IMMEDIATE ATTENTION

0450

SM/90/95

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INFORMATION

May 17, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Israel - 1990 Staff Report on the Interim Article IV Consultation Discussions

It is not proposed to bring the attached 1990 staff report on the interim Article IV consultation discussions with Israel to the agenda of the Executive Board for discussion unless an Executive Director so requests by noon on Thursday, May 24, 1990. In the absence of such a request, the draft decision that appears on page 25 will be deemed approved by the Executive Board, and it will be so recorded in the minutes of the next meeting thereafter.

Ms. Ross (ext. 7188) or Mr. Traa (ext. 4545) is available to answer technical or factual questions relating to this paper.

Att: (1)

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INTERNATIONAL MONETARY FUND

ISRAEL

1990 Staff Report on the Interim Article IV Consultation Discussions

Prepared by the Staff Representatives for
the Interim Article IV Consultation

Approved by P. de Fontenay and S. Kanesa-Thasan

May 16, 1990

I. Introduction

A staff mission 1/ held interim Article IV consultation discussions in Jerusalem and Tel Aviv during the period February 21 to March 4, 1990. The mission met with the Deputy Prime Minister and Minister of Finance, Mr. Peres; with the Governor of the Bank of Israel, Mr. Bruno; with the Minister of Economics and Planning, Mr. Modai; and with the Director General of the Ministry of Finance, Mr. Lifschitz. The Israeli representatives also included officials of the Prime Minister's Office, the Bank of Israel, the Ministries of Finance, of Economics and Planning, and of Commerce and Industry. Separate discussions were held with representatives of the Trade Union Federation (Histadrut), the Manufacturers Association, the Bankers Association, and the academic community.

The last Article IV consultation with Israel was completed in the Executive Board on June 23, 1989. At that meeting, Executive Directors recalled that the stabilization policies, adopted by Israel in 1985, had quickly achieved a sharp reduction in the rate of price inflation, and that the external payments position had been strengthened. However, containment of the budget deficit was seen as an essential prerequisite, along with further wage and price moderation, for a resumption of growth. While the contribution of incomes policy to wage restraint in 1988 had been useful, Directors believed that the system of wage determination should be made more flexible as the outlook for employment continued to weaken. Directors noted also that a more active policy of monetary restraint was called for to support a stable exchange rate as a nominal anchor for the economy. Israel continues to avail itself of the transitional arrangements under Article XIV.

Following elections in November 1988, a broad coalition government was formed with Likud's Mr. Shamir as Prime Minister and Labor's

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1/ Comprising Messrs. Schmitt, Hauvonen, Traa, Ms. Ross, and Miss Strayer as secretary (all EUR).

Mr. Peres as Deputy Prime Minister and Minister of Finance. In early 1990, differences between the two major parties with regard to the regional peace process grew acute, and on March 13 the Prime Minister dismissed Mr. Peres. Other Labor Ministers also left the Cabinet, which then lost a confidence vote in the Knesset on March 15, but continued in a caretaker capacity. The President first called on Mr. Peres to seek a majority for a Labor-led Government, and when he failed, on Mr. Shamir. Should he also fall short, new elections may have to be called.

II. Economic Background

The poor performance of the economy continued in 1989 to be a source of disappointment to the Israeli authorities. Fixed investment fell by another 5 1/4 percent following a 1 percent drop the year before. The growth of GDP sagged further from 1 1/2 percent to 1 percent and unemployment rose sharply from 6 1/2 percent in 1988 to as much as 9 percent last year (Tables 1 and 2).

A number of special factors could be pointed to as having aggravated the economic slowdown. Agricultural output is estimated to have fallen by 1-2 percent in 1989 after a 4 1/3 percent decline in 1988 due largely to unfavorable weather conditions. The hostilities in the West Bank and Gaza, following the uprising (intifada) in late 1987, reduced the demand particularly for Israeli textiles there and curtailed the supply of Palestinian labor notably to the construction sector in Israel. Tourism recovered modestly in 1989 but was still below its 1987 level. Finally, the cancellation of a military aircraft project explained some of the dip in industrial production.

Special factors apart, however, the view was also gaining ground that the roots of the recession reached back to the stabilization program of 1985. This program had been successful in lowering inflation sharply from 450 percent in early 1985 to less than 20 percent after 1986. It was particularly noteworthy that the balance of payments was not sacrificed in the process; on the contrary, an external deficit on current account of 5 percent of GNP swung into a surplus over the same period. Inflation was thus checked at its source, not exported. It had initially been thought that this could be achieved without serious loss in output or in jobs.

In retrospect, nevertheless, the drop in investment could quite plausibly be traced to some of the major features of the 1985 program: to the sharply increased tax burden that helped close the fiscal gap in 1985; to the high real rates of interest required to hold the nominal exchange rate in place as a nominal anchor for prices; and to the overshoot of wages before the reduction in price inflation became fully credible in the labor market. This overshoot in wages helped initially

Table 1. Israel: Aggregate Demand, 1981-89

	Average 1981-84	1985	1986	1987	1988	1989 1/
		(Percentage change at constant prices)				
Gross domestic expenditures 2/	3.9	-2.1	8.7	6.1	2.1	-1.7
Private consumption	5.5	0.5	14.2	8.4	3.0	-1.0
Government consumption 2/	2.1	-0.8	-2.9	2.7	2.9	-0.6
Domestic defense	(1.8)	(-2.5)	(-5.7)	(2.1)	(3.2)	(-2.6)
Civilian	(1.7)	(0.2)	(-0.8)	(3.1)	(2.6)	(0.7)
Gross domestic investment	3.1	-10.6	10.4	3.3	-2.1	-5.2
Of which: Fixed investment	2.6	-7.8	-0.6	13.0	-1.2	-5.2
Exports of goods and services	4.4	8.7	5.6	10.8	-2.1	4.2
Aggregate demand 2/	3.9	1.0	7.8	7.3	0.9	-0.1
Imports of goods and services 3/	6.7	-3.8	15.4	11.6	-0.4	-2.5
GDP at market prices	2.6	3.9	3.6	5.2	1.6	1.1
		(In percent of GDP at current prices)				
Gross domestic expenditure 2/		106	109	111	109	105
Private consumption		59	62	64	63	62
Government consumption 2/		28	27	27	27	27
Domestic defense		12	11	11	11	10
Civilian		16	16	16	17	17
Gross domestic investment		19	20	20	18	17
Of which: Fixed investment		19	18	20	18	17
Foreign balance 2/		-6	-9	-11	-9	-5
Exports of goods and services		45	39	39	36	38
Imports of goods and services 3/		51	48	50	45	43
Memorandum items:						
Gross saving rate, income from all sources						
National		21.7	19.1	16.5	15.9	17.1
Private		19.1	14.2	13.5	13.8	17.8
Public		2.6	4.9	3.0	2.1	-0.7

Sources: Central Bureau of Statistics, Monthly Bulletin of Statistics; and data provided by the Bank of Israel.

1/ Preliminary estimates.

2/ Excludes net direct defense imports, purchases of which are very closely associated with the receipt of intergovernmental transfers and loans.

3/ Civilian.

Table 2. Israel: Prices, Wages, and Employment, 1984-89

(Percent increase during the period, at annual rates)

	1984	1985	1986	1987	1988	1989
Consumer price index						
General index	445	185	20	16	16	21
Controlled prices 1/	387	249	15	15	17	30
Uncontrolled prices 2/	460	170	21	16	16	19
Official exchange rate						
Against the U.S. dollar	493	135	--	4	3	22
Against a foreign currency basket 3/	462	154	6	14	1	20
Real wages 4/	-0.3	-9.0	7.8	7.9	6.0	-1.4
Business sector	-1.1	-6.5	9.1	7.9	4.7	-1.8
Public services	1.5	-14.3	4.4	7.1	9.7	0.4
Working age population	2.2	2.2	1.9	1.9	2.0	2.0 5/
Civilian labor force	2.9	1.6	1.8	1.5	3.9	3.3
Employment	1.4	0.7	1.4	2.6	3.5	0.6
Business sector	1.4	0.3	1.7	4.0	3.1	--
Public services	1.3	1.8	0.7	-0.5	4.2	1.9
Memorandum items:						
Participation rate	49.4	50.7	50.6	50.4	51.4	52.0
Unemployment rate	5.9	6.7	7.1	6.1	6.4	8.9

Sources: Central Bureau of Statistics, Monthly Bulletin of Statistics; IFS; and data provided by the Bank of Israel.

1/ The index of controlled prices comprises the following items: flour, eggs, frozen meat and poultry, edible oils and margarine, milk and milk products, property tax, municipal rates, electricity, water and gas for household use, school fees (kindergarten, elementary, and secondary), cigarettes and other tobacco products, public urban and interurban transport, mail and telephone, and gasoline, oil, and licenses for private cars. The weight of these items in the consumer index is about 22.8 percent.

2/ The index of uncontrolled prices comprises items not listed in the preceding footnote.

3/ A new five-currency basket was introduced in August 1986: U.S. dollar, deutsche mark, pound sterling, French franc, and Japanese yen.

4/ Average monthly wage per employee post at constant prices.

5/ Preliminary estimates.

to sustain consumer demand and to keep the economy buoyant, until profit margins had been squeezed to the point where they could no longer sustain investment.

The economic slowdown served a positive purpose in speeding the shake-out of enterprises whose lack of economic viability had been obscured in an inflationary environment. The associated increase in unemployment was nevertheless unwelcome. An increased participation rate for women and an upturn in net immigration last year added to the problem, by feeding a 3 1/3 percent increase in the labor force while employment rose by only 2/3 percent. The increase in net immigration was the beginning of what promised to become a wave of new immigrants from the Soviet Union. An initial estimate of 40,000 new arrivals for 1990 was already being overtaken by events.

Despite the increasing slack in economic activity, consumer price inflation accelerated to 21 percent in 1989 from 16 percent the year before (Table 2). Consumer prices had increased at a rate of 25 percent in the first half, in response to a two-step devaluation of the sheqel at the turn of the year, and to the associated rise in controlled prices as subsidies were reduced. Although in the second half housing prices and construction costs continued to rise steeply, now also in anticipation of increased demand from new immigrants, the rise in the overall index fell back to the earlier rate of 16 percent annually.

The weakness of demand had a more immediate impact in the labor market. A moderation of wage demands despite continued price increases caused real wages per employee post to drop by about 1 1/2 percent in 1989, following a cumulative rise of 13 percent in 1985-88 (Table 2). Real wages in the public sector still rose by about 1/2 percent, reflecting a catch-up with the private sector that was agreed with the trade unions in 1988. Real wages in the private sector declined by almost 2 percent. Real unit labor costs fell by some 2 1/2 percent as productivity in the business sector still managed to rise by 3/4 percent.

The slack in domestic demand was also reflected in the external balance on current account. It swung from a deficit of 1 3/4 percent of GDP in 1988 to a surplus of 2 percent of GDP in 1989 despite a 1 percent deterioration in the terms of trade (Table 3). A cumulative depreciation of 20 percent in the nominal effective exchange rate during the year barely maintained the real effective exchange rate at its 1988 level or still about 11 percent above its level in 1987 (Chart 1). Exports nevertheless grew by 4 1/2 percent in volume, while civilian imports dropped by about 2 percent, reflecting weak demand for consumer durables and investment goods.

There was a sharp cutback in military imports. Tourism showed a modest recovery in 1989 following a major reverse as noted earlier. But net transport services deteriorated again, taking total net service receipts down with them. Net interest payments also fell significantly

Table 3. Israel: Balance of Payments Summary 1985-89

(In billions of U.S. dollars) 1/

	1985	1986	1987	1988	Prel. 1989
1. Exports, f.o.b.	6.6	7.7	9.1	10.0	10.9
2. Imports, f.o.b. imports	-9.0	-9.6	-12.9	-13.2	-13.0
Of which:					
a. Military imports	-1.8	-1.2	-2.4	-2.1	-1.5
b. Civilian imports	-7.2	-8.4	-10.5	-11.1	-11.5
3. Services, net	-1.4	-1.9	-2.0	-2.2	-2.1
4. Goods and services, net	-3.8	-3.8	-5.8	-5.3	-4.1
5. Civilian goods and services, net	-2.0	-2.7	-3.4	-3.3	-2.8
(1 - 2b. + 3)	(-8.8)	(-9.3)	(-9.8)	(-7.9)	(-6.5)
6. Transfers, net	5.0	5.4	4.8	4.7	5.0
7. Current account balance	1.2	1.6	-1.0	-0.7	0.9
	(4.9)	(5.0)	(-2.9)	(-1.7)	(2.1)
8. Long- and medium-term capital	0.1	0.5	0.5	-0.7	-0.3
9. Basic balance	1.2	2.1	-0.4	-1.3	0.6
10. Short-term capital, errors and omissions	-0.8	-1.1	1.2	0.2	0.8
11. Overall balance	0.4	1.0	0.8	-1.2	1.4
12. Increase (-) in reserves	-0.4	-1.0	-0.8	1.2	-1.4
Memorandum item:					
GDP at current prices	23.8	29.4	34.7	41.8	43.0

Source: Data provided by the Israeli authorities.

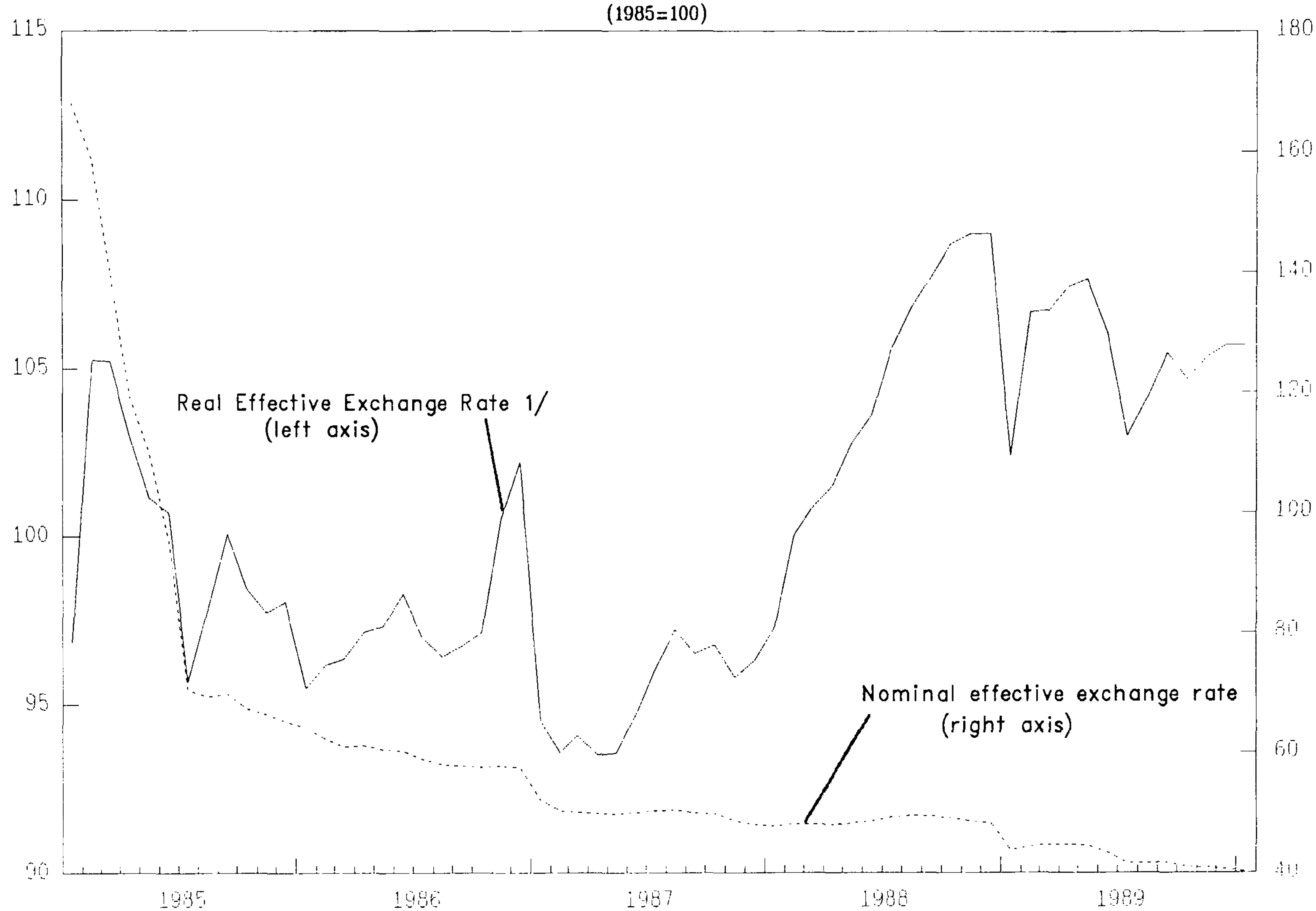
1/ Figures in parentheses refer to percentages of GDP.

CHART 1

ISRAEL

EFFECTIVE EXCHANGE RATES, JANUARY 1985- JANUARY 1990

(1985=100)



Sources: Information Notice System.

1/ Nominal effective exchange rate adjusted by Israeli consumer prices relative to those in main trading countries.

in 1989. Gross payments declined as the increase in international interest rates was more than offset by the effects of a refinancing operation in 1988 that reduced public sector interest payments by about US$100 million per year. Interest receipts meanwhile rose with the increase in the level of international reserves. Summing up, the overall balance of payments swung from a deficit of US$1.2 billion in 1988 to a surplus of US$1.4 billion in 1989.

Within that total, the medium- and long-term capital account had turned negative. The short-term balance was dominated by speculative movements, outward in anticipation of devaluation at the end of 1988, and inward in the opening months of 1989. As a result, official reserves rose to US$5.3 billion by the end of 1989, equivalent to more than three months' imports of goods and services. Israel's external debt position also improved in recent years. Little change in the gross external debt produced a fall, to 74 percent, in relation to GNP. Gross debt service payments declined, from 35 percent of exports of goods and services on average in 1985-86, to about 31 percent in 1987-88.

III. The Policy Discussions

Despite its best efforts to revive the economy, the Government that took office in late 1988 found itself one year later with an unemployment rate that had risen to near record levels. The root of the problem was seen to lie in the failure of investment to respond adequately to the stimulus of lower interest rates, lower taxation, and lower wage costs. The urgency of its revival was about to become critical if the expected wave of immigrants from the Soviet Union was to be effectively integrated into the labor force. The authorities hoped that immigration in itself would provide the missing stimulus to investment. As yet no clear view had emerged regarding the supporting measures that might become necessary, especially if inflation was also to be held in check.

1. Exchange rate objectives

A recovery of investment had been the major objective of the two devaluations, cumulating to 13 1/2 percent, of December 27, 1988 and January 3, 1989. The central rate was fixed again in relation to an unchanged basket of five currencies, but the actual rate was now permitted to fluctuate within a band of 3 percent on either side. The stability of the band was to safeguard the exchange rate as a nominal anchor around which price expectations could still stabilize. Since then of course, another devaluation took place on June 23, 1989, adding another 5 percent to the depreciation of the sheqel. However, further adjustments to relative prices were to remain discretionary and to be kept partial and infrequent.

In the event, investment fell deeper still, by 5 1/4 percent in 1989. And so far from abating, unemployment rose to a near-record high. Nevertheless, the most recent devaluation of 6 percent on

March 3, 1990, was designed merely to preserve competitiveness rather than significantly to improve it. To do more might have threatened a serious resurgence of inflation. At the same time, the bands within which the rate can fluctuate were widened, from 3 percent to 5 percent. Capital movements were also liberalized further, although restrictions remain significant in comparison with Israel's main trading partners.

The scope for discretion in the exercise of policy was widened by these measures. On the one hand, a liberalization of capital movements with fixed exchange rates will require more flexible interest rates to balance the external accounts; on the other, to keep interest rates stable in the face of potentially large speculative capital movements, will require exchange rates to be more flexible. At a time of considerable uncertainty regarding the prospects for the economy it was thought best to keep these options open. The authorities agreed that, if investment continued to lag, more decisive action would probably become necessary.

2. Monetary policy

Though exchange rate stability remained a long-term concern for monetary policy, it was no longer a major factor in short-term monetary management, which had come to be dominated by interest rate concerns. Monetary policy in 1989 was much influenced by the high level of unemployment and the desire to reduce interest rates to stimulate investment. In the view of the authorities, the fact that price inflation remained in the 15-20 percent range was regrettable, but monetary policy alone could not bring inflation down further. It needed support from other sources, notably fiscal policy. Putting the blame for inflation on monetary policy alone did not reflect the policy makers' view of their role.

The proximate target for monetary policy had also shifted from net domestic credit two years ago, to the level of bank reserves. In setting the quantity of liquidity to be offered to the banks in the weekly auction, the authorities took account of the expected foreign exchange flows and the financing needs of the Government (Table 4), and then decided how far to offset these in order to allow for the desired reduction in interest rates. Early in the year, the Bank of Israel closely followed the return flow of speculative capital in the private sector, only partly offsetting it, and later compensated for a sizable overfunding by the Treasury, so as to keep interest rates moving down.

Starting with foreign exchange flows, the mission asked whether pressures on the exchange rate at the end of 1989 and the beginning of

Table 4. Israel: Summary Monetary Survey and Selected Indicators

	1985	1986	1987	1988	Nov. 1989	1986	1987	1988	1989 1/
	(In millions of sheqalim at end of period)					(Real percentage changes during year) 2/			
Net foreign assets	67	1,646	3,456	1,581	5,463	1,953.0	80.8	-60.7	128.2
Net domestic assets	47,812	56,018	65,759	79,745	87,856	-2.1	1.1	4.2	-3.2
Domestic credit	49,825	57,822	69,727	85,188	95,757	-3.0	3.8	5.0	-0.8
To Government, net	30,411	31,585	34,368	40,169	42,576	-13.2	-6.3	0.4	-6.5
To private sector	17,053	23,267	31,698	40,720	48,073	14.0	17.3	10.4	4.5
To mortgage banks	2,361	2,970	3,661	4,299	5,108	5.1	6.1	0.9	1.7
Other domestic assets, net	-2,013	-1,804	-3,968	-5,443	-7,901	...	...	...	...
Monetary liabilities	27,361	33,039	42,010	51,390	60,477	0.9	9.5	5.1	4.9
M1	1,051	2,238	3,346	3,723	4,873	78.0	28.7	-4.4	12.6
Quasi-money	26,310	30,801	38,664	47,667	55,604	-2.2	8.1	5.9	4.3
Time and saving deposits	24,244	27,989	34,595	45,135	51,372	-3.5	6.4	12.1	2.2
Certificates of deposit	2,066	2,812	4,069	2,532	4,232	13.7	24.6	-46.5	39.4
Earmarked deposits	20,518	24,625	27,205	29,936	32,842	0.3	-4.9	-5.5	-7.5
Selected indicators									
M3 3/	8,668	11,013	14,260	15,630	19,149 4/	6.2	11.5	-5.8	1.5 4/
Real interest rate on bank overdrafts 5/	94.0	35.0	39.4	25.6	11.3	...	...	...	...

Sources: International Financial Statistics; Bank of Israel Annual Reports; and staff calculations.

1/ Twelve months to November 1989.
2/ Nominal change deflated by the CPI change.
3/ M1 plus short-term time deposits, CDs, and PATAM deposits.
4/ December 1989.
5/ Annual averages.

1990 could not have been predicted as the result of money growth 1/ of over 30 percent, set against a potential GDP growth of perhaps 5 percent and an underlying inflation rate of, say, 15 percent. In reply, the authorities conceded that they may well have taken an exchange risk in their drive to lower interest rates for employment reasons. It was of course difficult to know what interest rates would produce full employment. The mission thought that using the potential growth rate in setting a monetary target came as close to supporting full employment as one could reasonably hope for.

The mission noted that a balance of payments oriented monetary policy needed to look at deposit rates, while the concern for economic activity revolved around the lending rate. The size of the spread between them exacerbated the conflict between the two rival objectives, to raise deposit rates high enough to support a stable exchange rate and low inflation, or to press lending rates low enough to stimulate domestic investment and employment. By some emphatic moral suasion, the authorities had succeeded in reducing the size of the spread between interest charged on overdraft loans and those on time deposits, from 29 percent in 1988 to 21 percent in 1989 (Chart 2). However, deposit rates still remained for the most part negative in real terms.

The sizable spread that remained was traced in part to monopoly power in a highly concentrated market in which the two largest banks account for over 70 percent of loans to the private sector. In addition, the credit market continued to be highly segmented, and various classes of deposits were strictly regulated in the uses to which they could be put. Regulations apply particularly to indexed and foreign currency deposits that account for over 80 percent of the liabilities of the five major banks, the margin on which averaged only one percentage point. By contrast, on unrestricted and unindexed short-term local currency deposits, which account for about 10 percent of bank liabilities, the margin averaged 17 percent in 1988, making up for the low margins elsewhere.

Moving on to treasury financing, it was explained that large-scale overfunding in the course of 1989 had in large part been the result of the slow progress made with capital market reforms since 1985. 2/ These reforms were to reduce the role of government both as lender and as borrower in the market. The Treasury nevertheless continued to prescribe minimum shares for government bonds in the portfolios of bank-managed savings schemes, as it does for pension funds, provident funds, and life insurance companies, and to issue fixed interest nonnegotiable government bonds to cover them. As interest rates fell in the market and the yield on private bonds declined, these nonnegotiable bonds

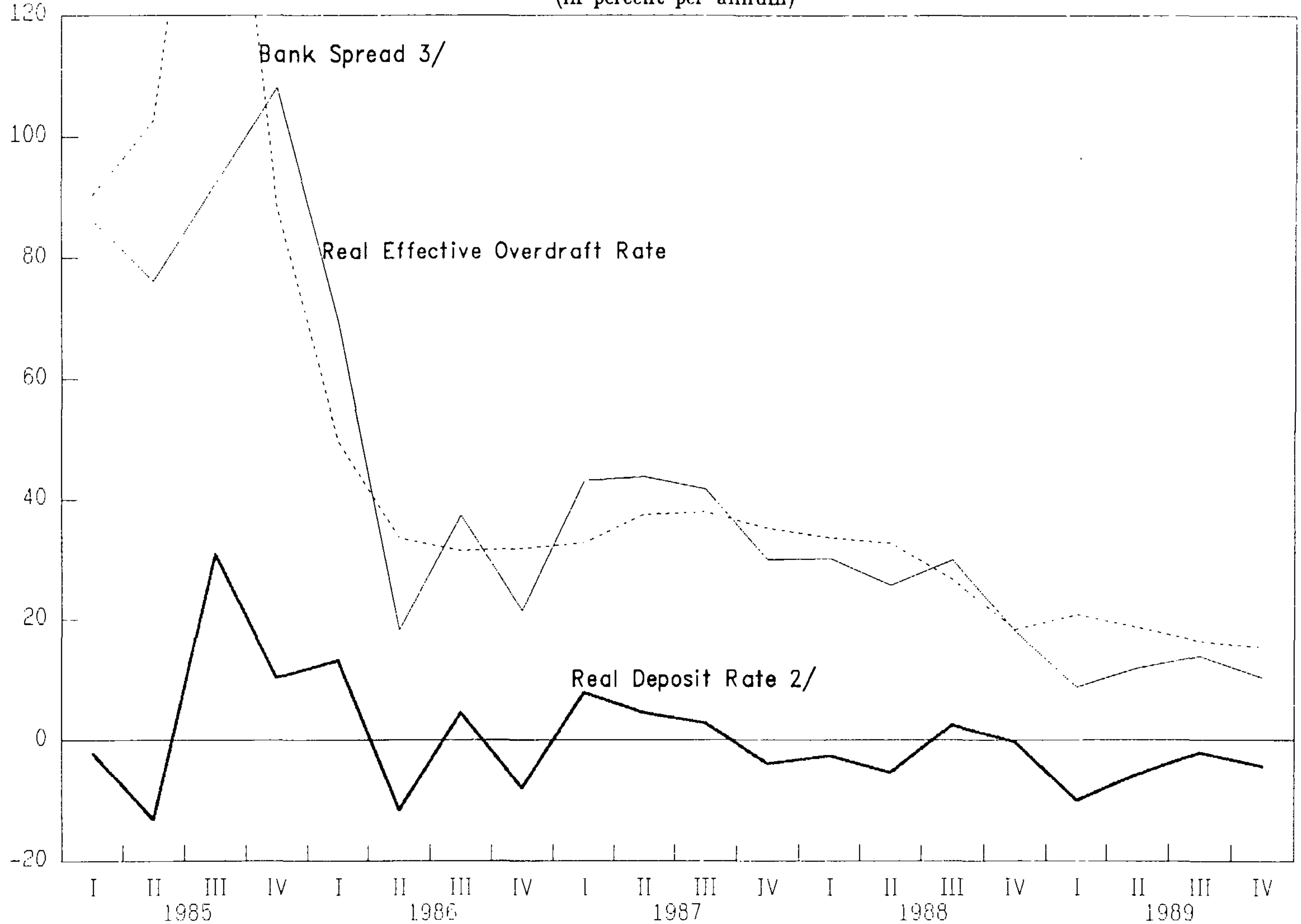
1/ M1 in the twelve months to the end of September 1989.
2/ A more detailed description of the capital market reforms is presented in "Israel - Staff Report for the 1989 Article IV Consultation," SM/89/96 (5/24/89).

CHART 2

ISRAEL

REAL INTEREST RATES AND SPREAD, 1985-89 1/

(In percent per annum)



Sources: Data provided by the Bank of Israel and staff calculations.

1/ Real rates are computed using average quarterly nominal rates and quarterly CPI changes.

2/ 14-day time deposits.

3/ Spread between effective overdraft rate and time deposit rate, quarterly averages.

became increasingly attractive to the banks, and they therefore invested more of their resources in them than was called for by the Government's domestic financing requirement. The liquidity absorbed from the market in this way, the Bank of Israel felt it had to restore.

The Treasury clearly did not focus on minimizing the cost of its borrowing, and despite its commitment to make room for private participation in the market, it was reluctant to give up schemes that had originally been created to stimulate savings by the public. It was the practice of the authorities to negotiate interest rates for savings schemes with the banks; when bond sales rose beyond all expectations, the Treasury could not at once engage in lengthy negotiations with the banks to reduce them. At the same time, the Treasury did not want to reduce its presence in the market for tradable securities below a minimum amount each month. For a quick resolution to the problem, therefore, it unilaterally closed some of the savings schemes to new deposits from September 1989.

The Government's capital market reform program also calls for a progressive substitution of tradable for nontradable bonds in the financing of the government deficit. The share of tradable bonds in new issues of government securities accordingly rose from 4 percent in 1984 to 63 percent in 1988 and their share in the outstanding stock of bonds to 18 percent. No steps have so far been taken to move the pension funds or the life insurance companies to the tradable bond market, however, because these institutions are heavily involved with the trade unions, and make up one element in the complicated relations between labor and the Government. Pension funds are still guaranteed a return of 6 1/4 percent and insurance companies 4 1/2 percent, compared to market rates on marketable long-term bonds of about 1-2 percent.

Summing up, the authorities stressed that lending rates had in fact come down sharply in 1989, from 14 percent in real terms on total credit at end-1988 to 6 percent at end-1989. On nondirected local currency credit, real rates had dropped from 18 to 7 percent, and on nonlinked local currency overdrafts from 22 to 9 percent. For 1990, only general policy outlines existed. The Bank of Israel would pursue a further reduction in spreads; bank-specific access limits to the weekly auctions could be removed within a given auction total and, in addition, the public would be allowed to bid indirectly in the auction through an intermediary bank, so as to increase competition for these funds with repercussions on deposit rates.

The need to absorb new immigrants from the Soviet Union added to the importance of the growth objective in monetary policy formulation for 1990. It was therefore a source of concern to the authorities as it was to the mission that, despite the sharp drop in real interest rates, still no signs had showed of a recovery of investment. This either highlighted the importance of other factors in determining investment--such as the political situation, structural problems, or the level of the exchange rate--or else implied that interest rates were not yet sufficiently low to stimulate economic activity. Increased risks would probably have to be taken with the balance of payments and inflation but the mission was assured that only moderate changes of policy were to be expected.

3. Fiscal policy

The central government deficit had provided a large impetus to inflation in the past, and the authorities were determined that this should not be repeated. Nevertheless, after achieving a surplus in fiscal year 1986/87, the central government incurred fresh deficits that rose from 2 percent of GNP in 1987/88 to a probable 6 1/2 percent in 1989/90 (Table 5). The budget outturn in 1989/90 might easily have been much worse than this, so it was claimed, given the Government's difficulties in implementing consistent fiscal policies. At least government finances had not gone out of control. The fiscal deficit had widened, particularly over the last two years, but in a fashion that could be cyclically justified.

Despite increasing tensions, the Government did not in 1989/90 increase its expenditures to combat unemployment. In fact, central government expenditures fell by about 1 percentage point in relation to GNP. This outturn largely reflected cuts in food and interest rate subsidies, a shortening of military reserve duty, and a curtailment of capital expenditures and of lending activities. The wage bill for the civilian public service still increased on the other hand, by almost 4 percent in real terms, reflecting: (i) a 6 percent increase in real wage rates provided for in the 1988 public sector wage agreement; (ii) the partial indexation for inflation specified in the 1989 cost-of-living agreement (COLA); and (iii) a slight increase in public service employment despite the reduction initially budgeted.

With such restraint on public spending, the estimated increase in the 1989/90 fiscal deficit largely reflects a decline in tax revenue, operating as a built-in stabilizer in a recession year. The decline in total receipts was expected to exceed 4 1/2 percent of GNP, compared to a budgeted 2 percent that took account of tariff cuts in January 1989. Government revenue is projected to fall 20 percent below budget in real terms. Nearly half of this shortfall reflects larger than planned tax rebates, and the remainder, the effects of the low level of economic activity in 1989, particularly as it affected imports of highly taxed consumer durables. Rebates of excessive tax advances paid by enterprises in 1988/89 became necessary once profits turned out to have been lower than expected. Finally, foreign grants also declined somewhat in relation to GNP.

The central government deficit in 1989/90 was financed mainly by the sale of domestic bonds. Net repayments of debt abroad in fact amounted to 1 1/3 percent of GNP. In addition, the Government's recourse to the capital market also covered: (i) the obligation to repay compulsory 15-year CPI-indexed loans that had been raised from the

Table 5. Israel: Main Budget Aggregates, 1985/86-1990/91

	1985/86	1986/87	1987/88	1988/89	Original Budget 1989/90	Updated Budget 1/ 1989/90	Proposed Budget 1990/91	Approved Budget 1990/91
					(In percent of GNP)			
Total revenue	43.9	47.6	43.1	41.3	39.4	36.7	40.0	40.1
Tax revenue	37.1	40.7	38.3	36.3	35.3	31.9	33.5	33.6
Direct taxes	20.5	21.2	19.6	19.3	19.0	17.4	17.6	17.7
Domestic taxes on goods and services	13.8	15.9	16.2	15.1	15.0	13.3	14.4	14.4
Taxes on external transactions	3.1	3.0	2.3	1.8	1.3	1.2	1.5	1.5
Other taxes	0.4	0.6	0.2	0.1	—	—	—	—
Nontax revenue 2/	6.8	6.9	4.8	5.0	4.1	4.8	6.5	6.5
Of which:								
Capital revenue	...	...	...	0.5	—	0.4	1.6	1.6
Total expenditure and net lending	63.0	59.9	54.1	51.8	49.9	50.5	50.7	50.7
Current expenditure	57.8	54.8	50.7	48.4	44.8	45.7	45.1	45.4
Civilian expenditure	37.4	36.3	34.5	33.8	31.7	32.4	32.2	32.4
Defense expenditure	20.4	18.5	16.2	14.6	13.1	13.2	12.9	12.9
Domestic purchases	10.9	10.3	10.3	10.0	9.0	8.9	9.0	9.0
Purchases abroad	9.5	8.2	5.8	4.6	4.1	4.4	4.0	4.0
Wages	7.9	7.8	7.8	8.2	7.9	7.7	8.2	8.2
Other goods and services	18.6	17.4	14.4	13.0	11.5	11.9	11.4	11.4
Domestic purchases	8.6	8.8	8.1	8.0	7.1	7.2	7.1	7.2
Purchases abroad	10.0	8.6	6.3	5.0	4.4	4.7	4.3	4.3
Transfers and subsidies	16.0	16.6	16.8	16.7	14.8	15.4	15.0	15.2
Interest payments 3/	14.8	12.4	11.1	10.0	10.1	10.0	10.0	10.0
Other current expenditure	0.5	0.5	0.7	0.5	0.6	0.6	0.6	0.6
Capital expenditure	2.6	2.3	2.5	2.6	2.3	2.3	2.5	2.8
Net lending	2.7	2.8	1.0	0.8	0.7	0.4	1.0	1.0
Unallocated expenditure	—	—	—	—	2.2	2.1	2.0	1.5
Budget deficit (before grants)	-19.1	-12.3	-11.0	-10.5	-10.5	-13.8	-10.6	-10.5
Foreign grants	17.9	14.2	9.1	7.4	6.7	7.2	6.4	6.4
Overall deficit	-1.2	1.9	-1.9	-3.1	-3.8	-6.5	-4.2	-4.1
Domestic	-4.1	—	-1.4	-2.5	-3.6	-6.1	-3.3	-3.2
Foreign	2.9	1.9	-0.6	-0.6	-0.3	-0.4	-1.0	-1.0
Financing	1.2	-1.9	1.9	3.1	3.8	6.5	4.2	4.1
Foreign borrowing (net) 4/	-0.9	1.6	-1.2	-1.3	-0.7	-1.3	0.1	-1.0
Domestic bond issues (net)	4.6	4.1	2.0	4.8	3.7	6.9	4.1	4.0
Net credit from Bank of Israel	-5.4	-0.6	—	-1.5	0.9	0.9	—	1.1
Other 5/	2.9	-7.0	1.0	1.1	—	—	—	—

Source: Fund staff calculations from data provided by the Ministry of Finance.

1/ Based on approved supplementary budget.
2/ Excludes profits of the Bank of Israel.
3/ Excludes interest payments to the Bank of Israel.
4/ In 1988/89, includes NIS 770 million of collateral in U.S. treasury bills associated with FMS refinancing.
5/ Includes designated income from credit and change in deposits of the banking system.

public to finance the 1973/74 war, amounting to 2 percent of GNP in 1989/90; (ii) commitments to purchase commercial bank shares entered into after their collapse in the stock exchange in 1983, which took up another 1 percent of GNP; and (iii) the commitment to supply selected saving institutions with bonds carrying a guaranteed real return. It was recalled that overfunding had caused complications for monetary policy.

The major challenge for the economy in 1990/91, as seen by the authorities, was once more to keep inflation in check. There would be considerable pressure on resources to provide housing, jobs, and infrastructure for the new immigrants. The authorities considered it all the more important that the overall fiscal deficit be kept to no more than the 4 percent of GNP stipulated in the budget as presented to the Knesset, compared to 6 1/2 percent the year before. This budget assumed an inflow of 40,000 immigrants during the fiscal year, but could be stretched, it was thought, to accommodate up to 70,000-100,000 if necessary. Whether in that event the line could in fact be held was very much an open question.

Holding the line on the fiscal deficit was also seen to be the chief contribution the Government could make toward a resumption of economic growth. The pace of domestic investment would have to increase some time, in response to increased profitability in the business sector following the devaluations at the beginning and the middle of the year, and the wage restraint that had been shown in the face of them. Long-term interest rates had also fallen. The expected wave of immigration would now add a stimulus to construction that should spill over into nondwelling investment as well. The consequent recovery would be given a firmer basis by reducing the Government's overwhelming role in the capital market.

The "direct absorption" approach adopted by the authorities toward immigration was accordingly designed to minimize their own involvement in the process. The budget would provide the standard NIS 22,000 in income assistance per family of three during the first year. The immigrants themselves were then left to determine the best use of their resources depending on their individual needs and tastes. Some additional need was seen for risk sharing with private construction companies by guaranteeing the sale of newly built housing and for sharing with employers the cost of employing new immigrants for a limited time. Finally, a new urgency was seen for getting on with the renovation and expansion of urban infrastructure.

On balance, the budget proposed for 1990/91 provided for only a marginal increase in central government expenditure, mainly representing: (i) a continued catch-up of public sector wages; (ii) higher infrastructure investments; (iii) an increase in lending related to the restructuring agreements with the Koor conglomerate, the kibbutzim, and the moshavim, all enterprises that had suffered losses in the wake of stabilization; as well as (iv) additional loans for housing construction to accommodate immigrants. To offset these, a reordering of priorities was required. Accordingly, subsidies on public transport and defense imports were to be restricted further. It was also proposed to put transfer payments on a more selective basis by introducing a means test for child allowances and for some pension benefits. Opposition to these economies was strong in the finance committee, however, as it was expected to be in the full Knesset.

The draft budget for 1990/91 also projected an increase in receipts of 13 percent in real terms, or of 3 1/3 percentage points of GNP. Total revenues would be buoyed by the postulated increase in economic activity. Revenue from privatization of publicly owned enterprises was to contribute the equivalent of over 1 1/2 percent of GNP. The yield from direct taxes was to be little changed, however, as the projected expansion of incomes and profits would just offset losses stemming from reduced rates, following reforms to be introduced in July 1990. But indirect tax revenue was expected to rise with an increase in the VAT rate from 15 to 16 percent as enacted in March, together with increases in consumption taxes on fuel and cigarettes, which together would more than offset reductions in tax rates on foreign currency transactions, and in a series of minor excises. Improved collection would also help.

The projected rebound in fiscal revenues by 3 1/3 percent of GNP in 1990/91 could be defended on the same grounds as the preceding decline of 4 1/2 percent, as an appropriate response to cyclical conditions. The authorities were determined to preserve the benefits gained from the stabilization effort over the last five years and did not therefore propose a reduction in the structural tax burden. They did want to minimize the disincentives to investment and growth, which this tax burden entailed, by a phased reform of the tax system. 1/ The increase in the VAT rate on March 2, 1990 had cleared the way for reductions in the corporate income tax from 45 to 40 percent over the three years to 1993/94. On the personal income tax, marginal rates were to be reduced together with a broadening of the tax base, as a number of allowances, exemptions, and deductions were eliminated.

As a postscript to the discussions, the central government budget was passed by the Knesset on March 30, 1990, only after the fall of the Government on March 15, 1990. It left the overall budget deficit virtually unchanged at just over 4 percent of projected GNP. However, this result was obtained mainly by reducing the contingency reserve as an offset to: (i) additional transfers to religious schools and activities; (ii) additional grants for new housing; and (iii) additional expenditures in general education. The remaining contingency reserve was thought likely to be insufficient to meet emergencies, and a supplementary budget was therefore expected to become necessary in the course of the year. Also, the introduction of more selective payments

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1/ For a fuller description of the planned tax reform see "Israel - Staff Report for the 1989 Article IV Consultation," SM/89/96 (5/24/89).

of child allowances and certain pension benefits was not approved, and income tax rates were reduced by less than proposed so as to compensate for the retention of deductions and allowances that were to have been abolished.

4. Trade and payments system

The investment climate in Israel continues to depend very largely on access to markets abroad. To promote such access on reciprocal terms, the last remaining customs duties under free trade agreements with the European Community in 1977, and with the United States in 1985, were eliminated on January 1, 1989. Customs duties were also being lowered, often on a reciprocal basis, with many third countries including those in EFTA. By the end of 1989, about one third of all dutiable imports from some 30 countries had been affected, with an average tariff reduction of about 45 percent. The revenue loss from tariff reductions was partly compensated by increased purchase taxes at the wholesale level. Since April 1989 technical product standards have been applied in a less discriminatory fashion. In March 1990, the authorities announced their intention to replace all nontariff barriers by tariffs, which were then to be reduced gradually. No timetable was specified.

The authorities did not subscribe to the view that, for Israeli enterprises to take advantage of expanded market access, a major exchange rate adjustment was required. Rather than support entrenched industries with such an adjustment, they had begun to shift attention to smaller enterprises as the more likely source for new investment and growth. In 1989, they reported some 2,155 enterprises operating in the export market, selling US$5 billion worth of exports. Just 22 of that total number accounted for 42 percent of all exports, with some US$100 million or more in exports per company. In contrast, there were some 1,600 companies that exported less than US$250,000 each last year. This latter group, it was thought, stood the better chance of filling high-technology "niches" in world trade and therefore offered the larger potential for export expansion in the period ahead. The Government could most effectively help them prosper by eliminating as many impediments to domestic production and marketing as possible.

The new immigrants from the Soviet Union would, in the view of the authorities, fit most easily into just those lines of activity. It was estimated that no less than 60 percent of the new immigrants coming in would consist of scientific and other professional, technical, and related workers, as against 24 percent in the resident Israeli labor force. The comparable figure for the United States was thought to be 16 percent. To put the expected immigration in perspective, it was pointed out that 100,000 new residents would correspond to 2.2 immigrants per 1,000 current residents during 1990-91, as compared with the previous peak of 2.6 per 1,000 residents in 1961-64. Their potential productivity would materially strengthen the incentive to invest in Israel, it was argued. A more rapid liberalization of capital markets was again to be the Government's principal contribution.

Israel has continued to liberalize its exchange restrictions, but so slowly that, in comparison with trading partners, they now stand out as unusually extensive. During 1989, the minimum term for external borrowing by qualifying nonbank residents was reduced from 30 to 18 months, and loans can now be guaranteed by an Israeli bank or by its subsidiary abroad. Exporters are also permitted to borrow directly in foreign currencies from abroad. Import prepayments were liberalized somewhat, and residents permitted to make small credit card payments abroad. Mutual funds were authorized to invest up to 10 percent, and in special cases up to 50 percent, of their portfolio abroad. Incorporation of Israeli companies and the establishment of marketing subsidiaries abroad, and the quotation of Israeli securities in foreign stock exchanges were further broadened. Israeli banks are now allowed to lend to foreign residents at their discretion. Finally, hedging through broader spot options, forward options and swaps were liberalized, and the Bank of Israel now issues three-month foreign currency linked options.

Israel retains two exchange practices which have not been approved under Article VIII, Sections 2 and 3. These are, first, a 7 1/2 percent tax on imports of services levied at the time of the foreign exchange transaction and second, the exchange rate insurance scheme for exporters. 1/ The Israeli representatives explained that it was not possible at present to provide a timetable for the phasing out of these practices.

The restrictive measures maintained by Israel under Article XIV, Section 2, remain the following:

(i) the foreign currency travel allowance for Israeli citizens traveling abroad of US$2,000 per person per trip; higher allowances apply to business travel abroad;

(ii) the requirement of a specific authorization from the Controller of Foreign Exchange for an Israeli employer to make wage payments in foreign currency to an Israeli citizen working abroad; and

(iii) the limitation on the right of tourists to buy foreign currency against documents showing the conversion of foreign currency into Israeli currency in amounts in excess of US$5,000 for a person over 18 years of age, and US$2,000 for a person under 18 years of age.

1/ The tax on imports of services was reduced from 15 percent to 7.5 percent in April 1989, with business services exempted from September; the subsidy element in the exchange rate insurance scheme was also reduced along with the exchange rate adjustments during the year.

The Israeli representatives stated that there had been no change since the last consultation in restrictions on trade and payments in the occupied territories, or in the status of the Jordan dinar as legal tender there. These restrictions were introduced by military authorities for security reasons. As none of them relates to outward payments transfers from the occupied territories, they are consistent with Article VIII, Section 2(a).

5. Prices and incomes policy

Assuming that opportunities for productivity increases were being fully exploited, further gains in profits and competitiveness to stimulate investment would have to be achieved through wage restraint. Price inflation had already subsided to an annual 16 percent in the second half of 1989, and despite some recovery in economic activity, was expected to moderate further in the year ahead. The rapid increase in controlled prices of early 1989 would certainly not be repeated as most subsidies had now been reduced to insignificance, except for those on public transportation the removal of which would excessively damage low-income users. Devaluations of the exchange rate were not again to reach 20 percent as they had cumulatively over the past year; progressively smaller devaluations at gradually lengthening intervals were instead to be expected.

Reducing the degree of wage indexation to prices had made a major contribution toward moderating wage increases in the past year. The national COLA of February 1989 provided no compensation for inflation up to 6 percent per annum, but automatic adjustment of 85 percent on any additional inflation after March 1989, payable at six-month intervals until April 1991. The Government was very much in favor of reaching a similar agreement for the coming fiscal year. Also, to reduce the spillover of past inflation into current price increases, only a 90 percent passthrough of costs to controlled prices, rather than the current 95 percent, might be provided for.

The COLA provisions taken by themselves would have produced a decline in real wages of as much as 7-8 percent, against the 1 1/2 percent actually recorded for 1989. In fact, for the public sector alone, real wages still rose 1 1/2 percent in 1989, rather than declined at all. In an effort to allow public sector wages to catch up with wages in the private sector, the two-year framework agreement for the public sector signed with the Histadrut in 1988 had provided for a 5 percent wage increase between August 1988 and April 1989, and for a further 6 percent by March 1990. This agreement will also come up for renewal shortly, and as public sector wages are still deemed to lag far behind those in the private sector, adjustments in them were expected to continue to exceed private sector increases.

In the 1988 biennial wage agreement with the business sector, the Histadrut had by contrast refrained from specifying nominal wage increases altogether, concentrating instead on nonwage concerns. This allowed wage settlements to reflect more closely financial conditions in industrial branches and in individual firms. As these wage agreements, too, come up for renewal in the course of the coming year, it was thought important to moderate wage expectations among workers. It was also necessary, in the view of the Histadrut, to avoid tension in the labor market between new immigrants seeking jobs and young people coming out of the army seeking the same jobs. Immigrants were not expected to be very demanding and would therefore provide keener competition in the labor market.

The authorities acknowledged that the moderation in wage settlements would probably not have been possible without the rise in unemployment over the past two years. Many plants had closed, others were liquidated, while some reduced labor and cut production lines. The process had yet to run its course. The three largest entities, namely the Koor conglomerate, the kibbutzim, and the CLAL holding group, continued to experience financial trouble, and would have to be nurtured back to health before they could resume expanding their capacity and employment. It was agreed that, as declining and unproductive enterprises disappeared, resources would be freed for new industries oriented to markets abroad that would further strengthen the economy.

The Government meanwhile intended to improve the efficiency of labor markets by expanding vocational training facilities and employment incentives. In addition, the 1987 minimum wage law was to be amended. This law stipulated that minimum wages were to be periodically adjusted to equal 45 percent of the average wage for the economy as a whole. One problem with this formula has been that the adjustments are calculated for the basic wage only, rather than for total wage income which includes also overtime pay and various allowances and reimbursements. Since the share of basic wage income in total wage income differs widely by occupation, many inequities had resulted from its application. The Government planned to restructure compensation, at least in the public sector, so as to have a better test of who should benefit from minimum wage adjustments.

IV. Economic Outlook

The economic outlook for 1990 and beyond depends in large measure on the evolution of net immigration. There are two main sources of uncertainty. First, the size and the timing of net immigration are still unknown. And second, the response of investment to a sudden increase in the labor force is difficult to predict.

Immigration will have both supply and demand effects on the economy. The first impact will be felt in the labor market. The "direct absorption" approach to immigration that the authorities have adopted is expected to favor a market-oriented allocation of labor resources. This in turn will contribute to increased competitiveness and, it is hoped, to growth in output and employment.

As regards demand effects, these are most pronounced in the construction sector through the demand for new housing. Immigrants also add impetus to total consumption in the economy, albeit initially at lower levels per capita than the existing population. This combination of a surge in building activity with increased total consumption is expected in turn to trigger accelerator effects on nondwelling investments.

The authorities project the economy to grow by some 5 percent during 1990. This rate of growth, which assumes a net inflow of new immigrants of some 100,000 persons, is driven in the first instance by a 14 percent jump in fixed investments net of imports of dwellings, a pickup of overall consumption per capita from its depressed level during 1989, and a further expansion of exports.

Price inflation is expected to decline from 21 percent in 1989 to some 15-18 percent in 1990, based on a weakening of wage pressures in response to high unemployment, a slower pace of devaluation of the sheqel, smaller adjustments in controlled prices, and lower housing price increases after their initial response to immigration. A projected increase in civilian imports, net of imports of dwellings, of 9 percent also helps (Table 6).

The authorities expect real wages to stabilize in 1990 and after. Productivity growth is projected to recover from very moderate levels during 1988-89, to its historic average rate of some 3 percent per annum, and unit labor costs are therefore expected to fall. On balance, employment is assumed to grow sufficiently to leave the unemployment rate unchanged at about 8-9 percent of the civilian labor force.

The balance of payments, again excluding imports of dwellings, and the foreign debt position worsen only slightly in the official projection. The deficit in the civilian goods and services account is to increase from some US$2.6 billion in 1989, to US$3.2 billion in 1990. Including lower net defense imports and slightly larger transfer receipts, the current account surplus would drop from US$0.9 billion in 1989 to some US$0.4 billion in 1990, leaving the net foreign debt position to stabilize in U.S. dollars.

Lacking any clear signs of an economic upturn in the first quarter, the mission for its part considered growth at some 4 percent to be the maximum feasible in 1990, taking account of import requirements. Even at that rate there would be, instead of a surplus, a small deficit on external current account of about 3/4 percent of GDP this year. The slower rate of growth would also result in a more moderate growth of employment, with unemployment increasing from 9 percent during 1989 to about 9 1/2 percent during 1990.

Looking beyond 1990, the mission were again less sanguine about investments than the authorities (Table 6). It is not clear that the arrival of new immigrants alone will jump-start investment. It may well take more drastic action on the exchange rate to reduce costs, or on the liberalization of product, labor, and capital markets to increase returns, before investment will respond. However, calculating non-dwelling investments and imports mechanically in relation to total demand does produce an average growth rate for the economy of some 5 percent annually over the 1991-94 period.

The exact outcome for unemployment is very sensitive to the labor force participation rate that is expected to characterize the new immigrants. Staff calculations suggest that, with a participation rate among adult immigrants of some 75 percent, the average rate of unemployment could reach nearly 13 percent of the civilian labor force. This unemployment rate would reach a more moderate 11 percent, however, if the participation rate among immigrants were to come out to be the same as that of the current population, or about 52 percent.

The mission also projected a larger current account deficit and a higher gross external debt burden through the medium term. Import requirements over time are particularly sensitive to assumptions regarding investment. It seems likely that most of the increased housing demand will have to be met through imports. An initial worsening of the deficit on goods and services would seem to be in prospect, followed by a gradual recovery as immigration abates, and domestic supply begins to respond to increased demand.

On balance, the current account deficit could average some 4 1/2 percent of GDP during 1991-94. While large by recent standards, such a deficit is not likely to present a major financing problem. Keeping the gross debt to GDP ratio to its level of 1989, external borrowing of US$3 billion annually on average would be sufficient to allow for a buildup of international reserves roughly in proportion to total imports.

Table 6. Israel: Medium-Term Outlook, 1989-94

(In billions of U.S. dollars and percent)

	1989	Official projections 1990	Official projections 1991-94 1/	Staff projections 1990	Staff projections 1991-94 1/
Goods and services account	-4.1	...	...	-5.5	-7.9
Percent of GDP	-9.6	...	...	-12.1	-14.4
Of which:					
Civilian goods and services, excl. housing imports	-2.6	-3.2	-3.9	-3.9	-5.7
Housing imports	0.0	...	...	-0.3	-0.8
Defense imports	-1.5	-1.6	-1.6	-1.3	-1.3
Total net transfers	5.0	5.2	5.3	5.2	5.4
Current account	0.9	0.4	-0.1	-0.3	-2.5
Percent of GDP	2.1	...	...	-0.7	-4.5
Net medium- and long-term capital	-0.3	...	...	1.4	3.0
Increase in international reserves (-)	-1.4	...	...	-1.2	-0.6
Gross external debt (end-year)	31.0	...	...	32.6	44.5 2/
Gross debt in percent of GDP	72.1	...	...	71.6	72.1
Debt service in percent of exports of goods and services	29.3	...	...	24.1	15.2 3/
Gross official reserves (end-year) (months of total imports)	3.1	...	...	2.9	2.8 4/
Memorandum items:					
Real GDP	1.1	5.0	5.3	4.1	5.1
Gross fixed investment 5/	-5.2	14.0	9.8	14.3	12.0
Export volume	4.2	4.0	5.7	6.5	5.9
Civilian import volume 5/	-2.5	8.0	5.4	11.1	8.6
Population growth	1.6	2.6	3.4	2.7	3.1
(Net immigration, end of period, thousands)	...	100	100	100	65.0
Growth in civilian labor force	3.2	...	...	2.2	3.9
Growth in employment	0.4	...	...	1.6	2.6
Rate of unemployment 6/	8.9	8.5	8.3	9.5	12.8
Rate of unemployment 7/	8.9	...	...	9.3	11.1

Sources: Data provided by the Israeli authorities; and staff estimates.

1/ Average per annum.
2/ Level at end of 1994.
3/ In 1994.
4/ End of 1994.
5/ Excluding housing imports.
6/ Assuming a participation rate of immigrants of 75 percent.
7/ Assuming a participation rate of immigrants of 52 percent--equal to that of existing population.

V. Staff Appraisal

Two issues dominated this year's interim Article IV consultation discussions with Israel; one retrospective, the other prospective. In retrospect, there was disappointment with the continuing poor performance of the Israeli economy in 1989, when fixed investment fell by 5 1/4 percent, the growth of GDP barely exceeded 1 percent, and unemployment rose to nearly 9 percent. This record conflicted with the high hopes held in the first few years after the 1985 stabilization program, when the rate of consumer price inflation was brought down from a peak of 450 percent in 1984 to a range of 15-20 percent by 1986. This could be achieved, it had been thought, without serious loss in output or in jobs.

The disturbances in the West Bank and Gaza clearly had a debilitating effect on investment in Israel. There is also reason to believe, however, that the recession, which began in mid-1987, had its roots in the stabilization program itself: in the sharply increased tax burden that helped close the fiscal gap in 1985; in the high real rates of interest required to hold the nominal exchange rate in place; and in the overshoot of wages before the reduction in price inflation became fully credible in the labor market. These served a positive purpose in speeding the demise of enterprises whose lack of economic viability may have been obscured in an inflationary environment. The staff, indeed, this year as last tilt in favor of shake-out rather than bail-out, so as to create the basis on which a sustained recovery can be built.

The prospect for 1990 and beyond has meanwhile been complicated by the arrival in Israel of a new wave of emigrants from the Soviet Union, the total of which could rise to substantial numbers over the next few years. The budget approved by Parliament still assumes only 40,000 new arrivals in the current fiscal year. The staff is concerned that, whatever its size, such new immigration be dealt with in a manner that does not undermine the stabilization effort of the last few years. Under its "direct absorption" policy, the Government intends to minimize its direct involvement in the process, and to rely on standardized transfer payments to individuals and businesses which they may spend at their discretion. Nevertheless, both fiscal and monetary policy have already come under considerable pressure.

A prompt recovery of investment will be necessary for the effective integration of the new immigrants into the work force. The staff recognize two views on how in Israel's circumstances investment could be restarted while preserving internal and external balance. One would advocate a sharp devaluation of the currency to a new fixed rate, supported by tight monetary and fiscal policies, to restore to existing enterprises the profitability they lost in the immediate post-stabilization period. The other view favors a rapid deregulation of labor and capital markets, again supported by tight monetary and fiscal policies, that would permit new enterprises to exploit the full potential of an exceptionally skilled and motivated labor force.

The staff favor a strong emphasis on decontrol rather than on devaluation to start up new investment. A substantial devaluation would carry an excessive inflation risk; even if successful, it would in the Israeli context tend to support old rather than promote new industries, and thus preserve the structural distortions inherited from the inflationary period. By contrast, a strategy that centers on a radical freeing of markets, with a hard currency and a minimum of exchange controls, would help to accelerate the structural change required for a recovery of sustained long-term growth. Increased exposure to international capital markets would be risky in conditions of political instability within the region and domestically. It would nevertheless fall in line with Israel's expanding trade relations with Europe and the United States. A small and self-contained economy cannot offer much to private investors.

Since the last consultation, Israel has continued to liberalize its exchange and trade regime, if only in cautious and incremental steps. Israel retains two exchange practices subject to Fund approval under Article VIII, Sections 2 and 3. The tax on imports of services levied at the time of the foreign exchange transaction had its rate reduced from 15 percent to 7.5 percent in April, and business services were exempted in September 1989. The exchange rate insurance scheme for exporters has had its subsidy element reduced three times with exchange rate adjustments since early 1989. In the absence of timetables to eliminate them altogether, however, the staff still does not propose approval of their retention by Israel.

The Executive Board has placed Israel on the "bicyclic" consultation procedure. The next full Article IV consultation with Israel is scheduled to be completed in June of 1991.

VI. Proposed Decision

Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Israel's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1990 Article XIV consultation with Israel.

2. Israel maintains the restrictive measures described in SM/90/95 (5/17/90) in accordance with Article XIV, Section 2, except that the tax on the import of services and the exchange rate insurance scheme are subject to approval under Article VIII, Sections 2 and 3. The Fund encourages Israel to eliminate the exchange tax and the insurance scheme as soon as possible.

Israel - Basic Data

	1985	1986	1987	1988	Prel. 1989 1/	Forecast 1990
			(Annual percentage change)			
National accounts (at constant prices)						
GDP	3.9	3.6	5.2	1.6	1.1	4.1
Gross domestic expenditure 1/	-2.1	8.7	6.1	2.1	-1.7	6.3 2/
Private consumption	0.5	14.2	8.4	3.0	-1.0	5.1
Government consumption 1/	-0.8	-2.9	2.7	2.9	-0.6	2.7
Gross domestic investment	-10.6	10.4	3.3	-2.1	-5.2	16.3 2/
Of which: Fixed capital formation	-7.8	-0.6	13.0	-1.2	-5.2	14.3 2/
Prices, wages, and employment						
Consumer prices (end-year)	185.2	19.7	16.1	16.4	20.7	...
Wholesale prices (end-year)	152.8	15.1	20.9	15.8	19.5	...
Real wages per employee post 3/	-9.0	7.8	7.9	6.0	-1.4	...
Private sector	-6.5	9.1	7.9	4.7	-1.8	...
Public sector	-14.3	4.4	7.1	9.7	0.4	...
Unemployment rate (in percent)	6.7	7.1	6.1	6.4	8.9	...
			(In percent of GNP)			
Budget aggregates (fiscal years) 4/						
Revenue	43.9	47.6	43.1	41.3	36.7 5/	40.0 6/
Expenditure	63.0	59.9	54.1	51.8	50.5 5/	50.7 6/
Of which: Defense	20.4	18.5	16.2	14.6	13.2 5/	12.9 6/
Interest payments	14.8	12.4	11.1	10.0	10.0 5/	10.0 6/
Foreign grants	17.9	14.2	9.1	7.4	7.2 5/	6.4 6/
Overall balance	-1.2	1.9	-1.9	-3.1	-6.5 5/	-4.2 6/
Of which: Domestic balance	-4.1	—	-1.4	-2.5	-6.1 5/	-3.3 6/
			(Percentage change, end of period)			
Monetary developments						
Nominal						
Money plus quasi-money	168.5	20.8	27.2	22.3	25.9 7/	...
Domestic credit	180.7	16.1	20.6	22.2	19.0 7/	...
Of which: Private sector	173.4	36.4	36.2	28.5	25.4 7/	...
Real 3/						
Money plus quasi-money	-5.9	0.9	9.5	5.1	4.9 7/	...
Domestic credit	-1.6	-3.0	3.8	5.0	-0.8 7/	...
Of which: Private sector	-4.2	14.0	17.3	10.4	4.5 7/	...
			(Annual percentage change)			
External sector						
Exports, f.o.b. (in U.S. dollars)	6.7	15.7	18.1	10.5	8.9	15.9
Imports, f.o.b. (in U.S. dollars)	2.7	5.9	34.1	2.0	-3.2	17.9
Of which: Civilian	-1.6	16.8	23.8	6.0	3.2	20.0
Export volume	9.4	10.4	10.9	1.0	4.5	5.7
Import volume 1/	3.7	16.7	12.4	0.4	-2.0	13.1
Terms of trade 1/	2.4	4.1	-2.9	4.8	-1.0	-1.2
Nominal effective exchange rate 8/	-67.4	-13.0	-15.2	-0.3	-16.2	...
Real effective exchange rate 8/	-2.9	1.6	-3.7	13.1	-3.4	...
			(In percent of GNP)			
Current account balance	5.0	5.5	-2.9	-1.7	2.2	-0.6
External debt, end of period	128.4	108.2	94.1	76.9	74.2	74.2
Gross official reserves, end of period (in months of total imports of goods and services)	3.0	3.6	3.6	2.4	3.1	3.2
Gross debt service (as a percentage of total exports of goods and services)	36.0	34.0	29.4	31.8	29.3	23.7

1/ Excluding direct defense imports.
2/ Excluding housing imports.
3/ Deflated by consumer price index.
4/ Fiscal years beginning April 1.
5/ Estimates based on supplementary budget for 1989/90.
6/ Proposed budget 1990/91.
7/ Twelve-month change to November.
8/ Based on INS standard index (using consumer prices); fourth quarter over fourth quater.

Israel--Fund Relations

(As of April 30, 1990)

I. Membership Status

(a) Date of membership: July 12, 1954
(b) Status: Article XIV

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 446.6 million
(b) Total Fund holdings of new Israel sheqels: SDR 446.6 million (100 percent of quota)

III. Stand-By Arrangements approved since 1974

(i) One year stand-by arrangement for SDR 32.5 million (25 percent of quota) approved on November 8, 1974. Fully disbursed; cancelled on February 14, 1975.
(ii) One year stand-by arrangement for further SDR 32.5 million (25 percent of quota) approved on February 14, 1975. Fully disbursed.
(iii) One year stand-by arrangement for SDR 29.25 million (22.5 percent of quota) approved on October 20, 1976. Utilization: SDR 12 million.

IV. SDR Department

(a) Net cumulative allocation: SDR 106.36 million
(b) Holdings: SDR 2.57 million (2.42 percent of net cumulative allocation).
(c) Current designation plan: Not applicable.

(B) Nonfinancial Relations

V. Exchange Arrangement

Peg to a currency basket reflecting the composition of foreign trade.

VI. Article IV Consultation

The last full Article IV consultation discussions were conducted in March 1989; reports on these discussions (SM/89/96 and SM/89/112) were discussed by the Board and the consultation was concluded on June 23, 1989.

Israel: Statistical Issues

1. Outstanding statistical issues

b. Government finance

Annual GFS data published in IFS cover transactions of the consolidated central government (i.e., inclusive of social security) and are consistent with the data published in Government Finance Yearbook (GFSY).

The 1989 GFSY includes data for consolidated central government for the years 1979 through 1988 (data for the last year being provisional), and the local government data for the years 1979 through 1986. Therefore, general government data have been compiled and published in the 1989 GFSY for the years 1979 through 1986 only.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published for Israel in the April 1990 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Israel which, during the past year, have been provided on a regular and timely basis.

Status of IFS Data

		Latest Data in April 1990 IFS
Real Sector	- National Accounts	Q1 1989
	- Prices: CPI	January 1990
	WPI	January 1990
	- Production	November 1989
	- Employment	November 1989
	- Earnings	November 1989
Government Finance	- Deficit/Surplus	1989p
	- Financing	1988p
	- Debt	1987
Monetary Accounts	- Monetary Authorities	November 1989
	- Deposit Money Banks	December 1989
	- Other Banking Institutions	n.a.

Interest Rates	- Discount Rate	January 1990
	- Bank Deposit/Lending Rates	December 1989
	- Bond Yields	n.a.
External Sector	- Merchandise Trade: Values	January 1989
	Prices	Q3 1989
	- Balance of Payments	Q3 1989
	- International Reserves	January 1990
	- Exchange Rates	February 1990

3. Technical Assistance Missions in Statistics (1987-present)

Subject	Staff Member	Date
Government Finance Statistics	Mr. J. Levin	May 5-19, 1989