FOR AGENDA

SM/86/85

CONTAINS CONFIDENTIAL
INFORMATION

April 23, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Israel - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Israel. A draft decision appears on page 19.

This subject has been tentatively scheduled for discussion on Wednesday, May 21, 1986.

Mr. R. P. Hicks (ext. 7187) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the 1986 Consultation with Israel

Approved by Brian Rose and J.T. Boorman

April 22, 1986

I. Introduction

A staff team consisting of Messrs. de Fontenay (EUR), Kreis (FAD), Hicks (EUR), Nielsen (EUR), and Op de Beke (EP-EUR), with Ms. Adams (EUR) as secretary, held Article IV consultation discussions in Jerusalem and Tel Aviv during February 27-March 10, 1986. The Israeli representatives included officials of the Bank of Israel and the Ministries of Finance and Commerce and Industry. The mission had discussions with the Minister of Finance, Mr. Moday, the Governor of the Bank of Israel, Dr. Mandelbaum, and the Director General of the Ministry of Finance, Dr. Sharon. Meetings were also held with the Heads of the Manufacturers' Association, the Bankers' Association, and the Trade Union Federation (Histadrut). Mr. Polak, Executive Director for Israel, and Mr. Steinberg, Advisor to the Executive Director, attended some of the meetings.

Israel continues to avail itself of the transitional arrangements under Article XIV.

II. Background

Over the past decade, Israel has experienced a period of prolonged economic difficulties. While output and productivity stagnated, private and public consumption continued to expand, resulting in a rapid increase in foreign debt, recurrent balance of payments crises, and a steep decline in the share of investment in GDP. Inflation accelerated by stages reaching 445 percent (on a year-end basis) in 1984 (Chart 1). Unemployment remained generally low, with the public sector's share in the labor force rising from 20 percent to 30 percent during the past ten years. Priorities for economic policy shifted between the balance of payments and inflation, with attempts at solving one problem usually aggravating the other.

There is broad agreement over the main causes of Israel's poor economic performance. A large responsibility rests on the government budget deficits, related in part to defense needs and the desire to maintain full employment. Despite special incentives to encourage savings, the Government has had to borrow massively from the central bank, thereby precipitating losses of official reserves and fueling inflation. Attempts at reducing the budget deficit by cutting subsidies or raising taxes, or the balance of payments deficit by devaluing, resulted in sharply higher rates of inflation as indexation of wages speeded up the transmission of such price shocks through the economy and indexation of financial assets implied automatic accommodation of the money supply to the higher prices.

The Israeli representatives said the notion that the adverse effects of inflation could be adequately countered by widespread indexation had been abandoned. Inflation was now seen as largely responsible for the decline in productivity and the overexpansion of financial services. Business decisions, and in particular the monitoring of costs and relative prices, had become exceptionally difficult.

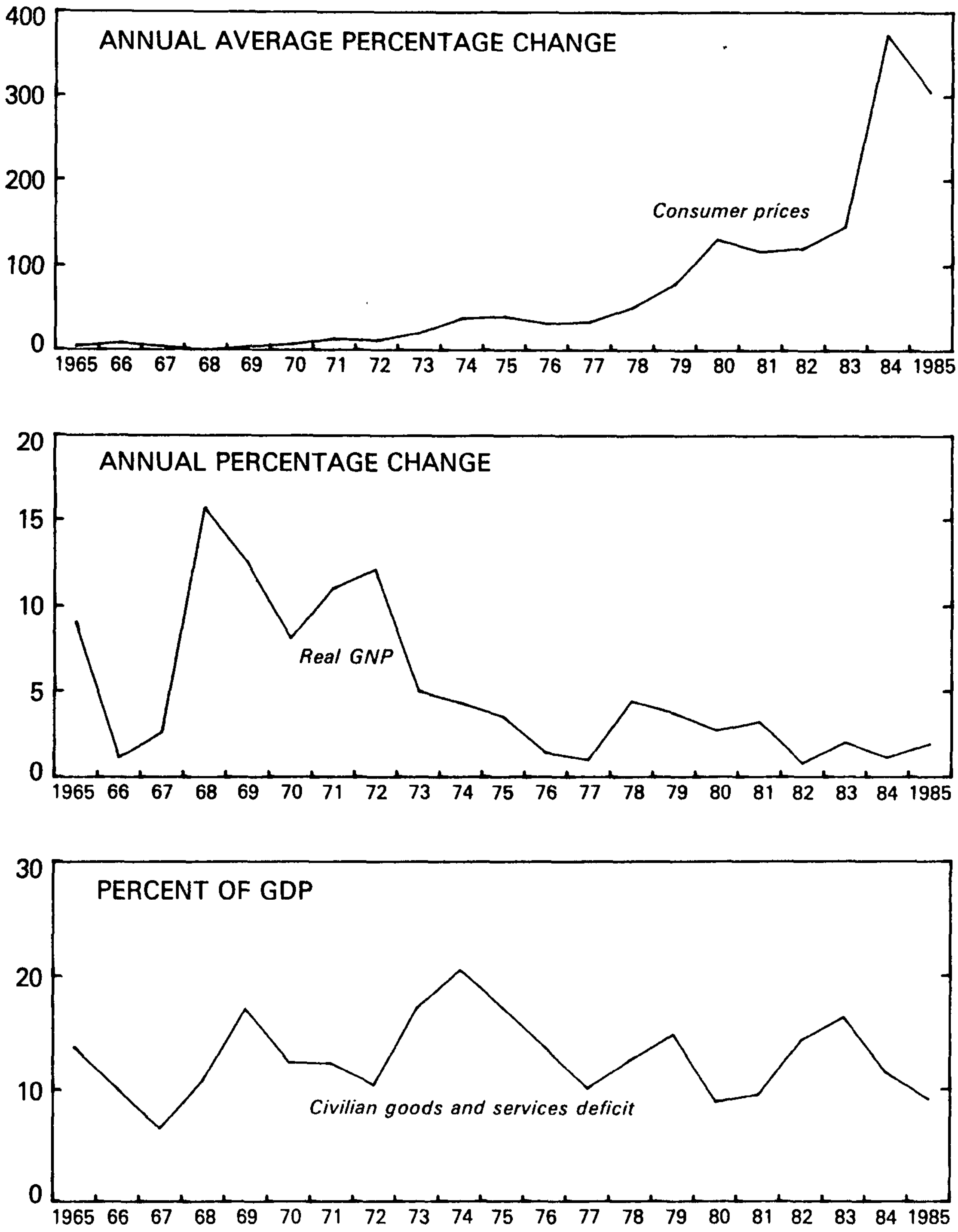
As discussed in last year's Staff Report (SM/85/118), Israel suffers from structural problems which have also contributed to the deteriorating performance of the economy: a high tax burden (although inflation bursts temporarily reduce revenue as tax receipts lag behind incomes and prices), a bloated public sector, and an excessive degree of interference by the Government in the economy, in the form of various regulations, subsidies and taxes which distort resource allocation.

On the occasion of the 1985 Article IV consultation with Israel Directors observed that the continuing failure to deal with the underlying imbalances in the economy, reflected especially in large and expanding fiscal deficits, had contributed importantly to the major economic problems that had emerged. They expressed serious doubts about the realism of a gradualist approach, given the dimensions of the economic problem, and emphasized the need for substantial, comprehensive and immediate adjustment measures. Directors underlined the critical role of fiscal policy in the stabilization effort, strongly supported the policy of maintaining high real interest rates, and expressed the view that real wage restraint should form an important part of a stabilization program in Israel. Directors also noted the exchange restrictions and multiple exchange rate practices recently introduced and regretted the extensive system of import restrictions and export subsidies.

CHART 1

ISRAEL

INFLATION, GROWTH, AND CIVILIAN GOODS AND SERVICES DEFICIT, 1965-85



Sources: Central Bureau of Statistics; *Monthly Bulletin of Statistics;* IMF, International Financial Statistics; and staff calculations.

III. The Stabilization Program

1. Economic developments in the period preceding the program

Economic policy shifted in late 1983 toward the improvement of the balance of payments. The sheqel was devalued by 19 percent in October 1983 and again by 8 percent in September 1984, and the prices of subsidized products were raised. Domestic demand, which had expanded rapidly in 1981-83, declined in 1984 partly due to the erosion of financial wealth associated with the stock market collapse of 1983 (Table 1). The budget had an expansionary effect as the deficit rose because of a sharp drop in revenue associated with the acceleration of inflation. The foreign trade account improved but the inflation rate soared to an average monthly rate of 23 percent in September-October 1984. Fears of hyperinflation prompted the coalition Government formed in September 1984, the Histadrut and the employers' organization to sign an agreement (which became known as the "first package deal") providing inter alia for a three-month price freeze, cuts in the budget deficit, and payments to wage earners of only two-thirds of the normal cost of living adjustment over the three months' period, which lowered the monthly rate of inflation to 4 1/2 percent by December-January. However, this success was short-lived. The continued depreciation of the sheqel, delayed wage adjustments for past increases in the cost of living, and the rising budget deficit (due to lower tax receipts and higher spending on subsidies to keep the price of subsidized products unchanged) created pressures to raise prices. At the end of January 1985, the Government raised controlled prices and negotiated with the Histadrut and the employers a "second package deal" which provided for controlled increases in prices of nonsubsidized products and continuation of the partial indexation of wages. Prices, however, rose by 13 percent a month in February and March 1985. A third package deal reimposed a price freeze for four months as of April 1, after immediate price increases which pushed prices up by 19 percent in April, and a second adjustment at the end of May which led to a 15 percent increase in prices in June. The increasing ineffectiveness of the "package deal" approach and the decision of the employers' federation to exercise its option to withdraw from the agreement led the Government to adopt in early July a comprehensive plan for economic stabilization.

Despite the intended reduction in the budget deficit for FY 1985/86 (beginning on April 1, 1985) equivalent to about 7 percent of GNP (excluding foreign grants), the deficit remained high during the first half of 1985. Implementation of some of the expenditure cuts and additional revenue measures approved in the budget was postponed and overruns were registered in subsidies and other spending items. As a result, the government deficit in relation to GNP remained in the first half of 1985 not much below the level recorded in the comparable period of 1984.

The wide fluctuations in the rate of inflation made the conduct of monetary and exchange rate policies particularly difficult. On balance, monetary policy remained accommodative and total credit to the private sector expanded by 2 percent in real terms during the first half of 1985, while the real effective exchange rate appreciated by about 5 percent. Domestic demand and GDP expanded in the first half of 1985, mainly due to the recovery of private consumption. Despite an improvement in the balance on civilian goods and services in the first six months of 1985, reserves declined, partly due to speculative capital outflows, and the premium on the dollar in the parallel market rose to a peak in excess of 30 percent by June 1985.

The Israeli authorities concluded from the experience of the package deals that the balance of payments and inflation problems had to be tackled simultaneously and that price and incomes measures, though useful in contributing toward a rapid deceleration of inflation, had no chance of lasting success unless they were buttressed by restrictive financial policies. It was also considered that exchange rate stability relative to the U.S. dollar would need to be an essential element of a stabilization plan.

2. The Stabilization Program 1/

The aim of the July 1985 Economic Stabilization Program was to reduce inflation rapidly by a combination of restrictive financial policies and of measures to limit drastically inflation inertia, i.e., the effect of past increases in costs and prices on the current rate of inflation either through the indexation mechanism or through other channels. A further improvement in the balance of payments was another important goal.

A key element of the program was the reduction of the budget deficit (before grants) for 1985/86 by US$1.5 billion (7.5 percent of GNP) below the level for 1984/85 (Chart 2). This implied, in addition to full implementation of the deficit reducing measures included in the 1985/86 budget, new temporary tax measures and expenditure cuts amounting to about US$750 million on an annual basis, or US$560 million for the remainder (July-March) of the 1985/86 fiscal year. The new revenue measures included a one-year income tax surcharge of 10 percent on the self-employed and corporations. Expenditure cuts consisted mostly of a further reduction in subsidies, loans, selected categories of transfer payments, and purchases of goods and services, including wages. Prices of subsidized consumer goods and services and of other goods whose prices are controlled were raised by between 30 percent and 100 percent immediately and the amounts spent on price subsidies were frozen in real terms. Monetary policy was also severely tightened in order to achieve within one month a 10 percent reduction in real terms in bank credit outstanding. The exchange rate of the sheqel was devalued by 16 percent

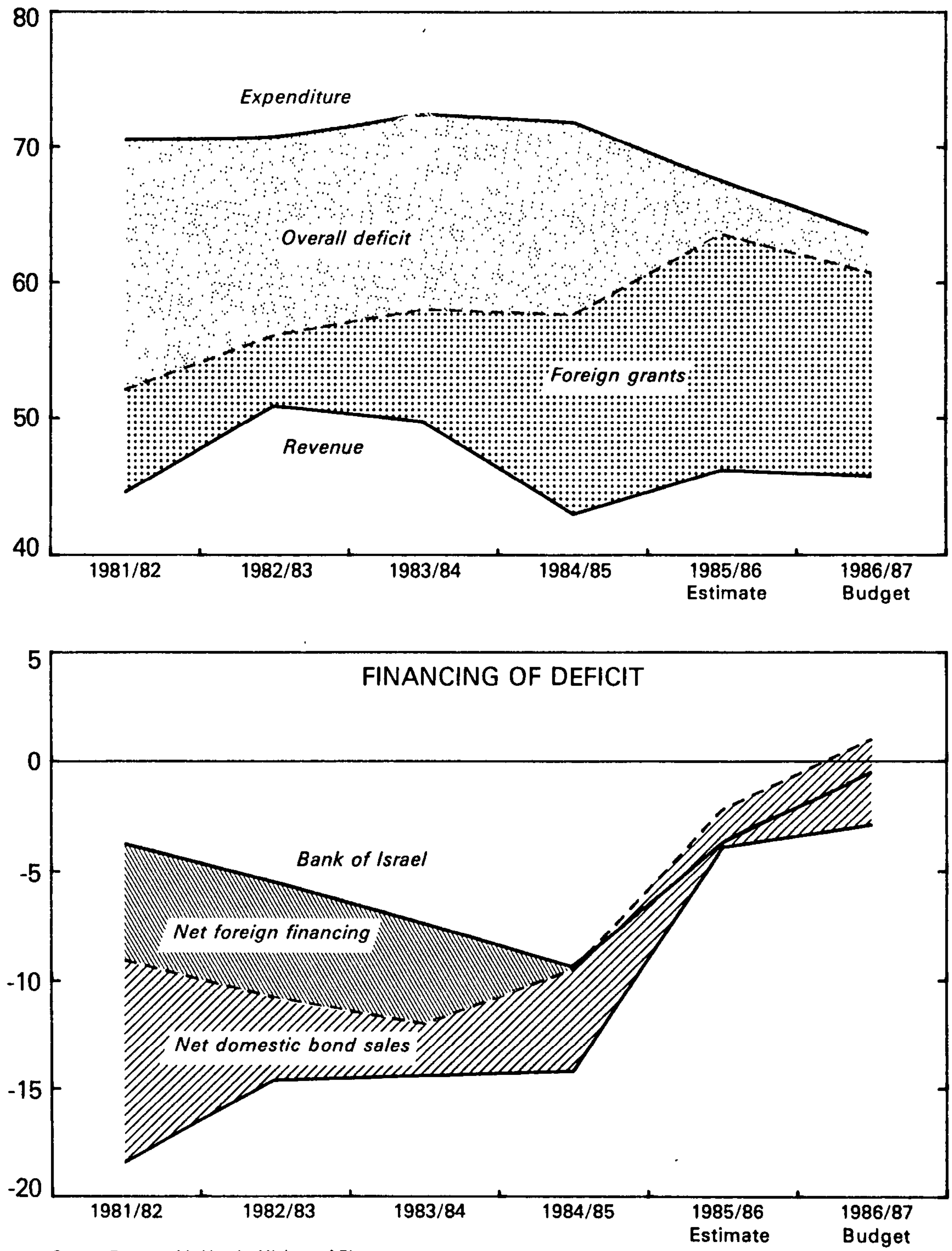
1/ See Appendix II for a comparison of the main features of the stabilization programs adopted by Argentina, Brazil and Israel in 1985 and 1986.

CHART 2

ISRAEL

CENTRAL GOVERNMENT OPERATIONS

(As a percentage of GNP[1])



Source: Data provided by the Ministry of Finance.

[1] GNP data adjusted to fiscal year (April-March) basis.

and the sheqel-U.S. dollar rate was stabilized (though this was declared to be conditional on wage developments). Prices of nonsubsidized products were frozen after an initial increase of about 17 percent and the indexation arrangement for wages was temporarily suspended. The wage agreements subsequently negotiated provided for full compensation by March 1986 for the erosion of real wages in the business sector during the first months of the program, while real wages in the public sector were to be eroded over the period by 5 percent (Chart 3). Finally, although the indexation of long-term financial assets was maintained, its scope was narrowed for foreign-exchange-linked (PATAM) deposits; henceforth new deposits of less than 12 months' maturity could no longer be effected in sheqalim, and the share of tradable government bonds issued by tender was to be raised gradually. The program was supported by US$1.5 billion in emergency grant assistance from the United States, of which half was disbursed in 1985 and the other half was expected to be received in 1986.

Some compromises had to be accepted by the authors 1/ of the program to gain its acceptance by the Government. The reduction in the deficit was smaller than needed to stabilize public debt in real terms and only 20 percent of the reduction in the deficit was to come from a reduction in public consumption. The size of the devaluation was smaller than what would have been required for a total abolition of export incentives (about 30 percent), largely because it was feared that the wage erosion that would have resulted from the inflationary effect of such a large devaluation--given the temporary suspension of the indexation arrangements--would have been unacceptable. Finally, the wage agreement signed in August by the Histadrut and the employers' association provided for the reintroduction of indexation and enhanced its extent by lowering the cumulated CPI increase that would trigger an adjustment from 12 percent to 4 percent and reducing the minimum period between adjustments from six to three months.

3. The first results

In the eight months following its introduction, the stabilization program has been a success. After an initial burst of 27.5 percent in July, resulting from a correction of prices, the rate of inflation declined to an average monthly rate of 2.7 percent in the rest of the year and virtual price stability in the first two months of 1986 (Chart 4). The Israeli representatives discounted the role of price controls in maintaining price stability, emphasizing instead the contraction of demand and the relative stability of the exchange rate with respect to the U.S. dollar, and pointing to the absence of shortages. By the beginning of March 1986, items accounting for 46 percent of the CPI were no longer controlled while, of the remainder, roughly one half

---

1/ A team of economists from the Government, the Bank of Israel and universities, headed by the Director General of the Ministry of Finance, Dr. E. Sharon.

consisted of goods and services normally controlled, such as utility rates and monopoly prices, and the other half is to be freed by the summer.

The overall fiscal performance improved substantially in 1985/86 compared with the outturn in the previous years as well as with the budget estimates (Table 2). The government deficit (before grants) is estimated to have been cut relative to GNP by 7.5 percentage points, and the financing requirement (deficit after grants) by over 10 percentage points, as foreign grants have risen by almost 3 percentage points of GNP. Because of an exceptionally large amortization of domestic debt, principally the redemption of about US$700 million worth of bank shares held by senior citizens and guaranteed by the Government, there was a sharp drop in net domestic bond financing, and net financing from the Bank of Israel remained high (3.7 percent of GNP), although much below the level authorized in the budget and substantially less than in 1984/85.

The improvement in the budget outturn for 1985/86 was due to an estimated increase in revenue equivalent to 3.2 percent of GNP and cuts in expenditure estimated at 4.3 percent of GNP. The increase in revenues reflected the positive impact of decelerating inflation on tax collections, the elimination of various tax benefits previously enjoyed by corporations, and other measures introduced in the budget in mid-year. Expenditure cuts occurred through sharp reductions in subsidies for basic products and lower payments for interest, wages and salaries, and defense outlays. At the same time, transfer payments--including those for export promotion--increased markedly during the fiscal year.

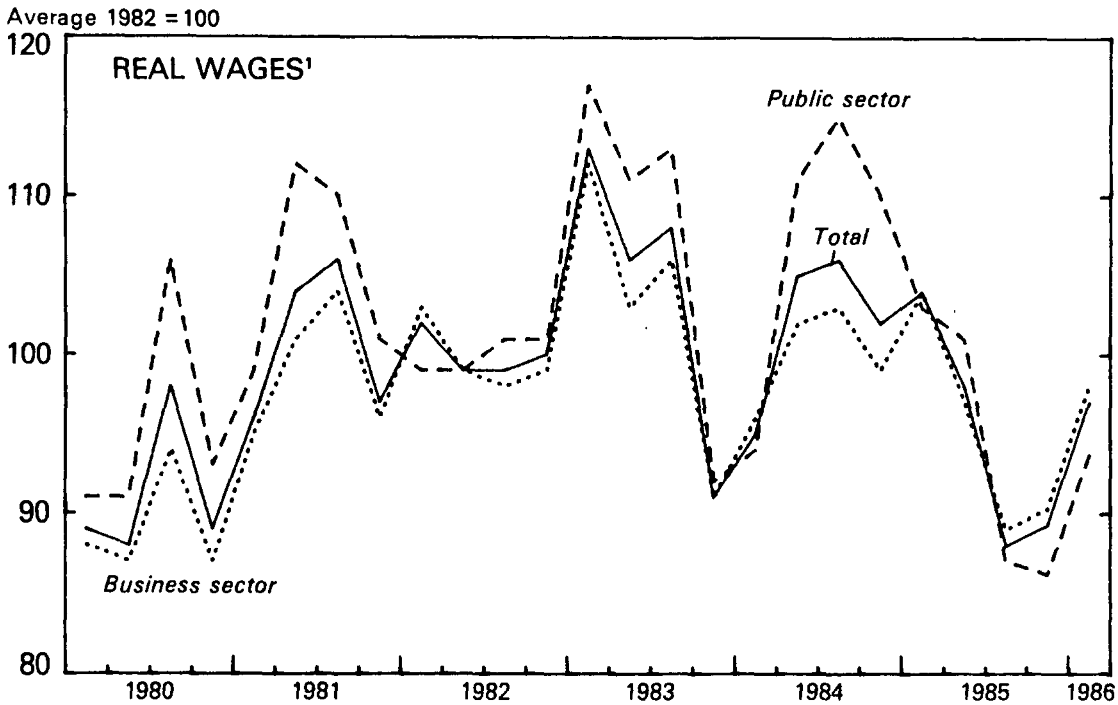
Monetary policy was tightened severely. The average cost of sheqel overdraft credit which had been 17 1/2 percent per month in the first half of 1985 initially declined only modestly despite the sharp drop in the inflation rate, thus putting pressure on firms to reduce their inventories. The high interest rates and stable exchange rate relative to the U.S. dollar prompted a shift from linked to nonlinked assets (Chart 5). As the reserve requirements on the latter are lower, the Bank of Israel had to raise them sharply in order to neutralize the potential for monetary expansion. "Directed credits" for exports were denominated from July entirely in U.S. dollars at an interest rate equivalent to 2 percentage points over LIBOR; the stability of the exchange rate implied a large gap between the cost of such credit and that of local currency loans. The introduction of a tax on capital inflows was considered but administrative regulations continued to be used to limit the use of foreign currency loans.

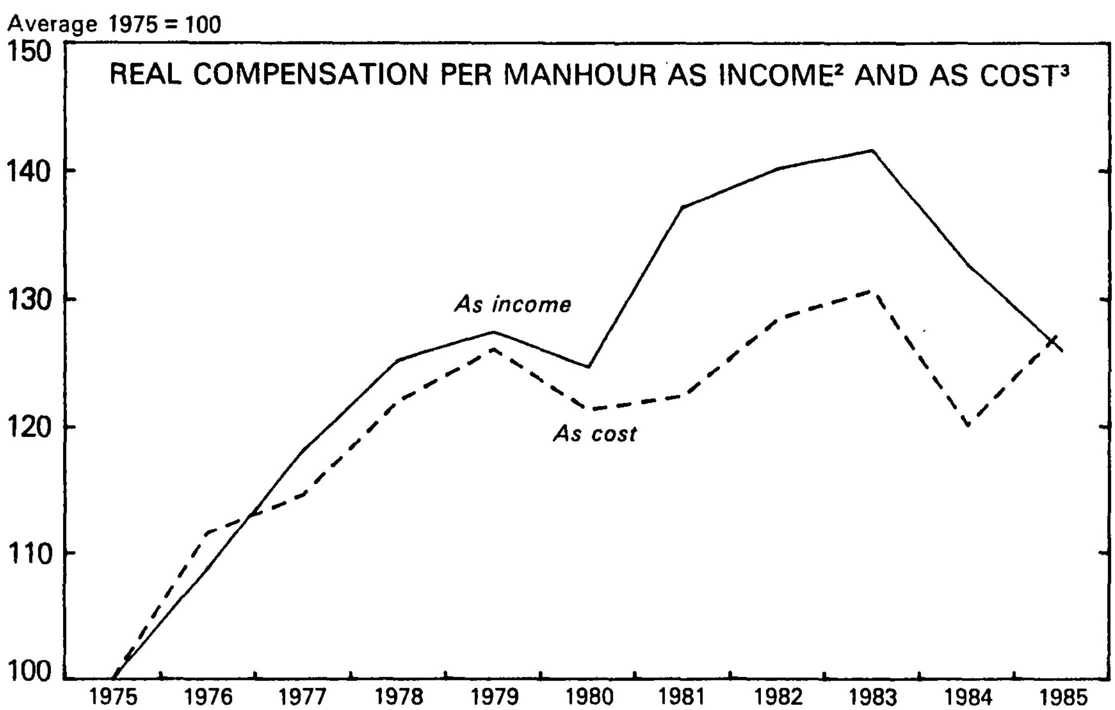
Interest rates were lowered gradually: by mid-March 1986, the average monthly cost of sheqel overdraft credit had fallen to 3.4 percent, compared with official expectations of a rate of inflation continuing at 1 1/2-2 percent a month (Chart 6). Total short-term bank

CHART 3

ISRAEL

WAGE DEVELOPMENTS





Source: Data provided by the Bank of Israel.

1 Average monthly wage per employee post at constant prices.

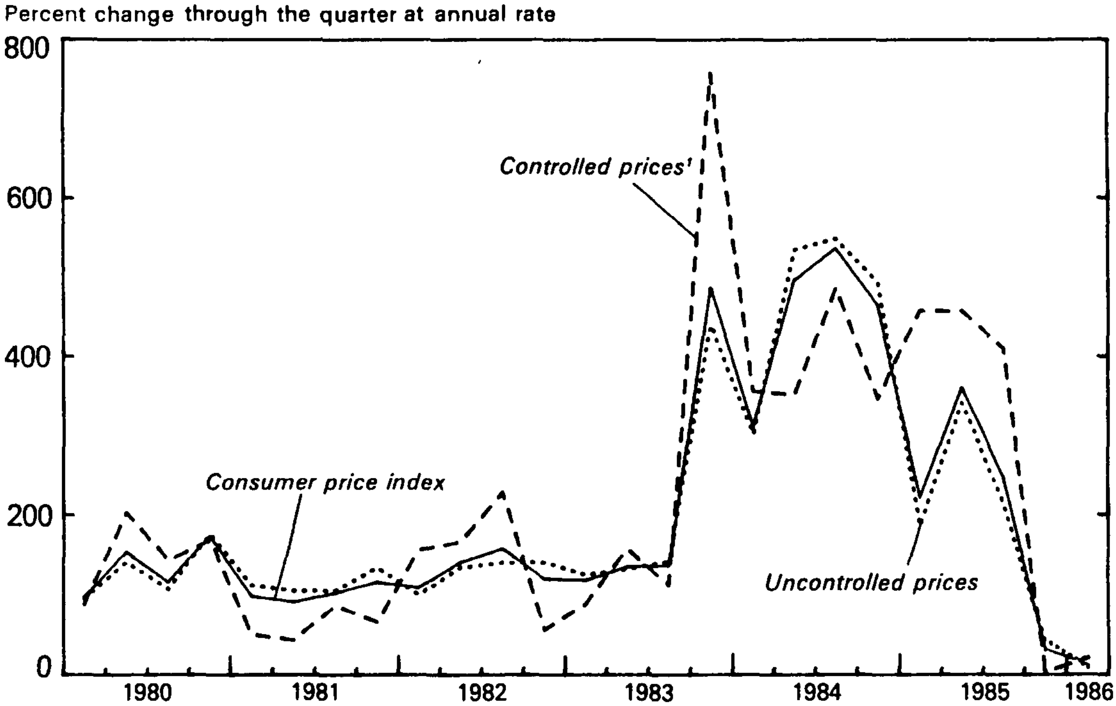
2 Gross; including nonwage compensation; deflated by CPI.

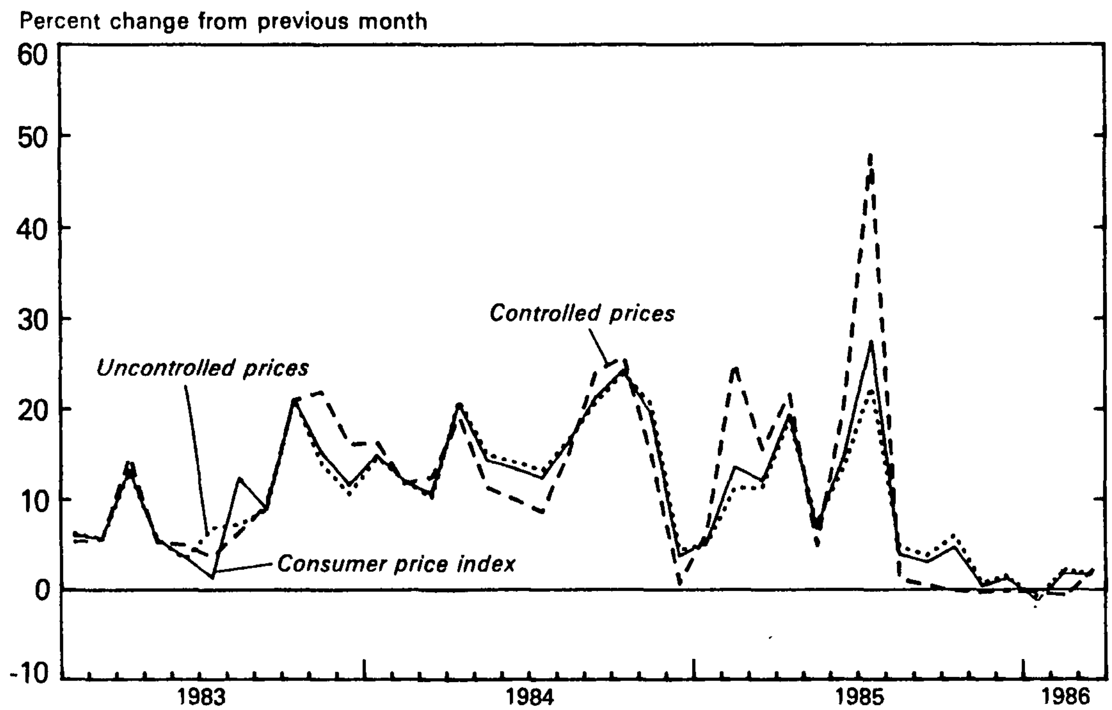
3 As indicated in footnote 2 but deflated by the implicit price index of business sector net domestic product

CHART 4

ISRAEL

CONSUMER PRICES





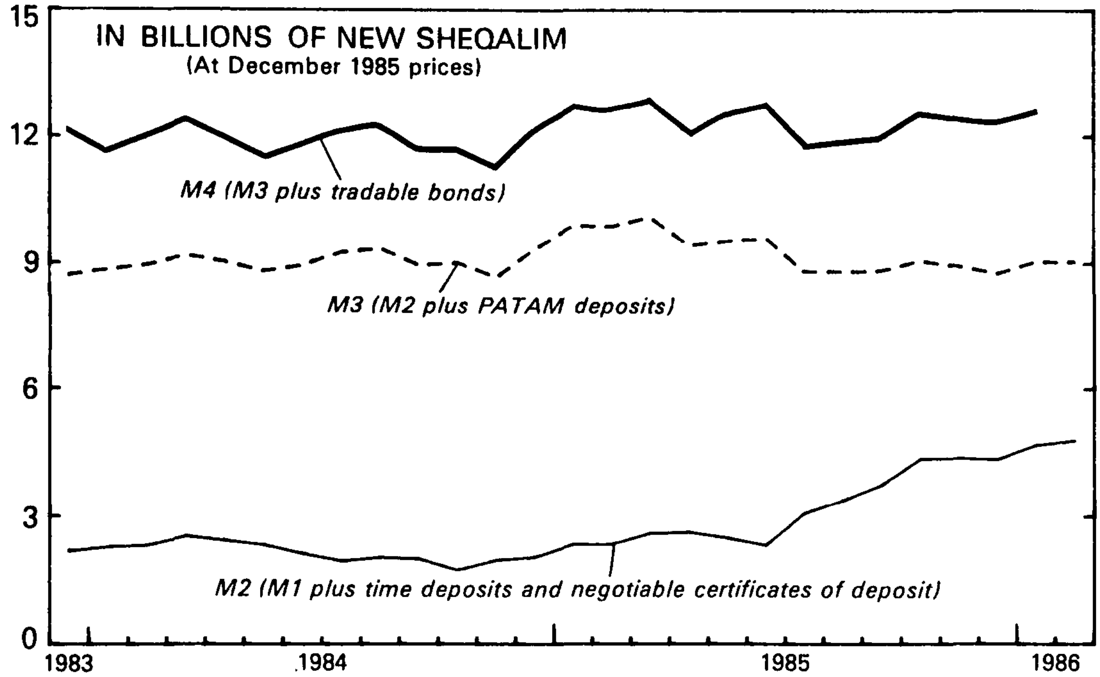
Source: Central Bureau of Statistics, *Monthly Bulletin of Statistics.*

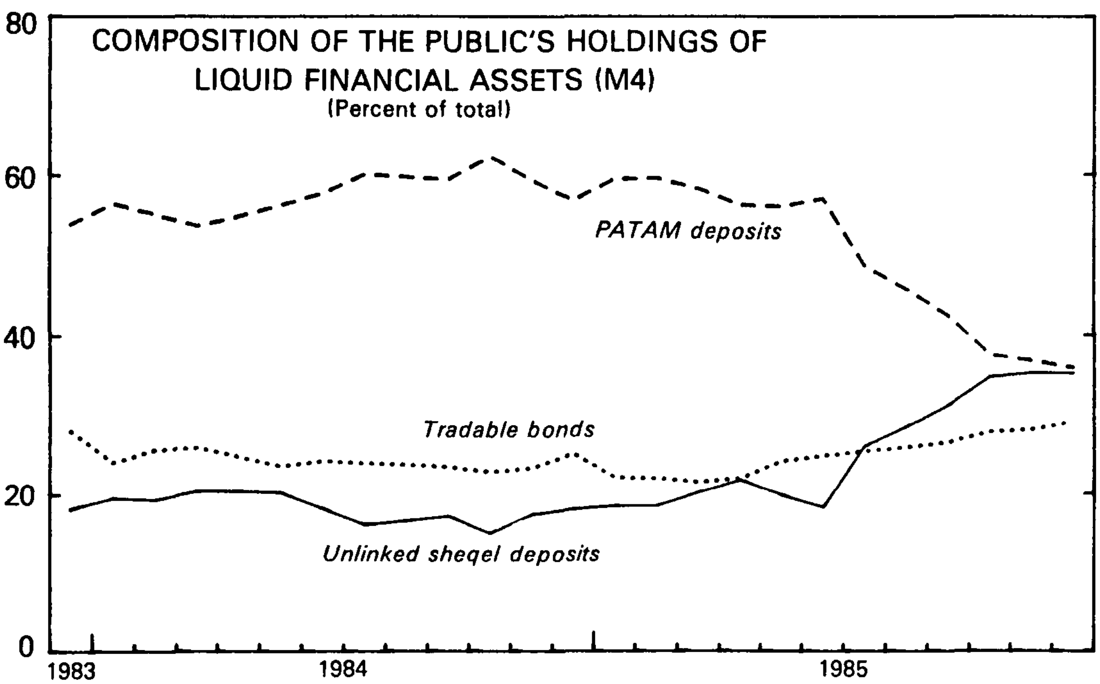
[1]Controlled prices (20 percent of the CPI) are prices traditionally fixed directly by the Government.

CHART 5

ISRAEL

LIQUID FINANCIAL ASSETS OF THE PUBLIC





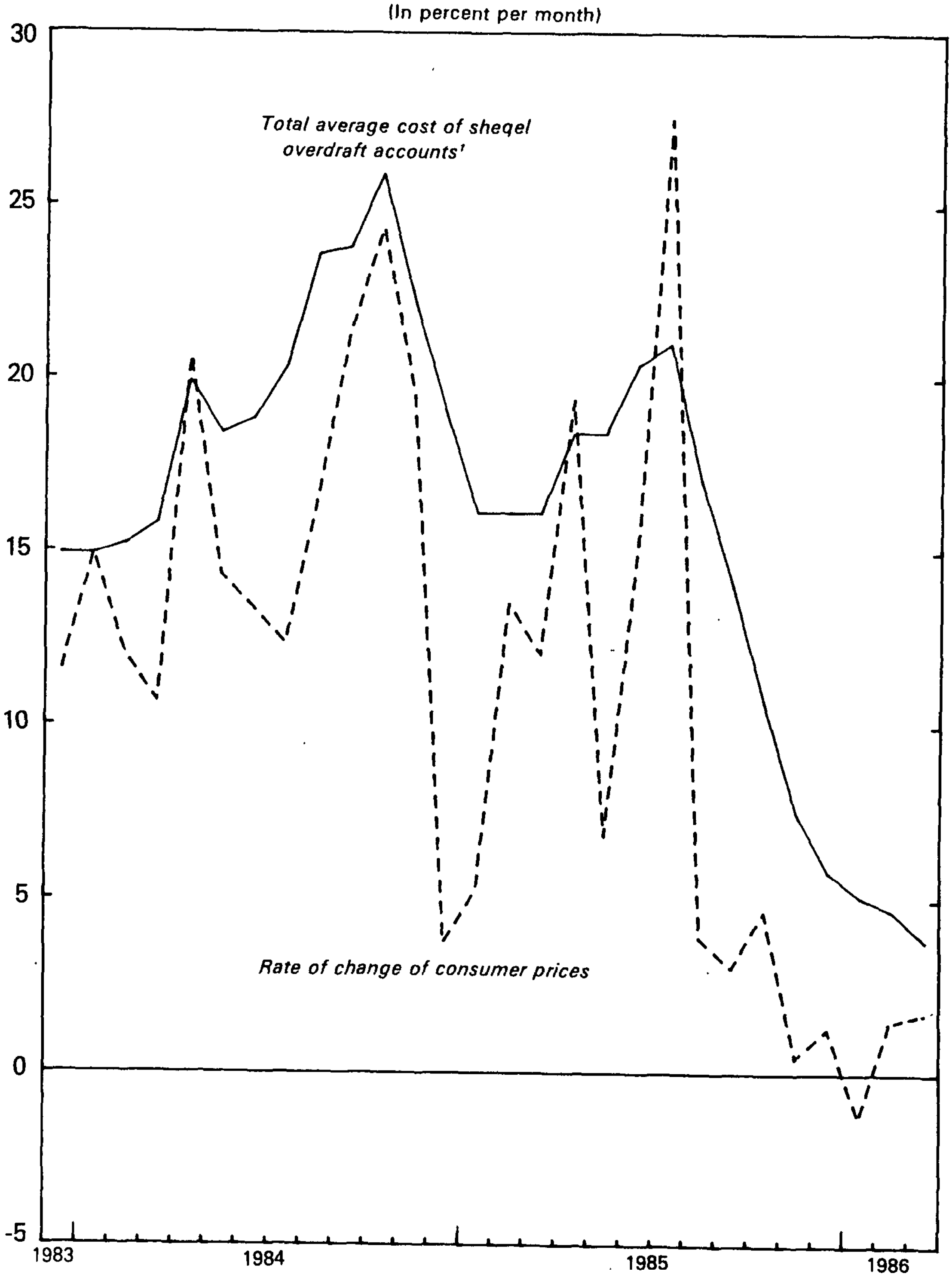
Sources: Bank of Israel, Research Department, *Recent Economic Developments;* and data provided by the Bank of Israel

CHART 6

ISRAEL

SHEQEL OVERDRAFT RATE AND CONSUMER PRICES, 1983-86

(In percent per month)



Sources: Bank of Israel, Research Department, *Recent Economic Developments;* and data provided by the Bank of Israel.

[1] Includes allocation fee and risk premium.

credit to the private sector fell by 7 percent in real terms in the second half of 1985, but began to pick up again in the first two months of 1986 (Chart 7).

The tightening of financial policies and the decline in real wages combined to reduce domestic demand in the second half of 1985 by 8 1/2 percent in real terms (after seasonal adjustment). Although real disposable income continued to fall sharply, private consumption declined by only 3 1/2 percent as households reduced their savings, while public consumption fell by 9 percent (largely due to lower domestic defense spending related to the withdrawal from Lebanon); fixed investment declined by nearly 7 percent, while stocks fell sharply. Real GDP declined by 5 percent in the second half but increased on average by 2 percent for the year as a whole. The rise in unemployment proved less serious than had been feared. The unemployment rate (seasonally adjusted) peaked at 7.8 percent in the third quarter, then fell to 6.6 percent in the fourth quarter, and in February 1986 stood at less than 6 percent (Chart 8). Demand and activity seem to have recovered from the final quarter of the year: retail sales and imports of consumer durables rose strongly due in part to the resurgence in real wages.

The improvement in the civilian goods and services account of the balance of payments continued in 1985 (Table 3). The effect of the weakening of foreign demand on the trade account was offset by the decline in domestic demand and improvement in the terms of trade. Despite an increase in defense imports, the overall goods and services deficit declined by about US$500 million in 1985 (Chart 9). The large increase in public transfers received from the United States (due both to emergency economic assistance and a shift from loans to grants) resulted in a current account surplus for the first time since 1954. The weakening in the capital account reflected the shift from loans to grants in U.S. assistance and the repayment of debt by the private sector. Speculative purchases of foreign exchange increased in the second quarter of 1985 on expectations of a devaluation and concern about a possible impairment of financial assets (through a tax on savings or reduced indexation); however, there was a shift to net sales of foreign exchange by the private sector in the third quarter. Strict capital controls limited the inflow of registered capital, but the Israeli representatives attributed the large positive errors and omissions account to the high domestic interest rates that attracted unregistered capital into the country. The authorities intend to use the U.S. emergency assistance to rebuild net reserves and this was largely achieved in 1985. Net reserves of the Bank of Israel rose by $590 million in 1985 to US$3.2 billion, equivalent to about three months of imports. Total net external debt (defined as gross debt minus banks' foreign assets) stabilized in 1985, despite an unfavorable valuation adjustment resulting from the appreciation of nondollar liabilities.

IV. The Problems Ahead

The Israeli representatives agreed that the stabilization program could be regarded as truly successful only if it had lasting effects on inflation and the balance of payments and in particular reduced reliance on foreign assistance which would be significantly lower by 1987. They recognized that the fall in the price of oil and the depreciation of the U.S. dollar had helped the program. Stability of the sheqel in terms of the U.S. dollar had advantages because of the high visibility of this rate, and the large share of imports denominated in that currency. At the same time, the depreciation of the U.S. dollar against major currencies, and hence the effective depreciation of the sheqel, prevented an erosion of export competitiveness and the real effective exchange rate of the sheqel depreciated modestly in the latter part of 1985. The rise in unemployment and the financial difficulties experienced by some companies had stiffened resistance against the stabilization effort, however, and the Prime Minister had recently stated that the emphasis should again be on economic growth. While confidence in the program appeared high, as measured by inflationary expectations and the modest premium on the dollar in the parallel market, the Israeli representatives acknowledged that changes could take place very rapidly. Most unlinked financial assets, bank deposits, and Treasury bills have a maturity of no more than two months and might be converted again into foreign exchange or linked assets although the scope for such transfers has been reduced in part since deposits in PATAM accounts of less than one year can no longer be made in sheqalim. The authorities saw the main problems ahead in the areas of wage determination, the 1986 budget, and monetary and exchange rate policies.

1. Wages

The wage agreement expired on March 31, 1986 and negotiations between the Histadrut and the employers' association on a new agreement are to commence soon. These negotiations are seen as crucial both for inflation and for employment. The Government has warned the Histadrut that a large settlement would be promptly followed by a depreciation of the sheqel in order to maintain competitiveness, thereby eroding some of the gain in purchasing power that workers might seek. It is also considering the possibility of reducing the employers' payroll tax to offset partly the effect of the wage increase on labor costs. However, the staff mission pointed out that, if such a tax cut were to be financed by increases in indirect taxes or cuts in subsidies which would be shifted to business through the indexation mechanism, firms would not receive any real relief.

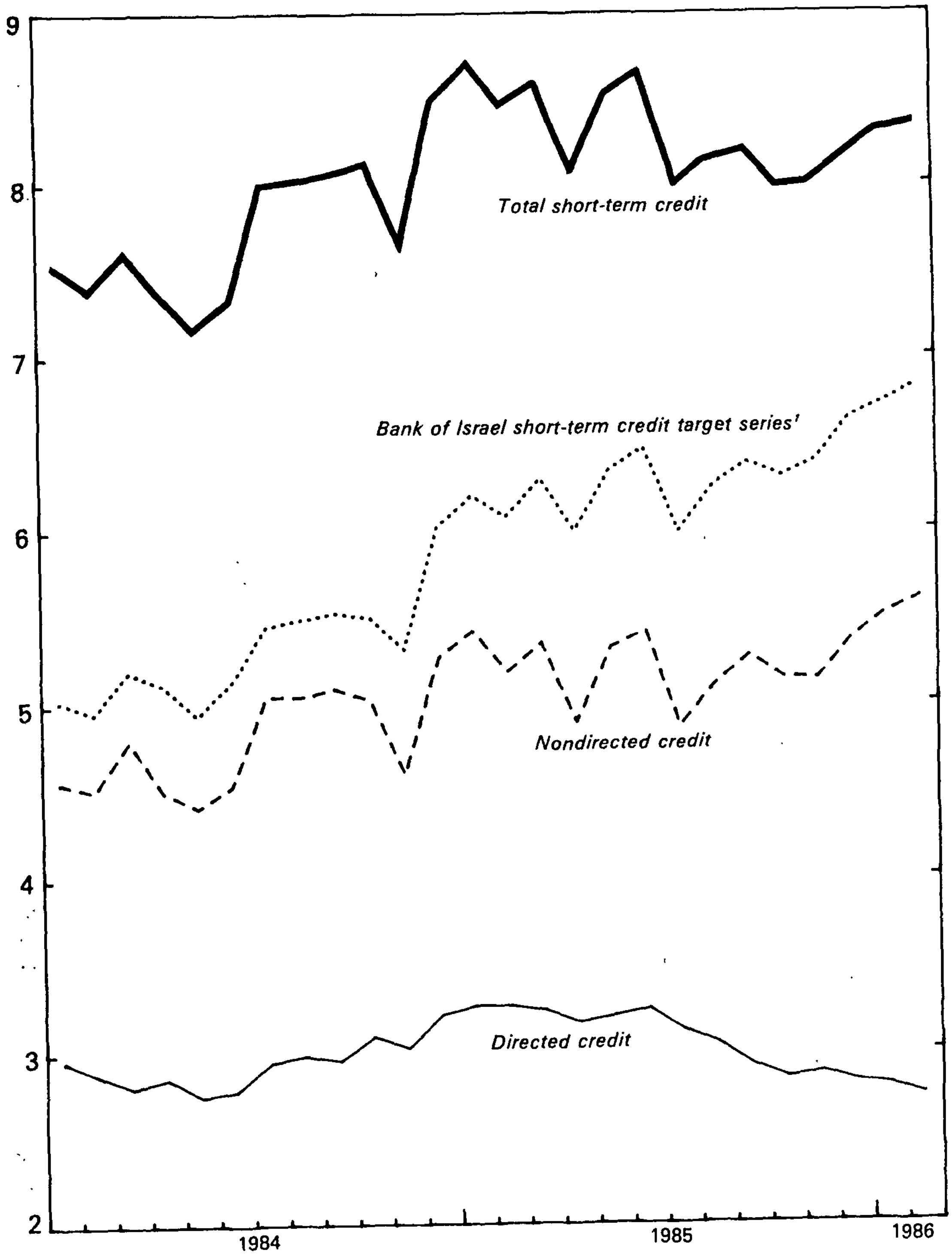
The Israeli authorities hoped that real wages in the business sector could be contained at their March 1986 level which, though unchanged relative to the period immediately preceding introduction of the stabilization plan, was about 4 percent below the average level for 1984 (and equivalent to the 1981 average); for public sector employees, the decline was larger. The staff noted, however, that labor

CHART 7

ISRAEL

SHORT-TERM BANK CREDIT TO THE PUBLIC, 1984-86

(In billions of new sheqalim; at December 1985 prices)



Sources: Bank of Israel, Research Department, *Recent Economic Developments;* and data provided by the Bank of Israel

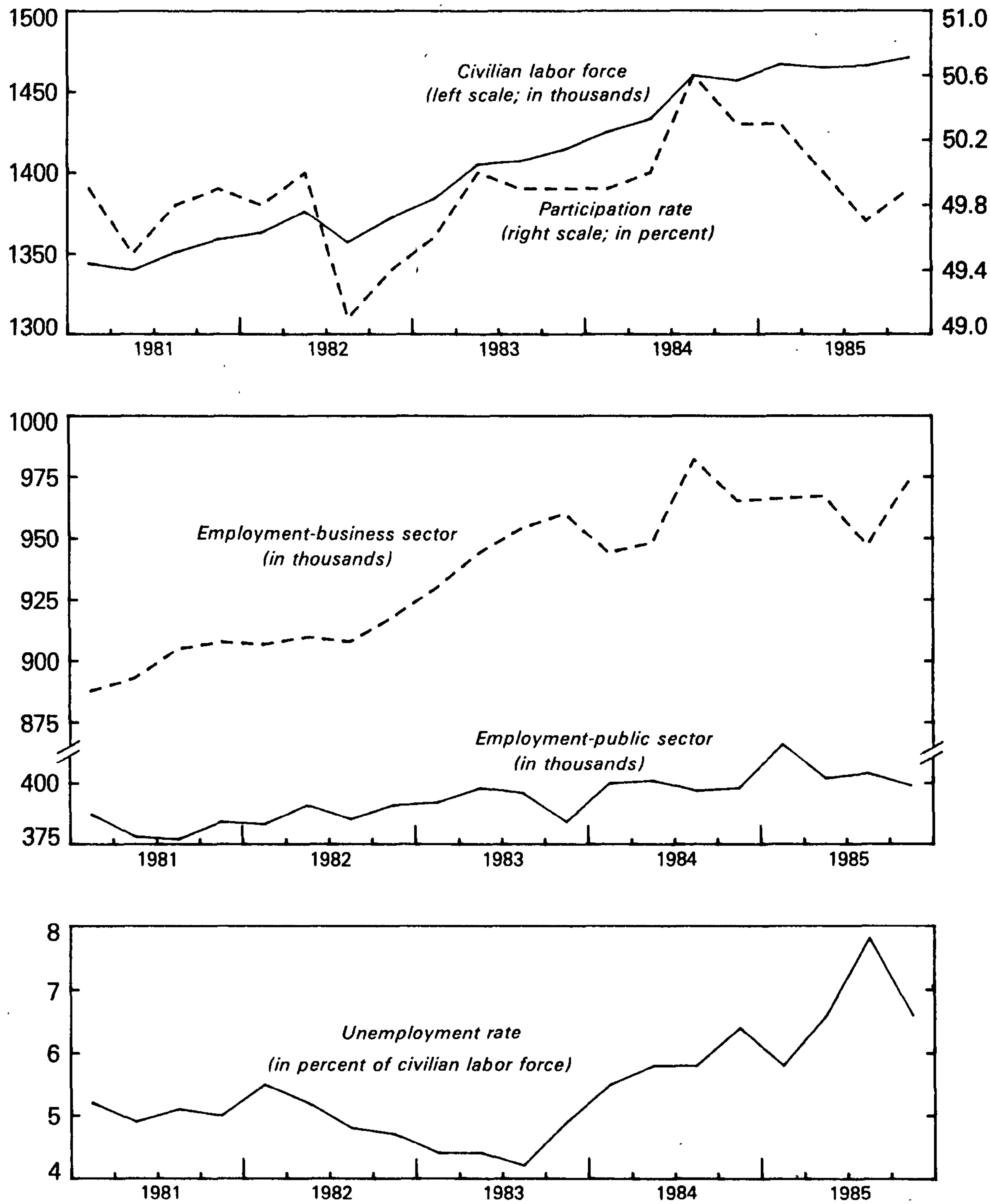
[1] Excludes credit for savings schemes, fuel, diamonds, and shipping and aviotion industries.

CHART 8

ISRAEL

LABOR MARKET INDICATORS, 1981-85

(Seasonally adjusted)



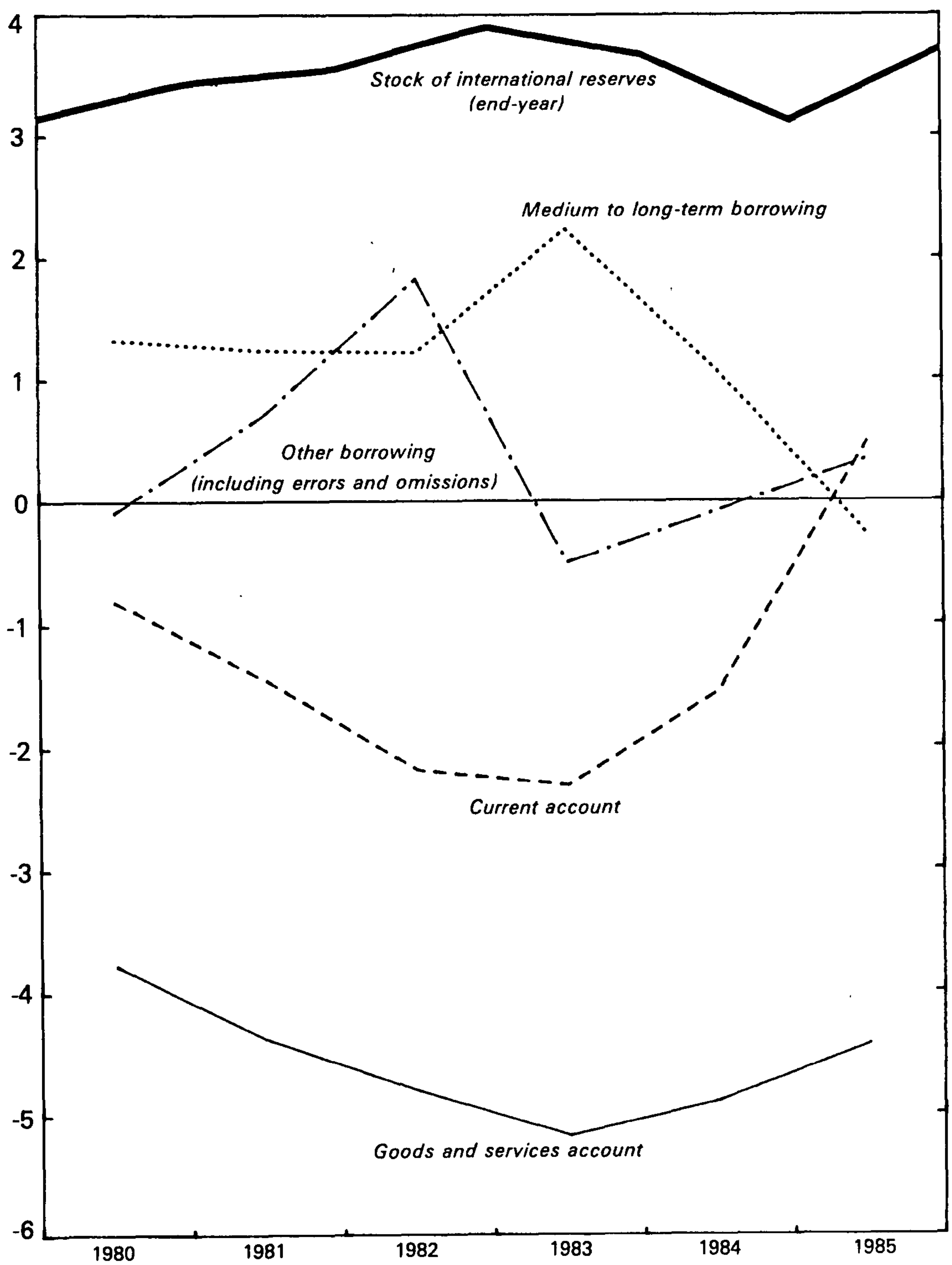
Source: Central Bureau of Statistics, *Monthly Bulletin of Statistics.*

CHART 9

ISRAEL

BALANCE OF PAYMENTS INDICATORS, 1980-85

(In billions of U.S. dollars)



Sources: Israel, Central Bureau of Statistics, *Monthly Bulletin of Statistics;* Bank of Israel, *Annual Report 1984;* and data provided by the Bank of Israel.

productivity had declined since 1981 and that full employment had been maintained in recent years in part by expanding public sector employment. This suggested that real wages, after their rapid increases since the mid-1970s, remained too high to achieve full employment with internal and external equilibrium.

2. The 1986/87 Budget

The 1986/87 proposed budget provides for a further reduction in the deficit (before foreign grants) equivalent to 3 1/2 percent of GNP, to about 18 percent of GNP (Table 2). As foreign grants are expected to decline by about 2 1/2 percentage points of GNP compared with 1985/86, (due in part to the phasing of military assistance), the financing requirement for the 1986/87 budget is to be cut by 1 percentage point to 3 percent of GNP. Total revenue is projected to decline slightly (in relation to GNP) because of an expected decline in nontax revenue. Tax revenues are expected to increase marginally, mostly due to a new education tax. All other tax revenues are projected to remain unchanged in relation to GNP, as the expected revenue gains in real terms resulting from the deceleration in inflation and the recovery of economic activity have been offset by adjustments in tax brackets, and because many of the tax measures introduced last year had only a one-time impact on revenue.

On the expenditure side, the 1986/87 budget proposes cuts amounting to about 4 percentage points of GNP, principally in subsidies and transfer payments and defense purchases abroad, and to a lesser extent in investment outlays. Excluding direct defense import expenditure, 1/ all other proposed cuts amount to less than 1 1/2 percent of GNP. Furthermore, the proposed level of expenditure, especially for education and health, is conditional on the Knesset authorizing the imposition of new fees and charges to finance a portion of these expenditures.

Although the total financing requirement is forecast to decline to less than 3 percent of GNP, domestic borrowing requirements are projected to remain at about 4 1/2 percent of GNP because net amortization of foreign debt is expected to amount to 1 1/2 percent of GNP. Net domestic borrowing from the nonbank public is projected to increase to almost 4 percent of GNP so that net financing from the Bank of Israel is programmed to decline sharply to less than 1/2 percent of GNP.

The Israeli representatives acknowledged that the planned reduction in the deficit remained below what was needed to eliminate completely liquidity injection on account of government operations and to avoid an increase in the overall public debt. They noted, however, that given Israel's special needs for defense and security in particular, the

---

1/ Defense-related imports are almost entirely financed by foreign grants and subject to large annual fluctuation due to the timing of their arrival in the country. A corresponding change is also registered in the inflow of foreign grants.

desirable was not always the feasible and a reduction in the tax burden remained an objective. The budget situation for FY 1986/87 has been further complicated by a recent decision of the Government's Interministerial Committee for Economic Affairs to add US$300 million to the US$150 million already included in the budget for assistance to enterprises in financial difficulties. The Israeli representatives explained that the decision may not affect the budget directly: the intention was to permit those enterprises to raise funds, with bank guarantees, on the capital market, which so far has been reserved exclusively for government issues. This was likely, however, to raise the cost of government borrowing.

The reduction in final purchases of goods and services by the public sector will be relatively small so that the direct pressure on domestic resources is expected to abate only slightly. The staff noted that workers' after-tax income was higher in March 1986 than it had been when the stabilization program was introduced due to adjustments in tax brackets, and that welfare and pension recipients, as well as holders of government securities, were fully protected against inflation; consequently, the burden of the cut in subsidies and the increase in taxes must have been largely shifted to the business sector. If this should be repeated in 1986, the prospects for a soundly based economic recovery would be impaired.

The very high and volatile rates of inflation and the current practice of presenting the budget in constant prices and the subsequent quarterly adjustment of the figures according to various indices result not only in a validation of inflation, but make it very difficult to determine the level of expenditure commitments. The data available on fiscal operations are on a cash basis and for very broad categories of expenditure. The authorities stressed that major efforts have been made in recent months to improve budgetary management and this objective will be pursued with vigor in the coming year.

3. Monetary and exchange rate policies

The conduct of both monetary and exchange rate policies will be delicate in 1986. Monetary policy must accommodate the increased demand for money resulting from the reduction of inflation, but must at the same time continue to provide support for the other stabilization measures. The Bank of Israel viewed further relaxation of credit policy as conditional on developments in wages, the budget and the balance of payments, but was forced by the Government to implement a further reduction in interest rates in mid-March. It was also concerned by continuing restrictions on the private sector's access to medium- and long-term financing in the capital market and at the consequent need to resort to the "grey" market where interest rates on such credit are especially high. A more liberal access to the capital market was seen as a way of encouraging investment and growth.

Even if the reduction in velocity experienced in the last quarter of 1985 were to be maintained throughout 1986, the balance of payments surplus, together with continued government borrowing from the Bank of Israel, would result in an expansion of money and credit not apparently consistent with the inflation target. The Israeli representatives believed that these financial savings would be adequate in 1986 to allow the public sector to sell more debt and reduce further, if necessary, borrowing by the Treasury from the Central Bank. They acknowledged, however, that such a plan was not in line with the Government's intention to stabilize public debt (including accrued interest) in relation to GDP and that room would need to be made in the capital market for the US$450 million earmarked for assistance to enterprises in difficulties. Pressures on interest rates were likely and entailed the risk of capital inflows which would cause a further expansion of liquid assets. Basically, the monetary authorities were concerned by the excessive burden placed on monetary policy if the stabilization program was to continue to restrain inflation. They believed that a lower budget deficit, with greater emphasis on demand reducing measures, would ease their task.

Exchange rate policy will need to steer a cautious course between the need to contribute to price stability and avoidance of an unacceptable real appreciation that would rekindle speculation against the sheqel. The Israeli representatives agreed that the stated policy of fully adjusting the exchange rate to compensate exporters for increases in wages, while useful in convincing unions that it would be futile to aim at large settlements, provided insufficient inducement to employers to resist wage claims and could not be strictly followed. At the same time, the experience of the past showed that anticipation of a devaluation whenever the exchange rate became overvalued was translated rapidly into speculative capital outflows and shifts of financial assets into either imported goods or foreign-exchange linked securities. So far, the competitive position remained favorable and the depreciation of the U.S. dollar relative to major currencies obviated the need for changing its relationship to the sheqel (Chart 10). There was, however, a risk in maintaining for too long the present rate of NIS 1.5=US$1 as it would create a psychological barrier for future rate changes the longer it remained unchanged. The mission suggested that somewhat wider fluctuations around that rate could reduce such a risk.

V. Prospects

1. Short term

The Israeli representatives emphasized that developments in 1986 would depend on the outcome of the forthcoming wage negotiations and the budget discussion in the Knesset. Assuming that wage increases after March would be limited to cost-of-living adjustments and that the budget would be approved as presented by the Government, they expected a moderate economic expansion in 1986, with GDP increasing by 1.6 percent in real terms, supported by a fairly strong recovery of domestic demand (projected to increase by 2.3 percent). Although public consumption would decline further, both investment and private consumption were expected to recover. After a sharp decline in 1985, personal disposable income is expected to grow by 0.5 percent in real terms in 1986, largely due to the pattern of wage payments which implies an average increase of real wages in 1986 even assuming no further increase in real terms after March. The savings ratio is assumed to stay roughly unchanged from 1985 though still well below the 1975-81 average. Pent-up demand for imported goods, especially durables, would account for a major part of the strength in private consumption. The projected recovery of investment is to come from the rebuilding of inventories with total gross fixed investment remaining unchanged and residential construction continuing to decline in response to demographic developments and trends in personal incomes and interest rates.

The Israeli representatives were confident that, unless the wage settlements were excessive, prices could continue to rise by less than 2 percent per month in 1986. The reduction in the price of oil was a favorable factor and, unless the competitive position became seriously impaired by higher labor costs, there would be no need for a large depreciation of the exchange rate. A moderate rise in unemployment is expected in 1986 despite a recovery of employment.

The balance of payments should remain strong in 1986. The combination of lower oil prices and the second tranche of emergency assistance from the United States should result in a current account surplus about the same size as in 1985, in spite of a pick-up in imports, and an increase in reserves. The Israeli representatives expected the volume of civilian merchandise imports to increase by 7 percent in 1986 (compared with less than 1 percent in 1985). Payments on invisibles, especially tourism, are also projected to show a marked increase compared with a steep decline in 1985; restrictions on imports and foreign travel were seen as having only a temporary effect and foreign exchange payments for those items were expected to revert to their trend in 1986. Another sizable increase in the volume of merchandise exports is projected in 1986 (8 percent compared with 9.4 percent in 1985) implying further gains in market share. The continued slack in the domestic market would remain a major factor in inducing firms to seek markets abroad. Receipts from invisibles (excluding transfers) are also expected to increase faster than in 1985.

2. Medium term

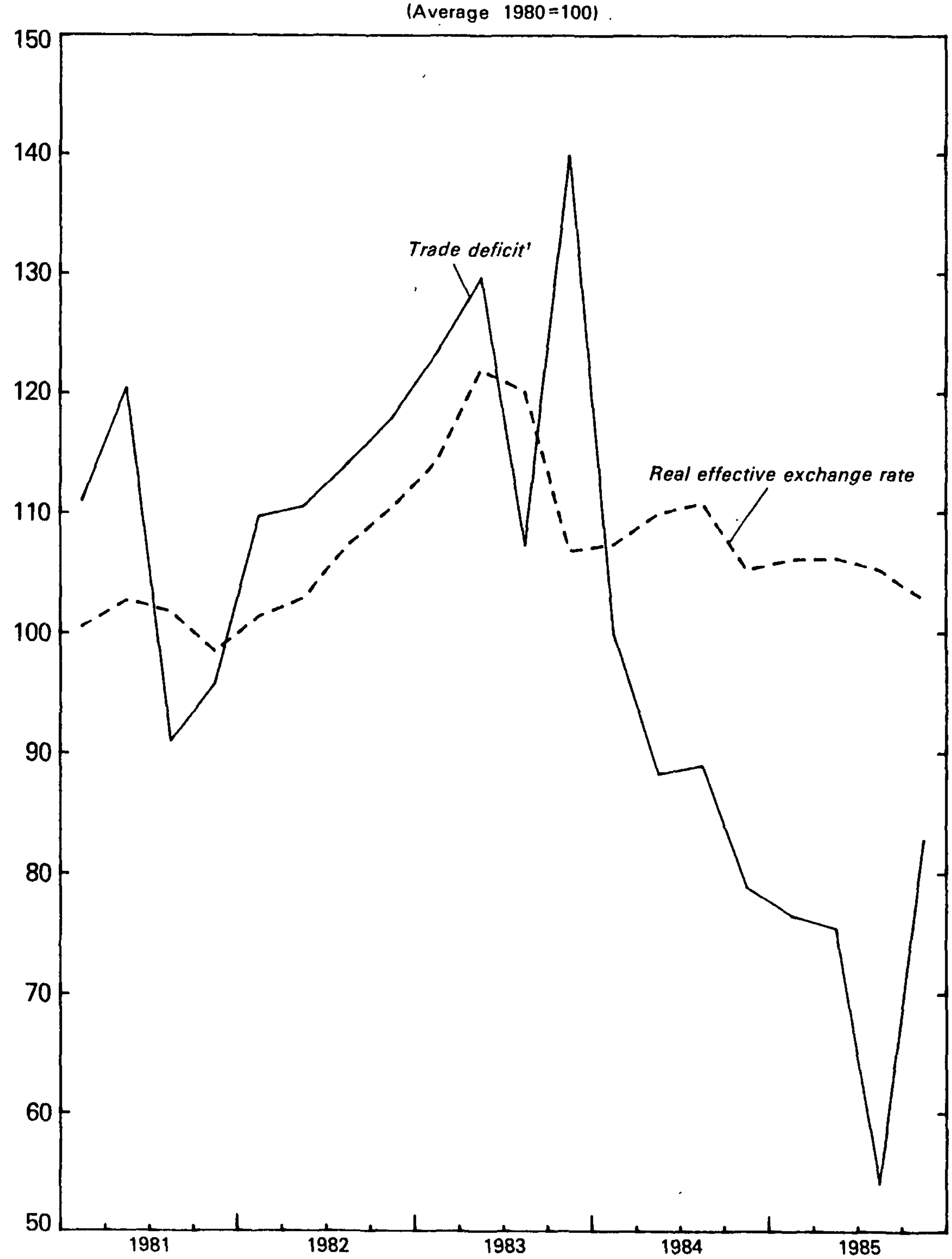
Medium-term projections by the Ministry of Finance feature a sharp upward shift in the trend of productivity in 1987 and beyond. The Israeli representatives explained that they expected the slower pace of inflation and the projected resumption of investment activity to have a positive effect on productivity. The staff team agreed that a much reduced rate of inflation was likely to raise the level of productivity but cautioned that it may be some time before greater price stability

CHART 10

ISRAEL

REAL EFFECTIVE EXCHANGE RATE AND TRADE DEFICIT, 1981-85

(Average 1980=100)



Source: Standard developed in connection with the Fund's Information Notice System (based on consumer prices); and Bank of Israel, Recent Economic Developments.

[1] Seasonally adjusted, excluding diamonds, ships, and aircraft.

could be reflected in productivity gains. Furthermore, a faster growth rate for the Israeli economy called for a number of structural changes, and a higher investment ratio also required that the public sector allowed firms to tap medium- and long-term savings in the capital market from which they are presently excluded.

The authorities restated their major goals for the medium term as a continuous reduction in inflation, a current account deficit of the balance of payments that could be financed with long-term capital inflows, while keeping net international reserves at an adequate level, and sustained economic growth. To achieve these goals, the authorities intend to reduce public consumption through further cuts in government expenditure and change the basic employment structure of the economy by reducing the number of employees in the public sector and transferring workers to sectors which are producing for export. Also, to prevent a continuous increase in the public debt with budget deficits and interest payments reinforcing each other, the Government has stated that the deficit should be cut to permit a reduction of the public debt, first in relation to GNP, then in absolute terms.

The fiscal projections in Table 4 suggest that even on relatively favorable assumptions, 1/ the budget financing requirement, in relation to GNP, would increase from 3 percent in 1986/87 to 4 percent in 1987/88 and 4 1/2 percent in the following years. This adverse trend reflects the phasing out of the special economic assistance from the United States (equivalent to about 3 percent of GNP annually) provided in both FY 1985/86 and 1986/87 and a projected moderate decline--relative to GNP--of economic and military assistance from the United States. The ratio of total government debt to GNP, which averaged about 215 percent in recent years, is expected to decline to about 190 percent by the end of this decade. Since such debt continues to increase in nominal terms, the cost of government interest payments as a proportion of GNP remains high and the burden of cutting the deficit necessarily falls disproportionately on noninterest expenditure. To achieve the stated long-term goal and reduce public debt not only relative to GNP but also in real terms, the budget will have to be cut by even larger amounts in coming years.

Under two alternative scenarios, which assume only a partial implementation of 1986/87 budget, the financing requirement increases rapidly to an unsustainable level. The Government would find it

---

1/ The "adjustment" scenario assumes that all the measures taken in July 1985 with the introduction of the economic stabilization plan, and the fiscal policies announced in the 1986/87 budget, will be implemented fully and on time. Furthermore, additional measures will be taken to cut government expenditure by about 2 percentage points of GNP annually, while tax reform is enacted in order to reduce the heavy tax burden and rationalize the tax system.

difficult, if not impossible, to finance such a requirement through the placement of bonds and would have to revert to borrowing from the Bank of Israel.

Medium-term balance of payments and external debt projections are given in Table 5. Under the "adjustment scenario," the current account would stabilize at a small surplus, and permit a marked decline in the debt service ratio. With moderately lower export growth rates (Scenario II), the civilian goods and services account would deteriorate marginally but the debt service ratio would still decline through the period. When the slower export growth is combined with a somewhat faster import growth rate due to less restrictive domestic demand policies (Scenario III), the civilian goods and services deficit increases by about one fourth during the scenario period, leading to a relatively fast increase in external debt and to a modest decrease in debt relative to GNP and the debt service ratio.

VI. Trade Policies and Exchange Restrictions

Although most restrictions on payments and transfers for current international transactions and multiple currency practices were eliminated in 1977, the authorities have from 1982 attempted to check capital outflows and protect reserves by introducing various trade and exchange restrictions as well as multiple currency practices. The exchange and trade measures pertaining to current international transactions include a 2 percent import levy, a 1 percent levy on the purchase of foreign exchange by the public, and a noninterest-bearing import deposit requirement. The exchange measures which give rise to exchange restrictions subject to approval by the Fund under Article VIII, Section 2(a), 1/ are the following:

(a) the suspension of residents' allowance for foreign transfers for support payments and gifts to the extent the suspension pertains to moderate remittance for family living expenses;

(b) the foreign currency travel allowance for Israeli citizens traveling abroad; the allowance was lowered from US$1,000 to US$800 per person per trip in May 1985. Higher allowances apply for business travel abroad;

(c) 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

---

1/ The staff is in the process of examining whether the imposition of a foreign travel tax represents a precondition on the making of current payments.

(d) the limitation on the right of a tourist 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 to US$2,000 for a person under 18 years.

The exchange measures that give rise to a multiple currency practice subject to approval by the Fund under Article VIII, Section 3 are:

(a) The imposition of a 15 percent tax on import of services levied at the time of the foreign exchange transaction; and

(b) The operation of the exchange rate insurance scheme.

The exchange rate insurance scheme has resulted in exchange transactions being conducted at effective exchange rates differing by more than 2 percent from the otherwise applicable exchange rate. Losses from the exchange rate insurance scheme--which increased to about US$500 million in fiscal year 1985/86--have been fully met from the government budget, and from July 1985 liability was limited to 11 percent of value added in exports and 10 percent for the fiscal year beginning April 1, 1986.

As part of the plan for economic stabilization, and as a step toward unifying effective exchange rates, the authorities moved toward some liberalization of the trade and payments system in July 1985. Specifically, the import deposit requirement was eliminated except for luxury goods, where it was significantly reduced and then lowered in steps to the current level of 15 percent; furthermore, export subsidies were cut by requiring--as mentioned earlier--that directed credit for exports would henceforth be denominated entirely in U.S. dollars, and no longer permitted in sheqalim as previously. Against this more recent liberalizing trend, a levy of 15 percent on foreign investment abroad was imposed in November 1985, which the authorities explained as essentially the closing of a loophole to ensure that enterprises could no longer avoid the tax on imported services by investing abroad.

The authorities reaffirmed that their policy toward strengthening the balance of payments rested on expansion of exports rather than restrictions on imports. This commitment was reflected in the importance attached to the Free Trade Agreement with the United States that came into operation in September 1985. The present trade and payments restrictions, partly aimed at boosting budget revenues, were therefore to be seen as temporary measures, even though--in a number of cases--specific termination dates had not been set.

VII. Staff Appraisal

Israel's economic performance since the mid-1970s has been marked by weak growth of output and productivity, recurrent balance of payments crises, and accelerating inflation. In late 1983 and in 1984 the authorities attempted to improve the balance of payments through large devaluations of the sheqel which, in the absence of an adequate tightening of financial policies, sent prices soaring. They then coped with the risks of hyperinflation by freezing prices and wages but, in the absence of measures dealing with the underlying causes of the problems, and in particular the large budget deficit, relief was only temporary.

In July 1985, the Israeli Government introduced a comprehensive stabilization program. Again, a temporary price freeze and suspension of indexation for wages and the stabilization of the exchange rate, following a substantial devaluation, were intended to reduce the rate of inflation rapidly but, in contrast with previous attempts, the adjustment effort was supported by severely restrictive fiscal and monetary policies. Money creation was curbed by reducing bank credit and the Treasury's borrowing from the Bank of Israel. Interest rates rose to very high levels in real terms and the budget deficit for FY 1985/86 is estimated to have declined (before grants) by the equivalent of 7.5 percent of GNP. Against this background, domestic demand contracted sharply in the second half of 1985.

The results of the stabilization program have thus far been rewarding. Inflation, after a spurt in July associated with a 16 percent devaluation of the sheqel and initial price adjustments, has averaged 0.5 percent per month from October to February. The improvement in the external position initiated in 1984 has been extended and speculative capital outflows have given way to inflows. The cost of the program in terms of unemployment and bankruptcies has been significant, but by the end of 1985 economic activity was strengthening and the rate of unemployment had declined from its third quarter peak by one percentage point. At the same time, the potential effectiveness of monetary policy has been raised by reducing the indexation of short-term financial assets and by increasing the share of tradable government securities in new public debt issues.

The staff urges the Israeli authorities to persevere with the stabilization program and to consolidate the results achieved so far, as a failure would make it more difficult to repeat the efforts made to put the Israeli economy back on a sound basis. Over the medium term the staff sees no conflict between the stabilization effort and the prospects for faster growth, as Israel's experience in the past ten years suggests that resumption of growth requires a more stable environment than has been present until recently. Growth also requires further progress in reducing the fiscal deficit, which would allow a lowering of interest rates and greater room for enterprises to raise funds in the capital market. The widespread use of grants, transfers, and subsidies to influence investment, production and exports should, the staff believes, also be phased out, especially when they are channeled to firms whose viability is questionable: a more neutral and transparent policy toward business would be more conducive to growth.

The reduction in the budget deficit expected in FY 1985/86 has been impressive, and a further decline is projected for FY 1986/87, although it is dependent on parliamentary approval of various fiscal measures and on further strengthening of expenditure control procedures. Taking the two fiscal years 1985/86 and 1986/87 together, the deficit (before grants) would be reduced by the equivalent of 11 percent of GNP, thereby diminishing the need to borrow from the central bank and to increase the public debt. But even if the new budget is approved as presented and implemented as approved, the staff regards the deficit as still too high in terms of its impact on aggregate demand and the need to avoid recourse to monetary financing and a further increase in public debt. Recent legislation is now restricting borrowing from the central bank, which has been a major source of inflation, but use of the counterpart of U.S. emergency assistance is tantamount to monetary financing, and it is taking place at a time when the reduced balance of payments deficit has a smaller moderating impact on the expansion of the money supply. At the same time, it is undesirable to increase government borrowing in the capital market, as the size of the debt is such that interest charges and the size of the deficit now reinforce each other continuously. As all government securities are indexed, inflation does not reduce the burden of debt, and there is therefore no choice but to reduce the deficit further to alleviate the debt problem.

In the view of the staff, the emphasis should be placed on curtailing expenditure in order not only to reduce the public sector deficit but also to allow over time a reduction in the tax burden, which would improve the prospect for faster growth. The heavy burden of corporate taxation inhibits investment activity and the high marginal rates of personal taxation discourage individual effort and encourage emigration of technicians and skilled workers. The large wedge between take-home pay and labor costs to the employers also prevents greater differentiation of remuneration as to skills and productivity. Although it appears that in 1985 the burden of the cut in subsidies was largely shifted to the business sector, leaving disposable income and private consumption little changed, complete elimination of subsidies remains desirable. The staff hopes, nevertheless, that efforts to reduce the budget deficit will also concentrate on the Government's purchases of goods and services in order to release real resources for use by the private sector.

The outcome of the wage negotiations which are about to begin will be crucial for the success or failure of the stabilization program. A large settlement, with the present cost-of-living adjustment provisions, would push up costs and prices both directly and through the exchange rate devaluation that would be required to avoid serious losses in competitiveness. After a temporary decline, real wages in the business sector have been fully restored to their level before the introduction of the stabilization program. That level, though somewhat lower than the average of 1984, remains excessive in view of the large real wage gains well above productivity advances in recent years and cannot be maintained without a risk of increasing unemployment, or of inflationary pressures and external disequilibrium. Restraint on public sector wages also remains necessary in order to encourage a shift of manpower back to private industry.

The conduct of monetary and exchange rate policies will be delicate in 1986. Monetary expansion must accommodate the higher demand for unindexed assets associated with the decline in inflation and the stabilization of the exchange rate. At the same time it must avoid fueling a reacceleration of inflation. In view of the present uncertainties as to the 1986/87 budget, the effect of the lifting of price controls, and the forthcoming wage negotiations, the staff believes that the monetary authorities should maintain a cautious attitude and allow interest rates to decline further only if monetary policy can be given support in the stabilization effort from fiscal and incomes policies. There is also a potential conflict between the benefits of a stable exchange rate for price developments and the risks of allowing a real effective appreciation of the exchange rate which, on the basis of past experience, could rapidly trigger massive capital outflows. Some flexibility is therefore desirable, although a commitment to adjust the exchange rate automatically to offset the differential in labor cost increases between Israel and its main trading partners should not be made, so as to put pressure on both employers and labor to reach moderate wage settlements. The staff believes that the adoption of strict inflation targets to be used as mutually consistent guidelines for monetary and exchange rate policies, as well as for the budget (which should no longer be presented in real terms), would in current circumstances greatly improve the prospects for a permanent reduction of the rate of inflation, especially if they should be accompanied by a further limitation on the scope of indexation in the Israeli economy.

Although the Israeli authorities have reaffirmed their commitment to a liberal trade and payments system, they maintain various exchange restrictions and multiple currency practices. However, since introduction of the economic stabilization program in July 1985, the authorities have taken some steps toward liberalizing the restrictive system. In the absence of a comprehensive plan to remove the remaining restrictions and multiple currency practices, Executive Board approval of these restrictions and practices is not being proposed. The staff is of the view that such a plan should be part of the adjustment effort and permit a return to a liberal exchange system.

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

VIII. Proposed Decision

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(a) and 3 in concluding the 1986 Article XIV consultation with Israel and in light of the 1986 Article IV consultation with Israel conducted under Decision No. 5392 - (77/63), adopted April 24, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions and multiple currency practices maintained by Israel are subject to approval under Article VIII, Sections 2(a) and 3. The Fund notes the complexity of Israel's exchange system, and the need to simplify it. The Fund hopes that efforts will be made to remove these restrictions and practices in the near future.

Table 1. Israel: Demand and Supply

	1981	1982	1983	1984	1985	Official Forecast 1986
	(Percentage change at constant prices)					
Private consumption	10.8	7.4	7.5	-6.3	-0.1	2.5
Government consumption 1/	1.3	3.1	1.7	0.2	-4.1	-2.3
Domestic defense expenditure	(2.4)	(5.3)	(-0.1)	(0.5)	(-7.1)	(-3.5)
Other	(0.9)	(0.7)	(0.6)	(-0.1)	(-0.1)	(-0.7)
Gross domestic investment	-5.7	14.5	10.1	-13.9	-14.7	5.7
Gross domestic expenditure 1/	5.0	7.8	6.8	-6.6	-3.8	2.3
Exports of goods and services	4.3	-3.2	2.1	14.5	6.7	7.0
Aggregate demand 1/	4.8	4.5	5.5	-0.9	-0.5	3.7
Imports of goods and services 1/	7.8	11.2	11.2	-3.8	-4.5	7.0
GDP at market prices	3.2	0.8	2.0	1.1	1.9	1.6
	(In percent of GDP at current prices)					
Gross domestic expenditure 1/	107	114	115	108	106	...
Private consumption	61	63	65	61	64	...
Domestic defense expenditure	14	15	15	14	13	...
Other government consumption	12	12	11	12	11	...
Gross domestic investment	22	24	24	21	18	...
Foreign balance 1/	-7	-14	-15	-8	-6	...
Exports of goods and services	45	41	38	45	48	...
Imports of goods and services 1/	52	54	53	53	53	...

Sources: Central Bureau of Statistics; and official estimates and forecast.

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

Table 2. Israel: Developments in Summary Budget Transactions, 1981/82-1986/87

(In percent of GNP)

	1981/82	1982/83	1983/84	1984/85	Budget 1/ 1985/86	Estimated Outturn 1985/86	Proposed Budget 1986/87
Total revenue	44.6	50.9	49.7	43.0	47.9	46.2	45.7
Tax revenue	36.7	40.3	39.1	35.8	39.6	38.2	38.6
Nontax revenue 2/	7.9	10.6	10.6	7.2	8.3	8.0	7.1
Total expenditure and net lending	70.5	70.7	72.4	71.8	69.3	67.5	63.6
Transfers and subsidies	21.9	20.4	19.6	19.1	17.5	18.0	15.1
Interest payments 3/	9.5	11.7	12.1	15.4	15.0	13.9	14.1
Defense	22.4	21.2	21.9	22.3	18.9	21.5	18.6
Domestic expenditure	(13.2)	(14.9)	(12.3)	(11.5)	(10.5)	(11.2)	(11.0)
Purchases abroad	(9.2)	(6.3)	(9.6)	(10.8)	(8.4)	(10.3)	(7.6)
Other current expenditure	8.2	9.0	8.7	8.5	8.3	7.3	7.5
Capital expenditure 4/	8.5	8.4	10.1	6.5	6.6	6.6	5.4
Unallocated	—	—	—	—	2.9	0.2	2.9
Budget balance	-25.9	-19.8	-22.7	-28.8	-21.4	-21.3	-17.9
Foreign grants	7.5	5.2	8.3	14.6	12.3	17.4	15.0
Defense grants	...	...	2.9	8.6	6.6	8.8	7.2
Economic grants	...	...	5.4	6.0	5.7	8.6	7.8
Financing requirement	-18.4	-14.6	-14.4	-14.2	-9.1	-3.9	-2.9
Foreign borrowing (net)	5.3	5.3	4.6	0.1	-1.6	-1.5	-1.5
Domestic bond issue (net) 5/	9.3	3.8	2.4	4.7	2.0	1.7	3.9
Net credit from Bank of Israel 6/	3.8	5.5	7.4	9.4	8.7	3.7	0.5

Sources: Ministry of Finance; and Fund staff estimates from information provided by the Israeli authorities.

1/ Calculated at first quarter (April-June) 1985/86 prices.
2/ Excludes Bank of Israel profits and sales of bonds to the National Insurance Institute.
3/ Excludes computed interest payments to the Bank of Israel.
4/ Includes support purchases of bank shares in 1983/84.
5/ Includes sales of bonds to the National Insurance Institute.
6/ Credit and change in deposits in the banking system.

Table 3. Israel: Summary Balance of Payments

(In millions of U.S. dollars)

	1981	1982	1983	1984	1985	1986 1/
Exports	5,906	5,561	5,538	6,198	6,575	7,528
Nondefense imports	-7,275	-7,355	-7,798	-7,412	-7,280	-8,336
Civilian trade balance	-1,369	-1,794	-2,260	-1,214	-705	-807
Net services	-854	-1,533	-1,893	-2,215	-1,870	-1,737
Civilian goods and services	-2,223	-3,327	-4,153	-3,429	-2,575	-2,544
In percent of GNP	(-10.5)	(-15.1)	(-16.7)	(-15.2)	(-12.2)	(-10.8)
Direct defense imports	-2,165	-1,476	-1,025	-1,464	-1,860	-1,750
Intergovernmental transfers	1,349	1,199	1,556	2,210	3,817	3,680
Private and other transfers	1,583	1,419	1,303	1,134	1,100	1,118
Current account	-1,455	-2,186	-2,319	-1,549	482	504
In percent of GNP	(-6.8)	(-9.9)	(-9.3)	(-6.9)	(2.3)	(2.1)
Medium- and long-term capital (net)	1,234	1,218	2,228	1,068	-280	-132
Official	(1,273)	(1,215)	(1,267)	(1,025)	(-60)	(-132)
Private (nonbanks)	(-39)	(3)	(961)	(44)	(-220)	(--)
Commercial banks (net)	762	1,627	236	-167	340	...
Short-term capital (net)	385	312	-235	231	-400	...
Official	(413)	(151)	(-347)	(377)	(-50)	(...)
Private	(-28)	(161)	(112)	(-146)	(-350)	(...)
Errors and omissions	-431	-115	-501	-148	403	...
Overall balance	494	857	-591	-564	545	...

Sources: Central Bureau of Statistics; Bank of Israel; and official estimates and forecasts.

1/ Staff estimates.

Table 4. Israel: Medium-Term Central Government Operations Scenarios, 1985/86-1990/91 1/2/

(In percent of GNP, unless otherwise indicated)

	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
		I. "Adjustment" Scenario				
Assumptions						
Revenue	46.2	45.7	45.0	44.0	43.5	43.0
Expenditure	67.5	63.6	61.0	59.0	57.0	55.5
Budget balance (deficit (-))	-21.3	-17.9	-16.0	-15.0	-13.5	-12.5
Foreign grants	17.4	15.0	12.1	10.6	9.0	7.9
Overall deficit 3/	-3.9	-2.9	-3.9	-4.4	-4.5	-4.6
Net foreign financing	-1.5	-1.5	-1.2	-1.1	-1.0	-1.0
Net domestic bond sales 4/	1.7	3.9	4.6	5.2	5.5	5.6
Net credit from Bank of Israel	3.7	0.5	0.5	0.3	--	--
Average real rate of interest on government debt (percent)						
Foreign	10.5	9.6	7.8	8.0	8.3	8.5
Domestic	6.0	6.1	6.3	6.3	6.5	6.5
Changes in real GNP (percent)	0.4	2.0	5.0	5.0	5.0	5.0
Results						
Government interest payments 5/	13.9	14.1	14.3	14.0	14.0	13.9
Other government expenditure	53.6	49.5	47.7	47.0	46.0	46.1
Government debt 6/	216.0	213.0	214.0	206.0	198.5	191.5
		II. "Partial Adjustment" Scenario				
Revenue		45.7	45.0	44.5	44.0	44.0
Expenditure		65.0	63.0	61.0	60.0	60.0
Overall deficit 3/		-4.3	-6.0	-5.9	-7.0	-8.1
Government interest payments 5/		14.1	14.4	14.2	14.1	14.0
Other government expenditure		50.9	48.6	46.8	45.9	46.0
Government debt		214.0	216.0	208.5	202.0	196.5
		III. "No Adjustment" Scenario				
Revenue		45.7	45.0	45.0	45.0	45.0
Expenditure		65.0	65.0	64.0	64.0	63.0
Overall deficit 3/		-4.3	-7.9	-8.4	-10.0	-10.1
Government interest payments 5/		14.1	14.4	14.4	14.3	14.2
Other government expenditure		50.9	50.6	49.6	49.7	48.8
Government debt		214.0	217.0	216.0	217.0	217.0

Source: IMF staff.

1/ In all scenarios, foreign financing of the budget is assumed to be the same. Financing from domestic resources would thus be substantially higher in Scenarios II and III than in Scenario I. It is further assumed that a sizeable part of such higher levels of financing would be met from sales of bonds to nonbank public and the Bank of Israel would reduce its share of financing to zero after 1988/89.

2/ Starting with fiscal year 1987/88 all projections are made at 1986/87 projected prices.

3/ Deficits after accounting for foreign grants.

4/ Includes purchases of bonds by the National Institute.

5/ Interest due during the year, including interest payments on medium- and long-term bonds tied to savings schemes, which are paid only at maturity.

6/ Excluding debt to Bank of Israel and PATAM, but including the debt resulting from converting commercial bank shares to government bonds.

Table 5. *Israel: Medium-Term External Debt Scenarios* 1/

(In billions of U.S. dollars, except where noted)

	1985	1986	1987	1988	1989
		I. "Adjustment Scenario"			
Civilian goods and services account	-2.6	-2.5	-2.3	-2.1	-1.9
Defense imports	-1.9	-1.8	-1.8	-1.7	-1.6
Total transfers	4.9	4.8	4.3	4.1	3.8
Current account	0.5	0.6	0.3	0.3	0.3
Net medium- and long-term capital	-0.3	-0.1	-0.1	-0.1	-0.2
Short-term borrowing (including commercial banks)	-0.1	-0.3	-0.1	-0.2	-0.1
Increase in international reserves	0.5	-0.2	--	--	--
External debt 2/ (end-year)	23.8	23.5	23.2	22.9	22.6
Short-term debt	3.5	3.2	3.1	2.9	2.8
Medium- to long-term debt	20.4	20.2	20.1	20.0	19.8
Debt in percent of GNP	113	99	95	89	83
Short-term debt in percent of GNP	16	14	13	11	10
Debt service in percent of exports of goods and services 2/	42	42	33	33	28
		II. "Sluggish Export Growth"			
Civilian goods and services account	-2.6	-2.6	-2.6	-2.7	-2.8
Debt in percent of GNP	113	100	97	93	90
Short-term debt in percent of GNP	16	14	15	16	17
Debt service in percent of exports of goods and services 3/	42	42	35	35	31
		III. "Domestic Expansion"			
Civilian goods and services account	-2.6	-2.6	-2.8	-3.0	-3.3
Debt in percent of GNP	113	100	98	95	94
Short-term debt in percent of GNP	16	14	15	17	21
Debt service in percent of exports of goods and services 3/	42	42	35	35	32

Source: IMF staff.

1/ Main assumptions underlying Scenario I are: an annual average growth of GNP in 1985-88 around 2 percent, export growth around 5 percent, and import growth around 3 percent. United States aid to Israel (excluding emergency aid) is assumed to decline slightly toward the end of the projection period. Private medium- and long-term loans falling due are rolled over while there is a moderate net redemption of public medium- to long-term loans every year; reserves are unchanged in nominal terms. In Scenario II, annual average growth of exports is around 3 percent, while Scenario III combines the lower export growth with higher civilian import growth (4 percent per annum on average in 1985-88).

2/ Gross external debt minus foreign assets of commercial banks.

3/ Excluding investment income.

Israel: Fund Relations

(As of March 31, 1986)

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 shekels: 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 25,475 (0.02 percent of net cumulative allocation).

(B) Nonfinancial Relations

V. Exchange arrangement: flexibly managed floating rate based on a currency basket reflecting the composition of foreign trade.

VI. The Board concluded the 1985 Article IV Consultation on May 24, 1985 with the following decision:

> 1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Israel,in the light of the 1985 Article IV Consultation with Israel conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Israel maintains restrictions on payments and transfers for current international transactions and restrictive currency practices as described in SM/85/129. The Fund encourages Israel to eliminate these restrictive practices and return to a liberal exchange and trade system.

Israel is on the standard 12-month consultation cycle.

Main Features of Stabilization Programs in Argentina, Brazil and Israel

	Argentina	Brazil	Israel
1. Date of program introduction	June 1985	February 1986	July 1985
2. Price policy	Freeze for unspecified period, to be followed by a move toward market determined prices.	Freeze for unspecified period.	Freeze, to be lifted gradually.
3. Wage policy	Freeze for unspecified period; eventually, a general wage increase was decreed by the Government at the beginning of January 1986.	Wages were adjusted to reflect their average real value in the previous six months, with both increases or decreases in nominal terms. The resulting amount was increased by 8 percent.	Temporary cut in real wages, followed by return to pre-program level in the business sector but lower in public sector.
4. Indexation	Interest on deposits and loans made before the reform were converted to the new currency unit according to a conversion table that was designed to offset the inflation premium implicit in contracts agreed prior to the reform.	Interest on non-indexed deposits and loans made before the reform were converted to the new currency unit according to a conversion table that was designed to offset the inflation premium implicit in contracts agreed prior to the reform. Indexation of financial instruments with maturities of less than one year was limited to savings and loan deposits and certain assets in pension funds. Wages would be partially indexed at the time of annual wage negotiations. In addition, full indexation would apply whenever the cumulative price increase since the preceding annual wage negotiation reached 20 percent.	Temporary suspension of wage indexation. Discontinuation of indexation for short-term (less than one year) bank deposits.
5. Exchange rate	Fixed in terms of the U.S. dollar, following a real effective depreciation of 36 1/2 percent from September 1984 to June 1985.	Fixed in terms of U.S. dollar at the rate prevailing on February 28, 1986.	Fixed in terms of U.S. dollar after 16 percent devaluation.
6. Monetary policy	There was to be no central bank financing of the public sector (except for the on-lending of money borrowed abroad by the Central Bank), and essentially no expansion of central bank credit to the rest of the economy; in the second half of 1985, interest rates were well above the observed rates of price increase.	The authorities intend to lower real interest rates from the earlier high levels that reflected a large risk premium in circumstances of high inflation.	An initial 7 percent decline in real bank credit; high real interest rates.
7. Fiscal policy	The combined public sector deficit was reduced from 12 3/4 percent of GDP in the first half of 1985 to 4 1/4 percent of GDP in the second half of the year.	The public sector budgets for 1986 are currently being revised.	Budget deficit was reduced by 7.5 percent of GNP in current FY to 21 percent of GNP (before grants and to 4 percent of GNP after grants).

Note: This comparison of the main features of stabilization programs in Argentina, Brazil and Israel is of necessity incomplete and does not do justice to the complexities and specifics of the individual countries' programs.

Israel - Statistical Issues

1. Outstanding Statistical Issues

a. Financial statistics

The mission discussed with the authorities problems encountered in reconciling national source data on the deposit money banks with data for these institutions published in IFS. The authorities indicated that they would welcome a Fund technical assistance mission to resolve this issue.

b. Government finance

Data in IFS correspond to the time series reported in the GFS Yearbook. IFS includes only annual data on government finance; debt data are available only through 1978.

The presentation for Israel in the 1985 Yearbook includes data in the statistical and derivation tables for the consolidated central government through fiscal year 1983 and data on outstanding debt through 1978. Data for local government operations are available through 1982, with the exception of data on local government outstanding debt.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Israel in the April 1986 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 timely basis.

Status of IFS Data

		Latest Data in April 1986 IFS
Real Sector	- National Accounts	Q4 1984
	- Prices: Consumer	January 1986
	Industrial Products	January 1986
	- Production: Industrial (seasonally adjusted)	October 1985
	- Employment: Industrial	October 1985
	- Earnings: Wages (daily earnings)	October 1985
Government Finance	- Deficit/Surplus	1983/84 1/
	- Financing	1983/84 1/
	- Debt	1983/84 1/
Monetary Accounts	- Monetary Authorities	November 1985
	- Deposit Money Banks	October 1985
	- Other Financial Institutions	n.a.

External Sector	- Merchandise Trade: Values:	Exports	January 1986
		Imports	Sept. 1985 2/
		Unit Values	Q3 1985
	- Balance of Payments		Q3 1985
	- International Reserves		January 1986
	- Exchange Rates		February 1986

1/ Fiscal year ending March 31.
2/ Data on imports (excluding military goods) are published through January 1986.

Israel—Basic Data

Population (end-year estimate 1985):	4.3 million
GNP in 1985 (market prices):	NIS 24,788 million (US$21,028 million)
GNP per capita in 1985:	US$4,890
Origin of GDP in 1985 (at factor cost)	(In percent of GNP)
Agriculture, forestry and fishing	10
Industry, mining and quarrying	30
Construction	10
Public utilities	4
Transportation and communications	14
Finance, trade, and services	31
GDP of the business ector	100

	1981	1982	1983	1984	1985 1/	Official Forecasts 1986
			(Annual percentage change)			
National accounts (at constant prices)						
GDP	3.2	0.8	2.0	1.1	1.9	1.6
Gross domestic expenditure 2/	5.0	7.8	6.8	-6.6	-3.8	2.3
Private consumption	10.8	7.4	7.5	-6.3	-0.1	2.5
Government consumption 2/	1.3	3.1	1.7	0.2	-4.1	-2.3
Gross domestic investment	-5.7	14.5	10.1	-13.9	-14.7	5.7
Prices, wages, and employment						
Consumer prices (end-year)	101	131	191	445	185	...
Wholesale prices (yearly average)	123	126	144	397	266	...
Real compensation per man-hour 3/	10.0	2.2	1.0	-6.3	-5.0	...
Unemployment rate (in percent)	5.1	5.0	4.5	5.9	6.8	7.4
			(In percent of GNP)			
Budget aggregates (fiscal years)						
Expenditures and net lending	70.5	70.7	72.4	71.8	67.5	63.6
Of which:						
Defense	22.4	21.3	21.9	22.3	21.5	18.6
Interest payments	9.5	11.7	12.1	15.4	13.9	14.1
Revenues	44.6	50.9	49.7	43.0	46.2	45.7
Foreign grants	7.5	5.2	8.3	14.6	17.4	15.0
Financing requirement	18.4	14.6	14.4	14.2	3.9	2.9
			(Real percentage change; 4/ end of period)			
Monetary developments						
Liquid financial assets (M4)	-3.3	0.1	8.4	1.2	1.4	...
Total financial assets of public	15.4	37.3	-32.0	15.0	-2.7	...
Bank credit to private sector	-8.2	0.5	-17.6	10.7	-3.6	...
			(Annual percentage change)			
External sector						
Exports, f.o.b. (in U.S. dollars)	1.9	-5.8	-0.4	11.9	6.1	12.3
Imports, f.o.b. (in U.S. dollars)	4.8	-6.5	-0.1	0.6	3.0	6.4
Of which:						
Nondefense	-1.0	1.1	6.0	-4.9	-1.8	9.6
Export volume	5.1	-0.9	1.1	17.2	9.4	8.0
Import volume 2/	2.8	10.9	11.2	-3.4	0.8	7.1
Terms of trade 2/	-1.1	3.3	1.6	-1.7	0.6	—
Nominal effective exchange rate 5/	-47.0	-47.2	-61.6	-81.2	-66.1	...
Real effective exchange rate 5/	-2.5	12.2	-3.2	-1.5	-2.1	...
			(In percent of GNP)			
Current account balance	-6.8	-9.9	-9.3	-6.9	2.3	2.8
External debt outstanding 6/	115.3	127.4	120.2	134.2	139.0	...
Gross official reserves, end-year (in months of total imports)	2.9	3.1	3.0	2.5	3.0	...
Gross debt service (as a percentage of exports of goods and services)	37.3	42.4	40.5	42.1	42.7	...

1/ Provisional estimates.
2/ Excluding direct defense imports.
3/ Including nonwage employee compensation; deflated by consumer price index.
4/ Deflated by consumer price index.
5/ Based on the standard index (using consumer prices) developed in connection with the Information Notice System; fourth quarter over fourth quarter; increase means appreciation.
6/ Gross external liabilities.