid consensus on the size of the special one-time allocation. I, therefore, like Mr. Kaeser and other Directors, urge Directors to show a willingness to form a compromise based on our latest proposal.

Second, the only reservation I have concerning the draft proposed by the staff echoes the points made by Mr. Wijnholds concerning the treatment of members with arrears to the Fund. I therefore support his proposal, and I would ask the staff to explore further the issue with the objective of not unduly affecting the principle of separation between the SDR Department and the General Department.

Finally, let me say that I have no objection to the inclusion of the language proposed by Mr. Esdar, but I reserve my position to hear the answer of the staff to Mr. Newman's concerns.

Mr. Autheman made the following statement:

I can go along with this draft proposed amendment with a few comments.

First, on Mr. Esdar's proposal, I do not see the need for such a sentence, but I wonder whether he is not pointing to another aspect, which is the title of schedule M, "Special Allocations of Special Drawing Rights." Should we not say, "Special One-Time Allocations of Special Drawing Rights"? Indeed, the definition of schedule M has to be factual, and it seems to me that if we said so, there would be no need to consider Mr. Esdar's sentence.

My second comment is related to the debate raised by Mr. Wijnholds. I am attracted by Mr. Wijnholds's approach, but I have one question which, indeed, came to mind regarding the treatment of the Federal Republic of Yugoslavia. It is very important, since we are agreeing on a special allocation, that we agree not to modify the rules governing the SDR Department, that we not legislate by circumstance, and that we not introduce general rules which would apply this time but would not have applied had we followed the avenue of a general allocation.

So my initial question is, is the treatment of the Federal Republic of Yugoslavia as proposed in this amendment different from the one which would have been applied to this republic had we agreed on a general allocation? And the second question is the same as that applying to Mr. Wijnholds's proposal. My point is that it would not make great sense to have one set of rules of a general character apply to this special allocation, which could not be applied if, in the future, we decided on a general allocation.

Mr. Waterman stated that the draft amendment covered the main issues appropriately, including the treatment of new members. Apart from the size of the allocation, Mr. Wijnholds's proposal was a good basis on which to consider how to treat members in arrears.

Mr. Al-Turki said that he supported the draft amendment. With respect to Mr. Wijnholds's proposal, it was important to maintain the separation between the SDR Department and the General Department.

Ms. Patel stated that she agreed with Messrs. Daïri and Mohammed.

Mr. Sivaraman suggested that the title of schedule M be changed to "One-Time Allocation of Special Drawing Rights."

Mr. Joyosumarto made the following statement:

> I would like to thank the staff for their efforts in producing the Draft of the Fourth Amendment of the Articles of Agreement.
>
> I will make very brief comments on the draft. First, for timely allocation of SDRs, the Board needs to agree on the determination of the level of the benchmark ratio. In this regard, for future discussions, I would like to suggest the staff put forth a proposal on the benchmark ratio, so that the Board can discuss and come to an agreement on that issue.
>
> Second, I also find that in Schedule M, which is to be added to the Articles, there are a few blanks in the bracket. It would be most helpful if the staff could, as an indication, provide some proposal of the possible content of blanks and the rationale behind that. By providing a proposal, we can thoroughly discuss in detail before coming to an agreement.
>
> In addition, we have the opinion that the substance of paragraph (3) of Schedule M can be read of merged in paragraph (2). So, paragraph (3) should not be included. This is to avoid the necessity of future amendments when a situation similar to Yugoslavia arises.
>
> For other issues, we can go along with the staff proposal.

Mr. Mozhin said that he agreed with the current draft of the proposed amendment.

Mr. Esdar suggested that, in light of the comments made by Messrs. Autheman and Newman, his previous proposal could be replaced by a sentence inserted at the beginning of schedule M explaining the nature and characteristics of the one-time equity allocation.

Mr. Kaeser asked whether the original framers of the SDR system had envisaged the possibility that a significant number of members would accumulate arrears to the Fund.

The General Counsel recalled that, at the time the SDR system had been created, the issue of members in arrears had been considered, but it had not been a major concern at that time. It had been the deliberate decision that violations of obligations in the SDR Department would have no effect on the exercise of rights with respect to SDRs. The matter had also been considered at the time of the Second and Third Amendment, with the same conclusion. As a result, while it was possible to modify the principle of separation of the two departments, in the past, the opposite view had prevailed.

Mr. Evans remarked that, at the time of the last general allocation in 1981, the level of arrears had been quite low; the current allocation under discussion would be the first with a significant number of members in substantial arrears.

The General Counsel stated that the staff would prepare another draft with alternatives for Board consideration. That draft would have to deal with the modalities of implementing Mr. Wijnholds's suggestion of a conditional allocation for members in arrears. Some questions would have to be resolved. What form would it take? Would the allocation take place, but the SDRs not be made available—which would mean that they would exist in the system—or would they not even be created? What would happen if countries in arrears did not increase their quota within a period of time—should there be a time limit within which they would have to complete their quota increase, after which the proposal for an SDR allocation to those countries would lapse?

Another question would be whether there should be a fallback position from the Ninth to the Eighth Review if the members in arrears did not complete the review, the General Counsel wondered.

While it would be possible to include a policy statement in either the text of the Articles or the schedule on the unique feature of the special allocation, it might be more appropriate to include such language in the report to the Board of Governors, the General Counsel suggested. In that way, it could be made clear that the special allocation was not intended to affect in any way the future of the SDR system.

Mr. Esdar remarked that it was important to clarify explicitly for future Board members the intentions of the current Board with respect to the proposed amendment. As schedule M provided many technical details, it would be useful to explain the justification for the one-time allocation in that section.

The General Counsel noted that, normally, a legal provision was limited to what was essential to have an effect, and explanatory justifications—as proposed by Mr .Esdar—did not have any impact and were kept out of legislative provisions, particularly as there was more than one purpose for the proposed amendment. As a result, while it would be useful to change the title to "special one-time allocation," the background and precise rationale for the amendment should be explained in the report to the Board of Governors.

On the treatment of the Federal Republic of Yugoslavia, the staff had attempted to parallel as much as possible the case for a general allocation if Yugoslavia were a member at that time, the General Counsel said. However, there would be a gap between the former and future member, with the principle that once Yugoslavia became a member, it would regain whatever rights would have accrued had they remained a member. That was the reason the staff was proposing a different provision for future members.

Mr. Autheman remarked that, according to the General Counsel's reasoning, had the Fund followed the route of a general allocation, Yugoslavia would have been eligible only if it had become a member before the entry into force of the general allocation. It would not, as in the case of the current draft amendment, have been offered a "second chance."

The General Counsel stated that the special status of Yugoslavia made it a unique case.

The suggestion by Mr. Evans that the SDR system should be updated fell beyond the scope of the current exercise of preparing an amendment on a special one-time allocation of SDRs, the General Counsel noted.

The suggestion by Mr. Esdar that the time frame in which members could take advantage of the equity allocation be limited to three to six months could be accommodated in the next draft amendment prepared by the staff, the General Counsel said.

The Chairman made the following concluding remarks:

> Directors generally agreed with the draft amendment prepared by the staff. The staff has noted the technical suggestions made by several speakers and will prepare the appropriate material for a further Board discussion in early 1997.
>
> Several Directors emphasized the need to focus soon on the question of the amount of the allocation so that the agreement can be finalized before the next meeting of the Interim Committee; this is certainly the intention of all. A few Directors, however, advised not to conclude too firmly on the proposed draft, so as not to exclude definitively or prematurely other alternatives at this stage, in the event that they turned out to be useful for the final consensus.
>
> Directors agreed to include the words "one-time allocations" or "one-time special allocations" in schedule M. There has been general agreement that future new members should also have the option to receive a one-time equity allocation when they join the SDR Department, as proposed by the staff.
>
> Regarding the proposal made by Mr. Wijnholds to withhold allocations under the equity amendment for members in arrears to the General Resources Account, there was strong support for the concept proposed by Mr. Wijnholds, but I have also noted the concerns expressed by some Directors with respect to the weakening of the separation of the SDR Department and the General Department. The staff was requested to explore further the issue and to present appropriate proposals.

2. ISRAEL—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Israel (SM/96/296, 12/3/96). They also had before them a background paper on selected issues in Israel and a statistical appendix (SM/96/295, 12/4/96).

The staff representative from the European I Department made the following statement:

> The government is in the process of trying to pass the 1997 budget through the Knesset and some information has come forward that is pertinent to the discussion.
>
> The first point is that inflation is doing somewhat better than had been anticipated in the staff report. Inflation seems to be coming down, ending up

the year around 10.5 percent, as compared with a peak at midyear of 13 percent and around 12 percent expected for the year in the staff report. Underlying inflation has also come down, although somewhat less.

In conjunction with the discussions on the budget, the authorities have announced an inflation target for 1997 of 7 to 10 percent, which is slightly lower than the 8 to 10 percent target that they had announced for 1996. They have also announced that by mid-1997 they would set a target for 1998. This, in our view, is a step in the right direction, because it effectively increases the average time horizon of the target from six months, as of now, to something like nine months, which is a step in the right direction, although still short of what we would see as desirable.

Economic activity remains broadly as described in the staff report. I would emphasize, however, one point which is also made in the staff report, which is that domestic demand remains quite strong. Growth of private consumption and private investment in the third quarter of 1996 increased at rates of 8 and 16 percent, respectively.

Finally, on the budget, the authorities, with the objective of strengthening the credibility of the 2.8 percent of GDP target for 1997, have announced additional cuts worth about half a percent of GDP for 1997. Our understanding is that these additional cuts are not because the 1996 deficit turned out to be worse than expected, but rather because it reflects a revision to their assessment of what revenues would be in 1997. This would also be a step in the right direction in relation to the issues raised in the staff report.

Mr. Wijnholds made the following statement:

As the staff's well written report sets out, Israel is in the midst of a critical stage of adjusting its economy to the rapid increase in population and economic growth of recent years. The wave of immigration from the former Soviet Union that led to growth in the years 1990–1995 at very rapid rates, has leveled off at a rate of 70 thousand per year, and its effect on the expansion of demand will diminish in years to come. As a result of these and other developments, the quantity and quality of the workforce has increased and so has the productive capital stock, although it is still lagging behind. All these factors reflect a potential from the supply side that is expected to lead to growth in the long run. The authorities recognize that a prerequisite for full utilization of this growth potential is a balanced and stable economic environment with adequate certainty. Economic policy in 1997 will focus on a reduction of the fiscal deficit together with other actions whose aim is to decrease the government's share in the economy, coupled with a continuation of a relatively restrictive monetary policy.

After an average growth rate of over 6 percent per annum in the years 1989–1995, GDP growth is projected to have decreased to a more sustainable rate of 4 percent this year. This development, reflecting both demand and supply factors, caused the demand pressures evident in the first half of 1996 to ease, positively affecting both the balance of payments and inflation. Prices have risen more slowly in the second half of 1996, at an annual rate of 6 percent per annum (July-November), and the trade deficit, which had already started to contract in the second quarter of 1996, continued to decrease in the months July-October. Inflationary expectations are also on a downward trend. Such a slowdown of economic activity to more sustainable levels is to be expected after six years of rapid expansion which brought the economy close to full employment. Other reasons for the slowdown, although of less importance, may be related to the real appreciation of the exchange rate over the past few years which may have affected the profitability of the tradable sector (although exports have actually picked up in recent months) as well as security problems and the closure which affected mainly the tourism and construction sectors.

An area of concern is the current account deficit, which is expected to reach $5.2 billion in 1996, in comparison with $3.9 billion in 1995. However, as portrayed very clearly in Chapter III of the Selected Issues paper prepared by the staff, the increase of the current account deficit is an expected phenomenon that is attributed to an increase in both investment and consumption as a consequence of the large wave of immigration. Undoubtedly, the increase of the public sector's budget deficit to about 4 percent of GDP in 1996 also affected the current account deficit at a time when fiscal restraint was called for. However, the increase in the current account deficit did not bring about a parallel increase in external debt. On the contrary, both gross and net external liabilities have decreased constantly in recent years, in relation to GDP, and the structure of the external debt has remained firm, with long term liabilities continuing to comprise over 75 percent of the debt and short term debt remaining only marginal. A major part of the financing of the current account deficit is due to foreign investment, which amounted to $2.3 billion in 1996 (January-November), exceeding the amount invested in all of 1995. The structure of foreign investment has also remained solid, with direct investment comprising over 40 percent of the total and the remainder due to portfolio investment in shares of Israeli companies traded mostly on U.S. stock exchanges and also on the Tel Aviv Stock Exchange. This inflow of foreign investment is an indication of the continued confidence of the markets in the growth potential of the Israeli economy, especially with regard to high-tech firms which comprise a major part of the shares issued in the U.S. Another indication of this confidence can be inferred from the recent flotation (December 5, 1996) of an amount of $200 million of 5 year Eurobonds by the State of Israel, at a spread of only 50 basis points over similar U.S. Treasury notes.

Over the past two years, the actual budget deficit has exceeded the planned deficit. These developments are mainly a result of over optimistic revenue projections and rigidness in adjusting actual expenses to lower revenues. In order to cope with this expanding deficit, the government has taken several steps whose aim is to gradually reduce the total deficit while increasing budgetary surveillance. The government has decided to set a total (local and foreign currency) goal for the deficit of 2.8 percent of GDP in 1997, with a decreasing path over time that will bring the deficit down to 1.5 percent of GDP in the year 2001. In accordance with the government's commitment to increased transparency and accountability, the Treasury will be obligated to report to the government at the beginning of each quarter about the developments of each component of the budget. At the beginning of each year, the budget will be adjusted to the actual revenues of the preceding year. This adjustment required a cut in the planned deficit for 1997 of a total of NIS 7.3 billion (in 1997 prices), or 2.4 percent of GDP. The decision for this deficit cut was made by government and it now awaits the approval of the Knesset.

Special emphasis will be placed next year on the adjustment of nominal expenses to an unexpected decrease in the inflation rate to a rate lower than that assumed in the budget, and a contingency reserve, included in the budget, will only be released if actual revenues remain on track.

Government revenues from privatization were exceptionally low in 1996, in comparison with previous years, a result of, inter alia, the perceived weakness of the stock market. The newly elected government plans to intensify privatization in 1997. In the sphere of structural changes, the telecommunications and public transportation sectors will be opened to competition in several stages, and the reforms in the petroleum sector will be continued.

Throughout 1996, the Bank of Israel conducted a restrictive monetary policy with the aim of achieving the inflation goal set by government for this year (8–10 percent) and preventing further acceleration of inflation. As the goal for the fiscal target was missed and as inflationary expectations continued rising, the main burden was placed on monetary policy, and the Bank began raising its key interest rates in several steps starting in mid 1996. At the end of June 1996 this interest rate reached an effective annual rate of 18.5 percent, a rate higher than 5 percent in real terms. As inflationary expectations eased, the Bank of Israel reduced the interest rate on its resources very carefully, still keeping the real rate at a high level.

The Bank of Israel did not intervene in the foreign exchange market since the beginning of February until the end of August 1996, enabling market forces to set the exchange rate within the sloping band. At the end of August, as capital inflows intensified, the Bank began intervening once again in order to prevent further appreciation of the exchange rate and to protect the lower boundary of the sloping exchange rate band. The amounts of intervention are much lower than those of the previous year and they were completely sterilized using various tools, including currency swap auctions and the new monetary instrument of auctions of banks deposits with the central bank. It should also be noted that more than one half of the capital inflows in 1996 (versus one third in 1995) are insensitive to short term interest rate differentials (mainly foreign direct investment and long term borrowing by Israeli corporations). Outflows resulting from direct investment abroad by Israeli firms (a result of the gradual liberalization of exchange controls) partially offset some of these inflows. The Bank of Israel plans to continue this careful liberalization process in 1997.

The rise in the budget deficit, its financing by borrowing from the public, the rise of short term interest rates and the sales of bonds by provident funds for the purpose of financing large scale redemptions, exerted upward pressure on long term rates. Consequently, in July, the Treasury and the Bank of Israel announced an agreement by which the Bank would be willing to prevent prices from plummeting by intervening in the bond market. Very little intervention was required by the Bank before the bond market stabilized. These operations were carried out by neutralizing their effect on the monetary base through the use of short term paper provided by the government for this purpose and without altering the trend of prices in this market.

In 1997 as well, the Bank of Israel will aim at attaining the inflation target set by the government, as part of a process to reduce the inflation rate to the level of Israel's trading partners. It is recognized that this longer term inflation target cannot be attained by monetary policy alone and that a continuous reduction of the government's expenses and deficit is a prerequisite for reaching this target.

Extending his remarks, Mr. Wijnholds noted that the government had announced the 1997 inflation target and their intention to reduce inflation to the level of the industrialized European countries by 2001.

Ms. Turner-Huggins made the following statement:

First, let me thank the staff for the candor expressed in a well-written staff report and for their informative and interesting set of issues papers. The staff has diligently exposed some of the more opaque features of the Israeli economy—including the appropriateness of budget deficit definitions (there seem to be many in Israel), and this has been helpful in appreciating and understanding this complex economy. During last year's Article IV discussion on Israel, this chair was impressed by the strong economic outturn and some remarkable policy achievements. In particular, by the extent to which the Israeli economy was malleable in absorbing immigration flows by allowing room for the private sector, lowering unemployment and at the same time keeping inflation on track. Directors noted then that the key policy challenge facing the authorities in 1996 and beyond was to strengthen the level of domestic savings—including a stronger fiscal effort, and emphasized that what was needed to complement demand management was a "reinvigorated supply side"approach urging stronger efforts in privatization. Economic developments since our last discussion replay some of the events of 1995—again Israel faces another wave of immigration, albeit at a somewhat slower pace and the economy finds itself in another round of overheating, meanwhile inflationary expectations seem to be moderating, although inflation in Israel is still substantially out of line with their trading partners. The expansionary fiscal stance of 1995—which led to overshooting of the budget by 0.4 percent of GDP, with the adverse impact on the external account raise concern. We share the staff's view and Mr. Wijnholds that Israel is indeed at a critical juncture.

My remarks are concentrated on one general issue—indexation, and two specific ones related to the tax/GDP ratio and structural reforms.

On indexation, I would welcome the staff's views on when Israel will begin to break the reliance on indexation which is pervasive in throughout the economy. In particular, the impact of indexation on financial markets. We observe that now that Israel's disinflation path is within reasonable limits as the country aims to reach inflation comparable to industrial countries (namely OECD), continued reliance on indexed instruments, including the partial indexation of wages, could mask the urgency of maintaining prudent macroeconomic policies.

On the tax/GDP ratio, it would appear that the authorities have embarked on an overly ambitious task of aiming to lower its tax/GDP ratio (based on a notion that Israel's tax to GDP ratio is out of line with OECD countries). Given the fiscal challenges ahead, we wonder about the appropriateness of this objective and would welcome the staff's comments on this. We note from the revenue data that in the recent years the authorities have been gradually lowering corporate taxes along these lines.

On structural reforms, we are concerned that Israel remains heavily regulated with a considerable amount of government ownership remaining. The record so far on privatization has not been convincing with a large number of banks still remaining with majority government ownership; key industries also remain (the airline, water and electricity sectors are still 100 percent government owned). Further elaboration by the staff on the status of the government's privatization program would be helpful as progress to improve efficiency and remove market distortions where they exist would go a long way in creating a more competitive private sector.

Ms. Lissakers made the following statement:

I want to commend the authorities for the significant progress they have made in the last several years. Most notably, a large influx of immigrants has been absorbed, primarily by the private sector. But the new government's economic record is, so far, mixed. There is a large gap between their early promises to pursue market-oriented reforms and their achievements to date.

In one sense, recent indicators that growth is slowing are welcome. It was obvious that the economy was overheating. On the other hand, some of the factors behind this reduced growth are troubling.

First, certain export and interest-rate sensitive sectors have been hard hit because monetary policy has had to bear all the burden of containing excess demand. The increase in interest rates on short-term deposits has also drawn investors' funds away from equities. New issuance of shares by private firms on the Israeli stock market appears to have dried up.

Second, some of the reduction in tourism revenues, trade, and investment has been due to slippages in the peace process and the border closures with the West Bank and Gaza. Does staff have any quantitative estimates of the effect of the closure on the Israeli economy for the past year or forecasts for next year?

While monetary policy has had to bear all the burden, it has only been partly successful in restraining domestic demand, which remains strong because of Israeli firms' access to international lending.

I agree fully with staff that it would be better to reduce overheating through a more balanced policy mix rather than relying solely on monetary policy. By any measure, recent fiscal trends are troubling. The primary surplus has declined. And the overall deficit, measured with generally accepted accounting practices, has averaged over 12 percent of GDP during the last 3 years. Net public debt is over 100 percent of GDP. And even these adjustments do not take into account the government's large unfunded pension liabilities.

While I agree the authorities should adopt more ambitious medium-term fiscal targets, one would also like them to meet next year's target. This, more than anything else will indicate their commitment to stabilization and reform. I commend the authorities for recognizing that their projections were optimistic and proposing further spending cuts and revenue increases.

Mr. Wijnholds stated that Israel is trying to be more transparent in reporting data. While I agree with the authorities that an operational budget may better reflect the extent to which discretionary fiscal policy is stimulatory, reporting increases in principal due to indexation is needed to assess the sustainability of fiscal policy. I urge the authorities to explain fully their methodology for reporting fiscal data on their home page in the data dissemination bulletin board. With the authorities tapping international capital markets, transparency is important.

Given the poor record in forecasting revenues, I think monetary authorities are right in waiting to see if next year's budget target is likely to be met before lowering rates. We agree with staff that it would be helpful if the government set medium-term inflation targets. This would reduce political pressure on the central bank and encourage Ministers to pay more attention to the inflationary effects of fiscal policy.

It might also spur firms and unions to move toward more forward looking wage setting schemes, which I think will be needed for authorities to cut the inflation to G-7 levels in the medium-term. The problem with Israel's pervasive indexation is that one shock, such as increased demand for housing due to the influx of immigrants, is quickly turned into general inflation throughout the economy.

In its campaign, the government promised to pursue many market oriented reforms. Many of these could reduce supply constraints and ease the burden on monetary policy. Land reforms which allowed people to enter into long-term leases and transfer ownership of leases would help ensure that land is used more productively. It is positive to see the authorities moving in this direction, and in some instances allowing leases of up to 200 years. I wonder why they don't take the next step. Does staff see any political support for allowing private ownership of land?

Reducing barriers to the flow of goods and services between Israel, the West Bank, Gaza, and Jordan, and normalizing economic relations, would enhance both competition and the peace process. Measures to remove impediments to the flow of labor between Israel and the West Bank and Gaza, in a manner consistent with Israel's security needs, would help ease wage pressures in tight labor markets.

One can see the need for increased competition in many sectors is sorely needed. This will have to be accompanied by a much more ambitious privatization program since it is difficult for governments to press for competition in sectors where they own enterprises with dominant market positions. In some sectors, authorities are right about the need to establish regulations before privatizing. While this is true, announcing an ambitious privatization program could help spur the regulatory effort.

The government should also make it easier for firms to raise equity by reducing subsidies and tax incentives to invest in government securities. Many of the reforms proposed by the Brodet Commission are a step in the right direction. The most important is to reduce the supply of government bonds with above market guaranteed real returns. This would improve both the allocation of savings and the fiscal deficit. It might also make households more aware of the trade off between risk and rewards, and perhaps more tolerant of stock market volatility.

However, some of the Commission's proposed reforms seem to us to be quite timid, such as increasing the percentage of assets institutions can invest overseas from 2 percent to 5 percent. This would take pressure off the shekel, and reduce the central bank's need to intervene in the foreign exchange market.

Finally, I would like to hear staff's views on whether they believe this summer's "bailout" of the government bond market has increased the risk of moral hazard on the part of investors.

Mr. Shields made the following statement:

Normally, it is difficult to argue with an economic success story. The fact that the Israeli economy has been able to absorb so many immigrants over the last six years and sustained average growth rates of around 6 percent during that time, and also without inflation taking off to the extent that it did in the 1970s and 1980s, is no mean achievement.

But in the case of Israel, it seems that the warning signs are currently so clear, and have been for the last year or so, that I have little hesitation about agreeing with the thrust of all the staff's recommendations for change. In fact, there are a lot of areas where progress needs to be made—quite urgently in some areas. If anything, although the staff report listed them all, it could have been stronger in the tone in which these things were addressed.

Looking at the economy at the moment, there are clear indications of pressures—for example, the rising current account deficit and the fact that inflation, although improving in recent months, is still too high. The recent modest deceleration in the economy, although welcome, came essentially from lower exports and perhaps a worse-than-expected investment performance, reflecting in fact the worsening security situation in Israel. These are not the most reassuring origins for the desired slowdown.

I appreciated the efforts in the background paper to review the factors behind the current account deficit. Indeed, part of that deficit may indeed be appropriate, given the pace of absorption of immigrants in recent years and the need for investment to back their future employment. But the speed of the deterioration in the last few years in the current account, and the fact that it is associated with the domestic economy that shows other signs of overheating, suggests to me that a considerable part of the deficit reflects inappropriate policies and, in particular, poor fiscal policies. As a result, the current account deficit is not sustainable. Israel needs substantial investment in the years to come, which may mean deficits rather than surpluses on the current account, although not of the current size. That means that there will need to be more urgent action on the fiscal side and stronger targets by the authorities.

I liked the analysis in the background paper on the public sector accounts. As with the current account, there is no clear conclusion, but I would be inclined to take two major messages. First, in targeting the public sector deficit, it is necessary to have a comprehensive coverage of all public sector activity. Secondly, although in an indexed economy it may not be appropriate to give full weight toward accrued liabilities, it is equally unwise to hide all the effects of indexation outside of a recorded or a targeted deficit. When one sees figures on an international basis more like 10 percent of GDP for the public sector deficit, it gives us great cause for concern. It does suggest that one should not be looking simply at a measure of deficit which basically gives the most optimistic assessment of the underlying situation; in fact, I would not give 100 percent weight to either end of the spectrum, but rather some weight to each. As a result, when the staff was critical of the government's medium-term fiscal targets and was suggesting going to balance rather than a small deficit, it might have been more sensible, using the standard recorded deficit, to have actually gone for surpluses in the medium term. Another reason for that is the continued uncertainty over the effects of pension reform. Therefore, the government needs to get a real handle over its overall fiscal situation soon. Part of that means more ambitious targets, but also more effective implementation. I was glad to hear that there is another fiscal package on its way for 1997, which includes, amongst spending changes, some pruning on the defense side. In terms of actually getting the right outcome for 1997, the staff is right to insist on the need for a contingency reserve, given probable over-optimism in the figures that remain.

On the monetary side, the Bank of Israel and the staff are right to identify the fiscal situation as the main cause of monetary difficulties. Nevertheless, given the situation, there is still a danger from giving too much weight to exchange rate movements in setting monetary policy. There is more flexibility than there was in terms of the exchange rate band, but if capital flows persist, as they may well do given the still high relative rates on domestic borrowing, and the consistency of monetary policy is continually called into question, there might at some stage again be the need for more relative appreciation. I would join the staff in urging the authorities to give primacy to the inflation target.

Regarding the inflation target, the authorities are looking again at the time period and the definition of the target itself and the indicators that can be used to assess progress against the target. There is much refinement that could be done in that area. Hesitation about using inflation targets are understandable, but the fact that New Zealand, which is another small economy vulnerable to external shocks, has operated successfully and has substantially improved its credibility suggests that those credibility gains could be won by Israel as well.

On the problem of capital inflows, it seems to be exacerbated by illegitimate flows of capital; more effective anti-money laundering legislation would certainly help to limit this, as well as being important in its own right.

On structural issues, I fully endorse the calls by the staff for greater progress on privatization and deregulation, and the further liberalization of the capital account. There is a real need to increase the role of the private sector in Israel and to promote greater competition, so I am pleased that the new government is seeking to accelerate the privatization process. But, here again, the inherited credibility of the authorities is not high, so we will again need action to demonstrate commitment. In addition, I fully support the intended reduction in subsidies to industry. Perhaps more could be done in this area, which would also benefit the budget.

Finally, a word on the security situation. Clearly, as the staff outlined, security developments and confidence effects pose a great risk to the successful medium-term evolution of the Israeli economy. The crucial issue at the moment is the external perceptions of the peace process, which has suffered significant reversals since the optimism of 1994 and 1995. Even without security disasters, which could depress tourism and scare away investment, Israel's attractiveness as an emerging market of substance will depend crucially on arrangements for peace which can permit Israel to be at the center of a newly dynamized Middle East. I think this is what was hoped for two years ago. As the prospects of that recede, so will short- and medium-term investment in Israel. Given its enormous potential in terms of manpower and position, this would be a great waste.

Mr. Autheman made the following statement:

I would like to commend the staff both for the quality and the brevity of the report.

I am in broad agreement with the staff appraisal and with the emphasis on the need to strictly implement the planned fiscal consolidation as a precondition for monetary policy easing. It is welcome that the authorities intend to undertake a significant fiscal consolidation next year, although I must say at this stage that the credibility of the plan is not fully established, in spite of the good news reported today by the staff and Mr. Wijnholds.

I especially commend the staff for the quality of the background paper on the fiscal position and, indeed, also their treatment of the data which, as previous speakers say, show that there can be some significant differences between apparent situations and real situations. I was interested by Ms. Lissakers's comment on the accuracy of data provided to the SDDS, and I look forward to the staff's remarks on that.

Indeed, even if the external position seems to be sustainable, especially on the basis of dynamism of high-tech sectors in Israel, the very magnitude of the domestic debt and the fact that it is fully indexed is a major cause of concern. I remember that at the time of our periodic review of the Madrid Declaration in September, the case of Israel was mentioned, among others, as that of a country which presents a puzzling situation of persistent inflation.

One of the explanations given for the persistence of what the staff called "moderate inflation"—but some us did not agree with the adjective—was the fact that in many countries the inflation tax could explain the reluctance to make further efforts to reduce inflation. Clearly, this is not the case in Israel since the inflation tax is neutralized by the indexation of public debt. And since the authorities appear to be determined to make further progress in reducing inflation, I think the staff would be well inspired in the next Article IV consultation to pay close attention to the cost of the past tradeoff in favor of relatively high inflation in terms of sustainability of growth.

My second comment is related to the background paper regarding the sustainability of the current account position. First, I very much welcome the emphasis given to that issue and, again, the quality of the analysis, since it is of central interest to the Fund. I agree with the conclusion that the immigration shock has played a very important part in the deterioration of the current account position, although I think that Mr. Wijnholds may go a little further than the conclusion of the paper. It does not seem that the paper goes as far as accepting that the 5.2 percent-of-GDP current account deficit as recorded in 1996 can be fully explained by such shocks. There are clearly underlying elements of policy slippage.

The report points to several factors related to the structure of the external debt and to the nature of capital inflows, and also to the strength of capital goods imports, to reach the conclusion that there is no reason for serious concern. However, as regards the capital balance, I must say I am puzzled by some conflicting information. On the one hand, there is the indication that inflows are mostly insensitive to short-term interest rates, i.e., direct investment and equity portfolio investment. This point was made by Mr. Wijnholds in his buff. But, on the other hand, as noted by Ms. Lissakers, there is an indication that the recent increase in interest rates has resulted in a massive transfer from equity to interest rate instruments. My question is how these two elements of information relate, and is there not a recent trend which would show a deterioration of the quality of capital inflows.

The Deputy Director of the European I Department remarked that Israel had become rather passive on the subject of inflation, in large part owing to the fact that the real costs of inflation were not evident to the public. As a result of the country's inflationary past, elaborate mechanisms protected the system from purely nominal shocks, and it might be difficult to convince the public and some parts of the government about the importance of disinflation. While the government had announced a bold plan to reach OECD inflation rates in the near future, the precise manner in which the plan would be implemented was not clear. A serious effort at disinflation would need to limit the scope of indexation, but the situation in Israel, in some respects, was not as bad as might be feared. Indexation in the labor market was partial—at about 85 percent of the price increase over the preceding six months, adjusted twice a year—which compared well with a country like Belgium. More pervasive and unique to Israel was financial market indexation, which in the past was fully indexed to inflation. Indeed, in the case of some government instruments, guaranteed real rates of return were offered—quite large in some cases, such as 4.5 percent on all pensions. More recently, the government had been moving away from the exclusive reliance on such indexation and had been issuing so-called unlinked debt. Such instruments had been increasing as a proportion of the market—from about 2 percent in 1994 to 4.5 percent in 1995. Clearly, however, there was room for improvement, particularly by broadening the range of instruments providing unlinked debt. As the authorities succeeded in bringing down inflation, the public might increasingly shift to unlinked debt instruments. However, indexed debt should not be entirely eliminated, particularly in the context of the favorable experience of the United Kingdom with indexed debt instruments. Moreover, as indexed debt amounted to the government betting that inflation would be better than the public expected, it was attractive from a disinflation point of view.

On the measurement of the budget deficit, the current widespread perception in Israel was that the 3 percent deficit target for 1997 met the Maastricht Treaty criteria, the Deputy Director continued. That erroneous perception was due, in part, to the fact that the country was insulated from the actual costs of inflation. In that regard, the staff agreed with those Directors calling for greater transparency in fiscal policy.

Determining an appropriate medium-term budget target depended greatly on inflation performance, the Deputy Director remarked. However, the inflation formation process in Israel was still not fully understood. Nevertheless, the staff had estimated that a 1.5 percent of GDP operational deficit for 2001 would be consistent with a nominal deficit of about 7 percent of GDP. However, the faster the authorities moved toward operational balance, the more leverage they would have over inflation, and the nominal deficit on a Maastricht basis could be reduced to about 4 percent of GDP by 2001.

The authorities had begun the privatization process quite boldly, but as yet there had been little progress, the Deputy Director said. The prime minister, whose office was currently responsible for privatization, had promised a privatization plan, but the details were still to be announced.

While the authorities had expressed the desire to reduce taxes, reconciling such desires with the deficit objectives might prove challenging, the Deputy Director noted. Currently, the overall tax ratio was 40 percent, while the OECD average was 38 percent; the corporate tax rate was 36 percent, compared with an international average of 30–40 percent. The value-added tax was currently 17 percent.

The staff did not have any additional information beyond that included in the staff report on the impact of the recent West Bank and Gaza border closings, the Deputy Director stated. There had been a significant effect on the labor market, which had led to more foreign labor coming into Israel, and there was also a pronounced effect on perishables bought from the West Bank and Gaza, which had an effect on inflation performance.

The low level of private ownership of land might be affected by cultural factors, the Deputy Director considered. About 95 percent of land was currently held by the state, and the issue of increasing private ownership was not under consideration. Nevertheless, leases were often long term and renewable. Such long-term lease arrangements were also common in other parts of the world.

The recent financial crisis in July 1996 had not led to a full-scale bailout of the bond market, in the sense that there had not been a significant fiscal cost to the central bank or the government, the Deputy Director said. The large shift from liquid funds to nominal short-term deposits had been encouraged by certain tax incentives. In the end, however, the central bank's intervention had been modest.

The staff did not have any direct knowledge of the importance of illegitimate capital flows, but the central bank had been quite strict in its banking supervision and it would be surprising if there were a major problem in that area, the Deputy Director stated.

On the sustainability of the current account, as Directors noted, the strong supply shocks to the Israeli economy justified a current account deficit, the Deputy Director remarked. The staff's concern was that those shocks had been exacerbated by a fiscal shock to the demand side, which had compounded the investment dynamics underlining the current account performance. The staff would agree that a current account deficit of 6 percent of GDP needed to be addressed, which was one of the main reasons behind the advice to curtail the fiscal deficit. While Mr. Wijnholds was correct in noting that in the near term the current account deficit was not creating financing problems over the longer term some fiscal adjustment would be required.

Mr. Shields noted that the staff report had underlined that the authorities operational deficit target of 1.5 percent of GDP was not sufficiently ambitious, and that overall balance might be preferable. In the context of the widespread indexation in the Israeli economy, an early move toward overall budgetary balance would seem appropriate. Also, there had been several recent reports about the extent of money laundering in Israel and the weakness of the existing legislation; stronger supervisory efforts would be welcomed.

Mr. Erasmus made the following statement:

> The performance of the Israeli economy during the years 1989–95 was impressive. A situation of strong growth, at or near full employment, together with inflation declining to low levels, is indeed an experience that many other countries would want to emulate. It is therefore unfortunate that the authorities did not act comprehensively when the economy began to show signs of overheating. In fact, the relaxation of fiscal policy during this period, as

evidenced by the substantial increase in the overall budget deficit, contributed to the strength of aggregate domestic demand. Although monetary policy was tightened, it was not sufficient to maintain economic stability, as inflation accelerated again to a double-digit level and the current account of the balance of payments developed a substantial deficit.

Although there recently have been signs of a slowdown in economic activity, and the sharp deceleration of inflation in the second half of the year, as noted in Mr. Wijnholds's preliminary statement, is quite welcome, the continued buoyancy of aggregate demand emphasizes the need for an adjustment of policy to re-establish stability.

There is clearly a need to change the course of fiscal policy. Up to now, the burden of restoring stability has been placed on monetary policy—an approach which has necessitated the maintenance of higher real interest rates. The resulting inflows of especially short-term capital has not only exposed the external account to considerable risks, but has also started to affect the international competitiveness of the economy. A more appropriate fiscal policy will contribute to lower interest rates and improve the international competitiveness of the economy.

It is also necessary to strengthen domestic savings and investment at a time when it is needed to complete the adjustment to the immigration shock of the 1990s, i.e., to restore the size of the capital stock in relation to other factors of production. I therefore welcome the intention of the authorities to make fiscal consolidation the centerpiece of the policy framework. However, while noting that the reduction of the deficit to1.5 percent of GDP in 2001 represents a significant change, I agree with the staff that the authorities should consider a more ambitious program for the deficit, given its size when calculated on the basis of more conventional methodology.

Even if the authorities do not accept the alternative method for purposes of policy formulation, they should still take account of the absolute size of the deficit and its impact on the inflationary process. In this process, it would also be important for the authorities to strengthen budget discipline with regard to both revenue and expenditure in order to reestablish the credibility of fiscal policy. As the main reason for the past weakness seems to have been related to revenue, the authorities should adopt more realistic targets for revenue collection.

With regard to expenditure, the authorities should implement all of the measures under consideration, i.e., reducing public sector employment, reducing subsidies to enterprises, and controlling social transfers. I commend the monetary authorities for tightening policy when signs of overheating emerged, and I agree with their view that any relaxation of policy to counter the impact of high interest rates before evidence of a full implementation of fiscal policy will only be inflationary.

I welcome the increasing emphasis on inflation targeting, as it will provide a clear signal to the market as to the aims of the monetary authorities.

However, given the volatility of the overall consumer price index, I agree with the staff that targeting underlying inflation and developing longer-term measures of inflation expectations are useful concepts to be considered by the authorities.

Finally, I welcome the subscription of Israel to the SDDS, although there appears to be some uncertainty with regard to data on the fiscal accounts.

Mr. Watal made the following statement:

This chair congratulates the staff for preparing an informative and analytical report on Israel. We also congratulate the authorities for the steps they are taking to address major macro-economic concerns effectively.

While we are in general agreement with the analysis and assessment of the economy prepared by the staff, this chair would, however, like to flag the following points.

The sign of economic overheating after a period of 6 percent per annum growth between 1989 and 1995 is a matter of concern especially because 1996 is now being seen as a recession year. We have a situation where the current account has shifted to a deficit of 6 percent. The domestic savings have deteriorated. There is an upward pressure on inflation and real wages in the private sector. Activity in the construction sector has fallen and real GDP growth is estimated to decline to some 4 percent in 1996 from 7 percent last year. It would seem that the mix of the monetary policies of government, which have kept both interest rates and the shekel at high levels to curb inflation and the fiscal deficit, have contributed to decreases in both exports and imports, and in the rate of industrial growth. It is also our assessment that in the post-election period, there has been an increasing ambivalence about the stabilization of the economy which has been affected by the dominance of security problems.

The staff paper describes the Israeli economy to be at a point where it faces "a restive mixture of promise and risk." The phrase captures the predicament of the Israeli economy aptly. But apart from the possibilities and potentials the essential mold of the economy remains the same. The major factors which continue to influence Israel's economy are immigration, high defense expenditures, a lack of natural resources, high import bills, a relatively small domestic market and fiscal resource base, limitations on access to foreign markets and substantial inflows of foreign capital. The government's policies could be focused on controlling the fiscal deficit and inflation, but expenditures on defense which we believe are of the order of 10 percent of GDP and social safety nets (19 percent of GDP) are also on the high side. Industrial production is concentrated on military related equipment and the government is still heavily involved in the economy, with revenue from government owned companies in the range of 15 percent of Israel's GNP. The economy has always been supported by its partners who have provided timely foreign assistance to cover its trade and fiscal deficits. The security concerns of the state are understandable and this has given the Israeli economy a particular character. It is perhaps for this reason one can understand that the authorities cannot always apply standardized economic palliatives automatically. We subscribe to the view that "governance" in a broader context should always be determined by the genius and the ambition of each nation and need not be influenced externally.

We are confident that the new government's plan to cut the overall deficit to 2.8 percent of GDP in 1997 could be made an achievable target especially because the business sector is performing relatively well which would mop up higher revenues. This coupled with across the board spending cuts does make the target seem credible. We support the suggestion made by staff to include a contingency reserve in the budget which should be released when the authorities report to the Knesset at mid year that the fiscal accounts are on track. We also agree with the analysis of staff on the medium term path for fiscal consolidation. The authorities may wish to consider the recommendations made by staff. The authorities have, as reported, taken positive steps in this direction.

The monetary policies of the authorities have been tight. Despite this the inflation has been running above the targeted range. To ease the situation the monetary authorities have rightly emphasized that fiscal consolidation must go along with any easing in the monetary restrictions. The scepticism of the monetary authorities regarding fiscal credibility could well be misplaced. The middle path suggestion given by staff to achieve the medium term objective of an industrial country inflation rate by 2001 of 4 percent and an intermediate ceiling of 7 percent for 1998 as well as a target specification for 1997 is very good.

The observation made by staff that it is necessary that government intervention ought to be reduced to make the economy competitive and market oriented should be weighed carefully keeping in view the particular needs of the Israeli economy. We should also be conscious of the fact that public sector enterprises or institutions by definition are not necessarily unproductive or noncompetitive. There exist, in many economies, enterprises fully or partially owned by the state which are functioning autonomously and are facing international competition effectively. It may not be prudent to advocate, by reflex, a policy of "throwing the baby out with the bath water."

We would like to conclude by mentioning that the overall parameters of state security would play a basic role in determining the direction of the economy and we sincerely hope that adverse security developments do not impair the improvements that have been attained in the domestic and external sectors. We are confident that despite the hurdles, the critical factor of fiscal account consolidation will be achieved. Israel has in the past successfully implemented a stabilization program with remarkable results. We have no doubt in our mind that the authorities will be able to meet successfully the current challenges.

With these comments, we wish the authorities all success in their future endeavors.

Mr. Leiva made the following statement:

Since 1992, the Israeli economy experienced a significant economic growth. In spite of the challenge of absorbing a large number of immigrants, unemployment has declined to 6 percent. Inflation has remained around 10 percent. Investment expansion has increasingly relied on foreign savings as domestic saving has declined. Monetary policy has been tight to counterbalance an expansionary fiscal stance.

In general we are in agreement with the staff report. Nevertheless, I would like to make a few remarks on fiscal, monetary and exchange policies.

I concur on the need for attaining the 1997 fiscal target and for a stronger fiscal consolidation effort than envisaged by the authorities in the following four-year period. In this connection, I would like to note that there is a need to work out the budget on the basis of more prudent revenue estimates and that complementary measures should be taken to enhance the credibility of the deficit target. Fiscal deficits have exceeded those planned during the past two years. Furthermore, credibility in this area is being affected by opposition coming from those ministries whose budgets might be cut, and by the pressures being placed on the government to increase funds for settlers, which is an electoral promise.

According to Mr. Wijnholds's very illustrative preliminary statement, the substantial fiscal adjustment the government has planned for 1997 amounts to a deficit reduction of 2.4 percent of GDP. I wonder why the effort envisaged in the years up to 2001 is aimed only at the relatively modest deficit target of 1.5 percent of GDP.

I fully agree with the staff in that financing the high projected rate of investment and achieving the authorities' inflation objectives will require a larger fiscal effort. I would appreciate staff and Mr. Wijnholds's comments on this fiscal target for 2001.

As the staff's report points out, monetary policy has had to bear the brunt of the fight against inflation over the past two years. If exogenous factors are discounted, it has succeeded in counterbalancing the inflationary pressures coming from the rise in the budget deficit. During the first semester, inflation went up and so did interest rates. Although inflation expectations appear to have eased in recent months, relaxation of monetary policy will have to be carefully graduated to allow for sufficient progress in the fiscal consolidation adjustment.

The Bank of Israel has maintained its exchange policy, interventions in exchange markets have been limited, its monetary effects sterilized and appreciation of the currency derived from capital inflows confined within the boundaries of the exchange band. The liberalization of capital outflows has helped to achieve these results and should continue in 1997.

I hope the peace process will continue and security concerns will not obstruct economic performance.

Mr. Konan made the following statement:

Israel has shown an impressive economic performance over the first half of the current decade. The rapid growth of domestic economy, boosted by exports and investments, has been accompanied by striking improvements in implementation of structural reforms regarding mostly privatization, capital markets, exchange and trade regulations prices controls as well as labor market and land reforms.

However, expansion of supply and demand have, ever since, worsened the Israeli economy overheating which was perceptible at time of the last Article IV consultation discussions in mid-September 1995.

As a result, in 1996, the economy grew at a lower pace, as did exports of goods and services and investments; labor indicators showed an unchanged average unemployment rate, while inflation rate measured by changes in end of period consumer prices increased substantially, and current account deficit widened further more.

There is no doubt that the macroeconomic disequilibrium need to be corrected for a return of the Israeli economy back to its dynamism of the first half of the nineties.

We therefore, concur with the staff appraisal regarding fiscal consolidation, disinflation and enhanced structural reforms. However, we would like to make some comments on fiscal and monetary policies.

On fiscal policy, we welcome revenue increasing reforms envisaged by the government for a deficit reduction. On expenditure side, we noted the authorities determination to strengthen measures on current expenditure, mainly on wages, and also believe that these measures should aim at curbing excess demand for further fiscal consolidation and domestic saving increase. In this context, it would be appropriate for the Israeli authorities to extend budgetary surveillance the other expenditure, and mostly subsidies and transfers, and to cope with their adjustment schedule.

For a better assessment of results in deficit reduction policy, we invite the authorities to improve the comprehensiveness of fiscal data. In this context, we are encouraged to note that Israel has subscribed to the SDDS.

On monetary and exchange rate policies, we understand the authorities' stance regarding the strengthening of monetary policy through increasing interest rates. However, high interest rates policy should take into account international trends and avoid to worsen the burden on external sector. We, therefore, encourage the monetary authorities to pursue the liberalization process.

With these comments, we wish the authorities every success.

Mrs. Gotz-Kozierkiewicz made the following statement:

Let me begin my short remarks by joining the staff's appraisal that the Israeli economy is at a critical juncture—a mixture of promise and risk. To be concise, I will pass over the many positive elements of the successful story of the Israeli stabilization. On the side of its risky aspects, the fiscal performance and high public debt have been fundamental issues. Postponement of a more substantial adjustment, which should be reflected in a stronger concerted action on both sides, revenue and expenditure during the first half of the 1990s, contributed to overburdening of the monetary policies in 1995–96.

There have been a number of factors in 1995–96 working toward an aggravation of potential and real imbalances in Israel. All of them have been comprehensively discussed in the staff's report and the background paper and in the very helpful preliminary statement of Mr. Wijnholds, and I would not enumerate them to avoid unnecessary repetitions. What seems to be of core importance, is the authorities' determination to proceed according to a well designed medium-term stabilization strategy based on clear targeting of a gradual inflation reduction and tight fiscal discipline. I agree with the staff and with other Directors that the medium-term fiscal targets should and probably could be more ambitious.

Fortunately, the second half of 1996 appeared to be a relatively successful period in reducing a portion of the implied imbalances. This may be additionally counted in factors promising for the longer-term prospects of the Israeli economy, although under the condition that said improvement would not weaken the authorities' commitment to keep up to their declared path of strengthened fiscal consolidation.

Progress in structural adjustment covering inter alia the banking sector functioning and increasing transparency in the Israeli financial markets must also be welcome.

Ms. Zheng made the following statement:

Six consecutive years of sound economic growth have laid the foundation for the Israeli economy to meet the more serious of its challenges. It is true that the large inflows of immigrants have brought domestic demand up and are eroding the past disinflation gains and that the latest security uncertainties have made it more costly for the economy to adjust to the new situation. Obviously, the current challenges are to quickly cool the economy by reducing the domestic demand. However, given the high quality labor force and the very diversified production base, the great potential for this economy will hopefully raise the aggregate supply quickly once the security situation improves. Therefore, attention should also be paid to supply side policies, such as structural reform. Since I broadly agree with the staff appraisal, I will focus on some important issues.

First, as Mr. Wijnholds pointed out, the signs of economic slow down have been manifested by the decline in growth, inflation, and the current account deficit in the second half of 1996. However, the strong growth in investment and consumption caused by the immigrant inflows is still the fundamental reason behind the persistent current account deficit. More seriously, since immigrants need to settle down, their demands are usually insensitive to interest rates, which, to some extent, complicate monetary policy.

After 1994, policy mix began to overburden monetary policy, while fiscal policy became relaxed as evidenced by the wider margins of breach of fiscal targets. Monetary policy could be viewed as generally successful in combating inflation. As the result of high real interest rates, inflation expectations eased. However, as the staff has analyzed in the report, the side effect of tight monetary policy has created some dilemmas, such as large capital inflows, unsettled domestic financial markets, and the reorientation of the monetary framework from an exchange rate based one to an inflation targeting framework. Therefore, it is difficult for monetary policy to sustain the overburden without a tight fiscal policy. In light of this, I fully agree with the staff that, despite the continuous tight monetary policy, the centerpiece of the policy mix should be fiscal tightening.

Turning to fiscal policy, the authorities are encouraged to minimize the target breach in 1997. To this end, I welcome the authorities' itemized expenditure control plan, in particular to control the increase in wages. In this connection, I noted from Mr. Wijnholds's preliminary statement that the authorities are going to strengthen the budgetary discipline in order to increase transparency and budget accountability. On the revenue side, the 1 percent of GDP increase in revenue is clearly needed to offset the decline in foreign revenues. It should be noted that revenue in the past once fell short of target despite the cyclical upturn. In addition, the real GDP projection for 1997 is only slightly above that in 1996, which might be difficult to justify that the growth of the business sector will lead to significant revenue gains. Therefore, I can concur with the staff's cautious approach to include in the budget the contingency reserve. In this connection, we welcome the authorities' revised revenue estimates. The authorities should be commended for establishing a clear medium-term fiscal consolidation path throughout 2001. This approach will make clear the debt reduction process in the medium term.

Structural reform remains the core in complementing macroeconomic policy. Structural reforms have been embarked upon in almost all the important areas: the enterprise and banking sectors, the capital market and trade and exchange rate systems. It is encouraging to learn that "the newly elected government plans to intensify privatization in 1997" and this will not only include the telecommunications, public transportation and petroleum sectors, but also involve the banking sector. The authorities' emphasis on enhancing the regulatory framework before the privatization of several current monopolies seems justified, given the experience we have gained from other transition economies. It is worth noting that the break up of the monopolies without a good anti-trust law and its forceful implementation might cause the emergence of new monopolies. However, the wait-and-see approach is also not practical, for policy makers can never predict market innovation and regulatory framework can never be perfect. The only course for policy makers is to minimize the risks ahead by studying others' experience.

With these remarks, I wish the authorities every success in their future endeavors.

Mr. Fukushima made the following statement:

At last year's Board meeting, the Board expressed concern about the overheating of the economy and the widening of the external current account deficit. It is regrettable that neither of these has improved yet. I agree with the staff's appraisal, and will make a few brief remarks on some of the policies.

On fiscal policy, the authorities set an ambitious target for the fiscal deficit of 2.7 percent of GDP for 1997. I welcome the authorities' intention, but I urge them to indicate the specific measures they plan to implement, especially in the area of expenditure control, to achieve the target.

On monetary policy, the monetary authorities' efforts to reduce inflation seem to be constrained by a lack of coordination with fiscal and exchange rate policy. I urge the authorities to improve coordination with the other authorities involved.

On structural reform, the current short-term capital inflow should be turned into long-term capital through deregulation and improvement of investment conditions.

Finally, as the stabilization of the Israeli economy is crucial for the stabilization of the entire region, I wish the authorities further success in their endeavors.

Mr. Hamilius made the following statement:

During our last discussion on Israel in September 1995, the first signs of overheating were visible. Now the overheating is in full swing and seriously threatens Israel's competitiveness and macroeconomic stability. It is regrettable that authorities did not take advantage of the favorable economic and political conditions of recent years to correct the looseness of fiscal policy and stop the trouble before it started. Now, despite the remarkable economic strength illustrated by Israel's solid growth and the successful integration of some 750,000 immigrants, it will take years of strenuous effort to restore the stability and credibility of the Israeli economy.

Since I generally agree with the staff's assessment of Israel's situation, I will just comment briefly on some key aspects of the fiscal situation, the current account deficit, and privatization. I will not comment on monetary policy, since I share the staff's and previous speaker's views that the Central Bank of Israel has pursued adequate policies in an environment of deteriorating public finances. Of course, in the absence of adequate fiscal restraint, this tight monetary policy has caused the authorities some headaches.

I have to agree with the staff that caution and additional efforts are needed on the fiscal front. The authorities have finally recognized the need to act. Unfortunately they seem to lack the will needed to pursue a firm fiscal policy. In 1995, the fiscal situation appeared to improve, essentially because revenues were higher than expected. This windfall revenue improvement was not repeated in 1996, although it had optimistically been included in the budget, and the 1996 fiscal deficit will once more greatly exceed the target of 2.8 percent. The already high marginal tax rates leave little room for increasing revenues, so that any fiscal adjustment will have to rely on expenditure reduction and expenditure control. It is reassuring to learn from Mr. Wijnholds's statement that the government has proposed some measures to cut the fiscal deficit. But these measures need to be broadened. In addition, before they can accomplish their purposes they will have to be approved by the Parliament and be implemented and enforced.

It may be true financing the current account deficit is not presently a problem, since its causes are connected with stable foreign investment and a consumption boom caused by the large number of immigrants. But as this chair already mentioned last year, the point where the situation becomes unsustainable may be reached sooner rather than later. If imports continue to increase, the deterioration of the current account will increase with them.

It must be hoped that the overheating problem will reverse itself and relieve its pressure on the current account. However, the civil service wage increase will do nothing to persuade households to reduce inflationary spending. Fiscal policy should aim at increasing public savings, in order to prevent the gap between domestic savings and investment from widening further.

I have just a brief remark on privatization. The number of privatized enterprises has been especially disappointing, as acknowledged by Mr. Wijnholds. It is all the more disappointing following the small but real improvement observed in 1995. Given the additional quasi-fiscal consequences of the financial difficulties that affect many of these enterprises, the authorities would be well advised to speed up the privatization process to avoid further deterioration of the fiscal situation.

I wish the authorities every success in their future endeavors.

The Deputy Director of the European I Department remarked that it was not clear why the authorities, after trying to reduce the budget deficit by 2.4 percentage points of GDP between 1996 and 1997, would moderate their efforts thereafter. However, from a medium-term perspective, the indexed deficit concept was much less useful. It would be desirable for the authorities to think in terms of a nominal deficit target in a medium-term context where they could incorporate both their inflation objectives and their real objectives. However, the authorities needed to display greater resolve to tackle such problems.

Mr. Wijnholds made the following closing statement:

I would like to thank Directors for their useful contributions to this discussion. I would also like to thank the staff once again for its excellent report. I agree with Mr. Autheman that its brevity and quality set a good example. I also liked the elegant prose—particularly this "restive mixture of promise and risk," which also well reflected this debate.

The staff has made my task easy by answering the questions with great authority, and I have little to add. This question of the budget deficit definition is an interesting and difficult one, as far as I understand. I might just say that Box 1, on page 5, gives this comparison with the Maastricht criteria, and I think that is helpful. I might just point out that my understanding is that the original work on this was in fact done in an internal memo by the Bank of Israel. So, there are pockets of awareness about this, I believe, and I think that is hopeful. Also, it is a difficult matter because if, for instance, one had concluded that the fiscal stimulus was on the basis of the adjusted deficit, one might have drawn a wrong conclusion. Indeed, according to the Israeli definition, from 1994 to 1995, the budget deficit went up, but according to the adjusted definition it would have come down from a high level. So, there are some problems, but certainly it is correct that this matter was flagged in order to avoid giving a wrong sense of complacency.

On the size of the budget adjustment, the fiscal adjustment now of around NIS 7.3 billion, or 2.4 percent of GDP, is being proposed by the government for 1997. The initial amount proposed for this adjustment was smaller but it was increased in the meantime, perhaps not completely unrelated to some of the Fund advice that has been given. The size of this adjustment is considerable and probably also reflects political realities.

On the question of indexation, I have nothing to add, but it is certainly an important central problem. I took note also of some comments on the current account deficit and its financing. I just want to echo what the staff said that it does not create any financing problems at the moment. Of course, the budget adjustment should also help bring down the current account deficit in the coming years.

The Acting Chairman remarked that some elements of the staff report had been leaked to the media, which was a cause for concern. The leaked report focused on budget accounting issues, particularly on the issue that, if the accounting were done according to an alternative methodology, the deficit would be much larger.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their effective management of the economy over the last six years, which had witnessed a near halving of both the inflation and unemployment rates and the successful absorption of more than 750,000 new immigrants. They observed, however, that an expansionary fiscal policy starting at the end of 1994 had tipped the economy into overheating, with the current account deficit exceeding 5 percent of GDP and inflation rising. While welcoming the recent slowing in the pace of activity to a more sustainable rate, Directors remained concerned about the persistence of inflation and the high current account deficit. The main policy requirement was therefore for the authorities to strengthen domestic savings with a more ambitious fiscal consolidation effort to ensure the prospects for sustainable, investment-led growth over the medium term. Directors viewed the authorities' medium-term strategy of fiscal consolidation, disinflation, and structural reform as charting the appropriate direction of the needed adjustment to achieve the economy's potential; however, Directors believed that a more ambitious path of fiscal adjustment would be advisable. Directors also stressed the critical role of the peace process for economic prosperity in Israel and the region.

Noting that fiscal policy had been at the root of the overheating experienced in 1995/96, Directors stressed that a prompt and marked improvement in public sector savings was essential. Noting further that several years of expansionary budgets had been compounded by slippages in implementation, Directors called for strict adherence to the deficit target for 1997. In that respect, they viewed the authorities' recently announced plans to make up for further weakness on the revenue side through additional spending cuts and the establishment of a contingency reserve as important first steps. Directors underscored the need to hasten the beneficial effects of consolidation by strengthening the credibility of fiscal policy. They considered the emphasis on containing expenditures helpful in that regard, noting the importance of carrying through fully with plans to curb the wage bill, subsidies and tax preferences to enterprises, and transfers. Directors also welcomed the authorities' strengthened procedures for monitoring fiscal developments and for adjusting spending plans quickly if revenue estimates should again prove optimistic. They also suggested the adoption of more realistic revenue estimates.

Directors generally regarded the existing medium-term fiscal targets as insufficient to generate the domestic savings required to sustain a high rate of investment and to achieve low single-digit inflation over five years. They therefore urged the adoption of more ambitious medium-term objectives, particularly since, when measured in internationally comparable terms, Israel's fiscal imbalance remained very high. Directors urged the authorities to improve the transparency and accountability of fiscal policy, in particular by also providing deficit estimates inclusive of the accrued liabilities associated with indexation that are excluded from the present measures and by explaining the government's accounting methodology to the public.

Directors observed that monetary policy had had to bear the brunt of the fight against inflation over the past two years. In the prevailing circumstances of high resource utilization, escalating inflation, and fiscal laxity, they noted there had been no alternative to a marked tightening of monetary conditions. Directors considered that a shift to a less restrictive monetary stance should await credible progress with fiscal consolidation.

Directors generally thought that the increased emphasis on inflation targeting within the crawling exchange rate band framework had provided a clarity of purpose and objectives that could facilitate the pursuit of disinflation. They urged the adoption of a forward-looking, quantified strategy for achieving, and making early progress toward, the objective of reaching industrial country rates of inflation by 2001. Such a strategy could usefully integrate structural aspects—policies for leasing public lands, the privatization and regulation of utilities, and enhanced competition policies.

Directors considered that Israel's record on structural policies was mixed. Marked progress had been made in a number of areas, including the liberalization of trade, the strengthening of antitrust and competition policy, and the downsizing of banks' holdings in nonfinancial companies. However, Directors observed that much remained to be done, and progress in some areas was hard to discern. They stressed, in particular, the need to accelerate privatization and to decrease other forms of government intervention in the economy, especially those affecting the allocation of investment through subsidies and tax incentives. They welcomed, in that regard, plans to begin to rationalize the tax and regulatory treatment of various types of financial instruments, but considered that much more needed to be done if Israel was to establish a resilient and efficient capital market.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/96/113 (12/17/96) and EBM/96/114 (12/18/96).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 95/38 and 95/49 are approved.

APPROVAL: August 14, 1997

REINHARD H. MUNZBERG
Secretary