MASTER FILES
ROOM C-130 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/86

10:00 a.m., May 21, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	K. Yao, Temporary
C. H. Dallara	M. K. Bush
	P. Péterfalvy, Temporary
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
Huang F.	
	Jaafar A.
	J. Hospedales, Temporary
T. P. Lankester	R. Fox, Temporary
	H. Fugmann
	I. Puro, Temporary
	G. D. Hodgson, Temporary
	W. N. Engert, Temporary
	A. Abdallah
F. L. Nebbia	M. A. Weitz, Temporary
Y. A. Nimatallah	
P. Pérez	G. Ortiz
H. Ploix	G. Nguyen, Temporary
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present
Staff Association Committee: J. Berengaut, J. Hicklin, J. M. Landell-Mills, P. R. Menon, A. Muttardy, A. Salehizadeh, C. A. Sisson. Administration Department: H. J. O. Struckmeyer, Deputy Director; C. Ahl, D. A. Anderson, T. Cole, D. S. Cutler, A. D. Goltz, P. D. Swain, L. A. Wolfe. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; R. P. Hicks, P. C. Hole, E. F. Nielsen, A. A. F. Op de Beke, J. Somogyi. Exchange and Trade Relations Department: J. T. Boorman. Fiscal Affairs Department: M. I. Blejer. Legal Department: A. O. Liuksila, L. Maktouf. Bureau of Statistics: D. Nachmany. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, S. Ganjarerndee, A. Ouanes, A. Steinberg, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, O. S.-M. Bethel, A. Bertuch-Samuels, B. Bogdanovic, J. de la Herrân, G. Ercel, S. Geadah, V. Govindarajan, Z. b. Ismail, S. King, A. H. Mustafa, W. K. Parmena, L. Tornetta, A. J. Tregilgas, E. L. Walker, Yang W.

1. ISRAEL - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Israel (SM/86/85, 4/23/86; and Sup. 1, 5/20/86). They also had before them a report on recent economic developments in Israel (SM/86/96, 5/8/86).

The Deputy Director from the European Department observed that the supplement to SM/86/85 described the new wage agreement between the Trade Union Federation and the Manufacturers' Association and included some important revisions to the national accounts and the balance of payments. Those revisions suggested that the economy had been stronger in 1985 than anticipated at the time of the consultation discussion and that it had grown even stronger by the beginning of 1986. In passing, he noted that the staff had determined that the travel tax imposed by Israel did not give rise to an exchange restriction and that, accordingly, the footnote on page 14 of SM/86/85 should be deleted.

Mr. Polak made the following statement:

> The success of the stabilization program in Israel, which is now nearly a year old, has surpassed even the most optimistic expectations of those who drafted the program and who are still guiding it. The rate of inflation has been reduced from 20-25 percent a month to 1-2 percent a month; the budget deficit has been cut from 14 percent of GNP in 1984/1985 to 3 percent projected for 1986/1987, and the current account deficit has been practically eliminated. Public consumption declined in real terms for the first time in many years and, despite the drastic measures taken, unemployment has gone up only moderately. There are no signs of repressed inflation; the exchange rate premium in the black market is very low and stable; and public confidence is high.
>
> These and other positive developments (and some that are less so) are fully described and thoroughly analyzed in the excellent staff report with which my Israeli authorities fully concur and which they highly appreciate. Rather than repeat basic facts and trends already covered by the staff report I shall focus my remarks on concepts and considerations behind the measures taken, and I shall conclude with a few remarks on renewed growth in the Israeli economy.
>
> From the moment it took office in late 1984, the present Government of national unity has had to deal aggressively with the economic situation. At that time the increase in capital flight, causing a loss of international reserves, and the surge of the inflationary spiral could no longer be tolerated. To check the deteriorating situation and gain the needed time to prepare a comprehensive plan, the Government's approach consisted initially of a social contract with the employers' association

and the labor union, in the form of a series of so-called package deals. These deals, stretching from October 1984 to mid-1985, were not by themselves a comprehensive plan as they did not address all of the weak economic areas, and particularly not the fiscal imbalance. Nonetheless, they succeeded in stemming inflation, albeit temporarily, and in creating the conditions conducive to the more drastic move that followed.

Directors may recall last year's Board discussion of a gradual versus a drastic approach. This question has also continued to occupy economists and policymakers in Israel. However, before this debate was settled, the deteriorating economic situation in the second quarter of 1985 thwarted the gradualist approach and dictated the drastic move that was taken a few months later.

The aim of the economic stabilization program of July 1, 1985 was to tackle simultaneously the inflation and the real imbalances in the fiscal situation and the current account. Success in these areas should lay the groundwork for renewed growth and for much needed structural changes in the economy. The dual (monetary-real) objective of the program, however, set limits on the intensity with which various measures could be applied, since different measures tended to advance one objective at the expense of the other. Thus, a higher devaluation rate, which could have unified the exchange rate system, might have jeopardized the achievement of a complete eradication of inflation. The inflationary impact of so large a devaluation would have produced an additional decline in real wages, over and above that warranted by the plan, and this was not considered feasible from a sociopolitical point of view.

It has been widely agreed that the two most important causes for the acceleration of inflation and balance of payments difficulties of the past decade were, first, the fiscal imbalance that persistently increased the internal and external debt and, second, the loss of monetary anchor resulting from the indexation of financial assets and of the exchange rate which produced a system that fully accommodated continuous inflation.

The plan therefore incorporated real and nominal elements designed to attain a full synchronization of the stabilization process. The main real component was the sharp cut in the budget deficit to be achieved primarily through an increase in revenue and a sharp reduction in subsidies. These measures were accompanied by a decline, albeit a milder one, in government activity. The resulting reduction in the deficit and in the size of the public sector have checked the growth of the Government's internal and external debt.

The improvement in the balance of payments position in the second half of 1985 can be attributed only partly to the program that started in mid-1985. Perhaps the program's most important and immediate impact has been the change in the capital account, from capital outflow to capital inflow by the private sector, attesting to the growing public confidence in the program. The effects on the current account have so far been less conclusive. The continued decline of imports, which has partially been the continuation of trends that had started before the program, could also have reflected the decline in real income embodied in the program. Exports are expected to respond with a much longer lag than imports, particularly since the 20 percent devaluation was partially offset by the reductions of export subsidies.

The nominal elements have included a freeze on the dollar exchange rate and prices as well as wage control and a very tight monetary policy. One of the lessons learned from the preceeding package deals was that consumers could monitor whether prices remained unchanged, but not whether rates of charge were in line with agreed targets. Thus, a synchronization of prices, wages, credit with the exchange rate about a "zero" rate are far simpler for the public to grasp and to support.

The dollar exchange rate has, for a long time, been widely used as a proxy price index, since the CPI is published on a monthly basis with several weeks' lag, which can be crucial at high inflation rates. Fixing the exchange rate in dollar terms, at least in the early stages of the stabilization, was therefore deemed an extremely important component of the stabilization program. That the dollar/sheqel rate has been kept unchanged for ten months attests to the success of the program, but the program has also benefited from several external developments, such as the weakening of the dollar, which resulted in a de facto devaluation of the effective exchange rate of the sheqel, the drop in oil prices, and the decline of world interest rates, all of which have contributed to a further improvement in the balance of payments position.

The erosion of wages has played a larger role in the program than originally sought. This was dictated by the initial inability of the authorities to achieve a larger reduction in real government activity; to secure the required reduction in excess demand, it was thus found necessary to effect a deeper cut in real wages, even if temporarily, and not to moderate the erosion of net wages by tax concessions. It turned out later, however, that due mainly to unexpectedly large real tax revenues, the Government's real excess demand dropped by more than planned, while wage erosion was less than planned.

Monetary policy was assigned an important role in the stabilization program. Bank credit was sharply decreased in real terms in July 1985 and remained largely stable in the following months. A tight monetary policy was achieved through high nominal interest rates, which, due to the sharp change in inflationary expectations, turned out to be very high in real terms as well. The stable dollar/sheqel exchange rate, and the high sheqel interest rates, created the potential for a monetary flood, since the reserve requirements on sheqel deposits were much lower than those on foreign exchange-linked deposits. This tendency was reinforced by the increase in the demand for money that characterizes a disinflationary process. The resulting increase in liquidity in the banking sector forced the Bank of Israel to absorb the excess liquidity and to allow only a gradual decline in interest rates. Real interest rates in Israel are still very high; while this may be seen as the inevitable aftereffect of a period of high inflation, it caused widespread concern, not only among the business firms affected but also among many of the country's economists.

The rise in the number of business difficulties in Israel during the past year has been blamed on the high real cost of short-term credit, which for many firms had become the main source of funds. However, it can be argued that the high cost of borrowing only brought to the surface existing structural problems that might have ended up in a failure one way or another, so that the high interest rates only shortened the process. Nonetheless, the failures that did occur aggravated the fragile employment situation, particularly in some rural areas where the collapse of a single firm could mean a major unemployment problem.

The success of the program so far has focused attention on the question of economic growth, which has been very low in the last decade. Economic growth, besides enhancing the country's wealth, could create a more favorable environment for the solution of the country's economic problems, whether an external imbalance or a need for structural change. Contrary to the approach in earlier decades, it is widely accepted now in Israel that economic growth should emanate from the private sector. Its extent would probably depend on the degree of economic stability achieved and expected. This process could be influenced by the further removal of the existing price controls envisaged for summer 1986; by ensuring that the present budget will be implemented as planned, if not better; and by seeing to it that wages will not return to their pre-program level or trend. The Government is committed to work toward the achievement of these goals, and its good performance of the past year gives fair promise of a continued success.

Mr. Engert noted from the staff report that a series of remarkable and welcome developments, centered on the recently adopted stabilization program, had taken place in the Israeli economy, and the authorities should be commended for having undertaken a comprehensive and vigorous approach to dealing with the economy's difficult problems. A fundamental requirement of a stabilization program like that adopted in Israel was the establishment of a credible sustainable adjustment effort that reinforced expectations and actions on the part of the private sector. The breadth and rigor of the Israeli Government's actions had been consistent with that requirement, and the result thus far had been decreased inflation, an improved external balance, a stable exchange rate, and only moderately increased unemployment. However, as was clear from the staff report and from Mr. Polak's opening statement, a number of exogenous developments, such as declines in oil prices and world interest rates, had helped the adjustment effort; and, as the Israeli authorities had themselves acknowledged, a reversal in the high level of confidence in the program could take place rapidly and undermine the successes achieved to date.

His greatest concern was with the stance of fiscal policy and the likely path of the fiscal deficit and the debt/GNP ratio, Mr. Engert continued. Given the magnitude of the budget balance net of interest, the current high level of the debt/GNP ratio, and the excess of the real interest rate over the expected real growth rate, the budget deficit might need to be decreased relatively quickly in order to sustain the stabilization program. Failure to reduce the deficit could undermine the effort to restrain monetary policy and keep the exchange rate firm. As a consequence, inflation could resume and external performance could be adversely affected, with attendant capital outflows and poor growth prospects. Even the medium-term analysis in the staff report suggested that the budget would need to move toward balance relatively quickly in order to achieve the stabilization goals, and he endorsed the staff's view in that regard that fiscal restraint should focus on expenditure reduction.

It should also be emphasized that the stabilization effort and prospects for greater real growth in Israel were consistent objectives, Mr. Engert continued. There was no exploitable tradeoff between stabilization and price performance on the one hand and real growth and unemployment on the other. In that context, it appeared that loose financial policies over the past decade had not brought about improved real performance; indeed, they seemed to have undermined growth. Also, the recent stabilization effort had been associated with only a moderate and apparently temporary negative effect on growth and unemployment. Finally, in supporting the proposed decision, he agreed with the staff that the adoption of strict inflation targets to establish mutually consistent guidelines for monetary, exchange rate, and fiscal policies would be useful. Moreover, he would encourage the Israeli authorities to explore avenues for limiting further the endogeneity of the money supply and to remove restrictions on the private sector's access to medium- and long-term credit in the capital market in order to facilitate productive investment and growth.

Mr. Dallara observed that his comments at the present meeting on Israel's economic performance and policies would be notably more positive than they had been a year previously, when there had been general agreement in the Board that the authorities had not been dealing adequately with the economy's underlying problems and that the gradualist approach had not been working. The dramatic stabilization actions adopted in July 1985 had already led to a sharp deceleration of inflation, a strengthening of the external position, a much smaller fiscal deficit, and more moderate monetary growth. Of course, it was too soon to declare victory over the economy's problems; indeed, the underlying sources of inflation in the form of excessively expansionary fiscal and monetary policies, coupled with wage pressures, must be kept under control, and indexation must be permanently dismantled. Furthermore, the stabilization program must be complemented by a number of structural reforms if the economy was to return to a path of adequate real growth. Such reforms included, in his view, a reduction in the tax burden, cuts in the size of the public sector and its intrusiveness in the business sector, reforms in the capital market, and trade liberalization. At the same time, the use of grants, transfers, and subsidies to influence interest rates, production, and exports should be phased out.

A return to higher and more sustainable growth rates would also depend upon a recovery of private investment, Mr. Dallara continued. In that context, it should be noted that gross fixed investment was not expected to grow in 1986. Moreover, the financial environment for foreign direct investment could be improved. Real interest rates remained high, and the financial impact of cuts in subsidies--while such cuts were desirable in themselves--had apparently fallen mostly on business. Mr. Polak had focused in his statement on the role of the private sector in providing a basis for real growth in the Israeli economy in future. In that context, he would welcome staff assessment of private investment prospects in both the near and the medium term.

A continued decline in the fiscal deficit, a reduction in the public debt, and fiscal reforms were all crucial to the containment of domestic demand and the creation of appropriate incentives for work and savings, Mr. Dallara remarked. The reduction in the ratio of the deficit to GNP by 7.5 percentage points in FY 1985/86 was an impressive achievement, particularly since the decline in the expenditure ratio had played an important part in that reduction. For 1986/87, a further cut in the deficit ratio--before foreign grants--by nearly 3.5 percentage points would represent another important step forward, with the expenditure side carrying all of the burden. Nonetheless, it had to be acknowledged that the deficit remained high in terms of its impact on demand and on inflationary pressures; exceptional U.S. grant aid could not be expected to continue beyond 1986, and future aid levels were somewhat uncertain. Moreover, the revenue/GNP ratio of nearly 46 percent and the expenditure/GNP ratio of nearly 64 percent continued to testify to the very high tax burdens and the large size of the Government in relation to the economy... The medium-term scenarios in the staff report showed that a resumption of very large fiscal deficits might develop in the absence of a strong adjustment effort, with deficit ratios after foreign grants rising to 8-10 percent of GNP in 1990-91 under the two less optimistic scenarios and with the public debt/GNP ratio remaining rather large at 200 percent or higher in all three scenarios. He agreed with the staff that fiscal reforms should aim at cutting expenditures as well as reducing the tax burden. The top marginal rate for personal income tax of 60 percent and the corporate income tax rates of 50-60 percent must surely have disincentive effects that would, in a number of important respects, be inconsistent with the authorities' aim of a higher level of real growth. In that context, he had found the medium-term analysis particularly useful in framing the need for priority actions in the years ahead, especially in light of the important successes of the past year.

The decline in the fiscal deficit in 1985 had helped the monetary authorities somewhat by obviating the need for them to make monetary policy more accommodating to fiscal deficits, Mr. Dallara commented. Monetary policy in 1986 must walk a narrow line between accommodating the increased demand for money and avoiding the reigniting of inflation and capital outflows. He understood that recommendations for capital market reforms had been made by the Bejski Commission that were designed to reduce the extent of the Government's intervention and control of financial markets. He would be interested in hearing more about the prospects for such reforms.

Actions in the area of wages and prices were key elements of the July stabilization package and might in fact have played a more important role than originally envisaged for them, both in real economic terms and in reversing inflationary expectations and the behavior of participants in the economy, Mr. Dallara said. He was pleased to see that 46 percent of the items in the consumer price index had been decontrolled and that one half of the remaining items would be decontrolled during the course of the summer. The adoption of strict inflation targets could be helpful in setting mutually consistent guidelines for monetary, budget, and exchange rate policies. The staff had indicated that the notion that the adverse effects of inflation could be adequately countered by widespread indexation had been abandoned. However, the staff had also observed that an agreement had been reached in August to reintroduce some form of wage indexation, which seemed to suggest that the abandonment of the indexation approach might be less than complete. He wondered to what extent that abandonment, if real, was consistent with the more general indexation of both wages and financial instruments. The supplement to the staff report described the agreement recently reached on the mechanism for cost-of-living wage adjustments, but it did not evaluate the consistency of the outcome with overall economic objectives.

The achievement of a substantial current account surplus in 1985--the first since 1954--was striking, Mr. Dallara considered. Real export growth rates of 17 percent and 9 percent in 1984 and 1985, respectively, and the original forecast growth rate of 8 percent for 1986 were encouraging signs. Still, the staff might need to revise the export growth rate downward as a result of actual performance in the first few months of 1986. After witnessing periodic problems with price competitiveness internationally in the past, in part because of exchange rate policy, he was encouraged by the staff's conclusion that present competitiveness seemed adequate. However, the history of a keen sensitivity by Israeli residents to incipient exchange rate overvaluation would seem to suggest the need for considerable caution in that respect. On balance, he tended to agree with the staff that, despite the need to ensure continued international competitiveness and to maintain exchange rate flexibility, it was at least as important to make clear to labor and business that the authorities would not protect their position by automatic currency depreciation to offset potentially excessive wage rate increases.

Over the medium term, the balance of payments and foreign debt situation in Israel as portrayed in the staff report seemed rather more reassuring than the medium-term fiscal forecasts, although the supplementary paper indicated that there was a need to recalculate the medium-term outlook as a result of revisions of 1985 data, Mr. Dallara said. Apparently, under all three original scenarios, the deficit on civilian goods and services account would be within the 2-3.25 percent of GNP range in 1989, while the ratio of net debt to GNP and the debt service ratio would both decline. That having been said, a foreign debt ratio in the range of 80-90 percent in 1989 and a debt service ratio in the range of 28-32 percent would still be quite high and should not lead the authorities to be complacent. Finally, the continued wide array of trade and payment restrictions on multiple currency practices would need further attention as soon as possible. The balance of payments could not be viewed as sustainable so long as equilibrium depended on such mechanisms. In sum, he urged the continued implementation of the aggressive policies thus far pursued by the Israeli authorities and supported the proposed decision.

Mr. Weitz indicated that he was impressed by the stabilization that had occurred in Israel since July 1985. The authorities should be commended for having established a comprehensive economic program that had significantly improved the prospects for the Israeli economy. Following a long period characterized by weak growth of output and productivity, recurrent balance of payments crises, and increasing inflation, the authorities had decided in 1985 to deal in a drastic way with a worsening domestic and external situation. The main elements responsible for the success of the program had been the implementation of restrictive financial policies with a temporary price freeze and a suspension of indexation for wages as well as the stabilization of the exchange rate, following a substantial devaluation. The Israeli experience showed that price controls could help to stabilize economies characterized by very high inflation if they were properly combined with fiscal, monetary, and wage restraint. The experience of the various countries that had attempted seriously to deal with very high levels of inflation--including Israel, Argentina, Brazil, and Bolivia--deserved the attention of the Fund, although it should be noted that the approach taken in Bolivia was rather different from the approach adopted in other cases. He would welcome a staff paper analyzing the stabilization programs of the countries he had mentioned in greater detail than had been provided in Appendix II of the staff paper and on more empirical and theoretical grounds.

Fiscal adjustment was the key to the success of the program, Mr. Weitz observed, and important progress made in the fiscal area helped to explain the stabilization of prices and improvements on the external side. An interesting element of the program was the substantial improvement in tax revenues and the positive effects on the reduction in the fiscal deficit. As in other cases, the drastic reduction in inflation in Israel had had a positive effect on tax revenues, although the authorities had also taken strong measures to reduce expenditures. Monetary and wage policies had been generally adequate, although he was still somewhat concerned about the high level of interest rates. As Mr. Polak had indicated in his statement, fixing the exchange rate in dollar terms had been an important step, as the dollar exchange rate had been used in Israel as a proxy price index, although the authorities had been helped by several external factors including the weakening of the dollar and the drop in oil prices.

For 1986, it was to be hoped that the price system would be liberalized gradually, Mr. Weitz remarked. While it was essential to end price controls as soon as possible, it was also important for the authorities to ensure that fiscal and monetary areas were well in hand. He was optimistic that the liberalization of the Israeli price system would take place without major problems, but the authorities should nonetheless act with caution. At the same time, they must act to consolidate further the fiscal situation in order to ensure that inflation remained low, the balance of payments improved, and interest rates declined.

While real interest rates had been declining in recent months, they remained high, Mr. Weitz observed. As he saw it, nominal interest rates would not decline further until the fiscal situation was improved and inflationary expectations disappeared. At the same time, he had doubts that economic activity could recover without a further reduction in interest rates, which, in combination with price controls, might damage the profitability of the private sector. On the matter of wages, the recent agreement between the Trade Union Federation and the Manufacturers' Association on the cost-of-living adjustment to wages for the period ahead was welcome and should help to consolidate the improvements in the economy, especially if the Government applied those compensation agreements in the public sector.

Some flexibility in exchange rate management was desirable, Mr. Weitz considered, and the Israeli authorities should avoid a real effective appreciation of the exchange rate. However, considering that a drastic approach might affect price stability as well as confidence in the economic program, the authorities should be encouraged to look at the situation carefully and take some gradual action if they considered that external competitiveness might suffer. On economic growth, he agreed with Mr. Polak that the private sector should play a lead role, and he believed that the achievement of economic stability in Israel was a prerequisite for sustained growth. In sum, the Israeli authorities should be commended for having implemented a successful economic stabilization program. The consolidation of the courageous measures already taken should make it possible to further improve prospects for the economy.

Mr. Nguyen commended the Israeli authorities for the remarkable success of their stabilization program that allowed him to stress the exemplary character of the Israeli experience. As noted by Mr. Weitz, some similarities existed between the approach adopted in Israel and those adopted elsewhere in the western hemisphere; and useful lessons could certainly be drawn from those experiences--especially with respect to the control of inflation--and might be applied to Fund programs.

An explanation of the success of the Israeli program in relation to others might well be found in the combination of certain factors, Mr. Nguyen continued. First, given the size of the imbalances, a gradualist approach had not been conceivable, and the authorities must be commended for having adopted a radical and comprehensive stabilization program. Second, the program would not have been successful without the external and domestic support that it had received. Third, since its inception, the stabilization plan had been viewed from a broad perspective and had made use of a wide range of economic tools. The program had been supported by initial action on the exchange rate and other measures aimed at tackling inflation, including an initial price and wage freeze and later controls. It seemed in particular that the courageous measures aimed at partial deindexation had contributed to the credibility of the program, a credibility that had been reinforced later through the implementation of budgetary and interest rate measures. In that respect, it could be seen that the reversal of capital flows was symptomatic and provided a demonstration that the authorities had retaken full control of the situation.

In many important areas, including inflation and the external accounts, indicators had shown sizable improvements, Mr. Nguyen went on. More important, economic growth had been preserved, showing a strong 2.8 percent increase for 1985. However, the return to a strong growth path, which was indispensible given the increase in unemployment, should not be attained through a relaxation of budgetary and monetary discipline. Like the staff, he believed that it would be crucial for the authorities further to reduce the budget deficit, primarily by reducing expenditures on subsidies and transfers. In that context, the measures contemplated in the 1986/87 proposed budget were welcome, although more remained to be done, despite the constraints on the budget. In particular, greater selectivity should be granted to investments in those areas where Israel benefited from comparative advantages.

He would welcome comments from Mr. Polak on the staff's suggestion that inflation targets should be adopted as guidelines for monetary, exchange rate, and budgetary policies, Mr. Nguyen commented. On the exchange rate, while he could support the authorities' desire to maintain exchange rate stability, he had some sympathy for the staff's suggestion to allow rather wider fluctuations. A parallel exchange rate might serve as an indicator of existing imbalances. In the area of wages, he would appreciate staff views on the expected effects of the recent settlements on the economy as a whole and on Israel's external competitiveness.

In sum, Mr. Nguyen said, following several months of unprecedented economic difficulty, Israel seemed on the verge of recovering control of its growth. Despite external aids, the cost of the effort had been high, and success had not yet been achieved, as evidenced by the recent increase in inflation. Still, the first signs of success were undeniable and encouraging and justified for the first time the expression of prudent optimism. He encouraged the authorities to persevere in their adjustment program, to consolidate the results achieved thus far, and to resist the pressure for an early phasing out of adjustment measures in the face of unemployment and business difficulties. He could support the proposed decisions.

Mr. Goos stated that, like others, he was in full agreement with the staff's conclusions and policy recommendations and would thus limit himself to general comments on inflation and fiscal policy. He had found it interesting to compare the current economic situation in Israel with that prevailing on the occasion of the 1985 Article IV consultation discussion when the Board had reviewed the potential benefits and drawbacks of a gradual versus a more drastic approach to dealing with Israel's inflation problem. With hindsight, it could not but be concluded that the argument of those preferring a shock therapy had clearly been vindicated by subsequent developments.

In any event, Mr. Goos continued, the sharp deceleration of inflation that had occurred in Israel during the second half of FY 1985/86 was heartening and reflected a shift by the authorities toward a comprehensive stabilization approach. With the results achieved thus far, Israel could join the ranks of those few countries that had made spectacular strides in tackling the critical problem of high inflation. Nonetheless, the improvement in Israel's economic situation was not yet assured, and the authorities must continue to implement the stabilization program in order to consolidate the progress already made. A key element in their effort would be the maintenance of a decisive and uncompromising fiscal policy, especially given that high government spending--evidenced by expenditure/GDP ratios in the range of 70 percent--had been among the main reasons for Israel's inflation.

The authorities' success in reducing the fiscal deficit had been remarkable, Mr. Goos continued. However, their success rested, at least in part, on an extraordinary revenue-raising effort, which was unlikely to be repeated. Indeed, with revenues expected to decline and with a reduction in the tax burden remaining a commendable objective, the need for further significant expenditure cuts was obvious. In that context, he welcomed the reduction in government spending and the total financing requirement in terms of GNP proposed in the 1986/87 budget, although a closer look at the likely impact of those cuts on domestic demand seemed to suggest that a greater effort was needed in that regard. The proposed reductions were concentrated mainly in the area of direct defense imports, which were financed nearly in their entirety by foreign grants. Expenditure reductions of that sort could do little to relieve the pressure on domestic resources, and little comfort could be taken from the fact that a major part of the remaining, and still large, deficit would be financed by foreign grants.

As the staff had noted, using the counterpart of the external assistance for domestic spending was tantamount to monetary financing, with corresponding negative repercussions on domestic prices, Mr. Goos remarked. The authorities would thus be well advised to increase their efforts to release real resources for use by the private sector, which would complement the attention they were paying to the revival of economic growth. That latter objective could be expected to benefit from further cuts in public expenditure and the associated increasing scope for reducing the heavy tax burden. A reduction in corporate taxation for business investment would go a long way toward stimulating economic activity. On the other hand, lower payroll taxes might have a moderating influence on wage demands, which was seen by both the staff and the authorities as crucial to the process of safeguarding progress on the inflation front and enhancing external competitiveness. In that context, he had taken note of the details on the new wage agreement, which seemed consistent with the effort toward restraint. He encouraged the authorities to work toward a further phasing out of wage indexation mechanisms.

Israel's tight monetary policy had played a crucial role in bringing about a deceleration in the rate of inflation, Mr. Goos observed. While the authorities' monetary stance and the ensuing high level of interest rates had not been without cost in terms of business failures and employment, one should not underestimate the gains in renewed confidence in an environment of declining inflation rates. He agreed with the staff that interest rates could be allowed to decline only when supported by further fiscal retrenchment and wage moderation, so long as the risk of rekindling inflation had not been fully overcome. That assessment was shared by the Bank of Israel. The recent decision of the Government to substantially raise subsidies to enterprises in financial difficulty and to reduce interest rates--measures apparently implemented in spite of the concerns of the central bank--threatened to undermine the authorities' ability to persevere with their stabilization program, particularly in the face of growing internal resistance.

The Israeli Government had taken a courageous and commendable step in 1985 that had yielded encouraging results in a short period of time, Mr. Goos concluded. Now, as the external economic environment had become more favorable, the authorities must resist pressures to deviate from the chosen path, which deserved the full support of the Fund.

Mr. Fox considered that the comprehensive stabilization program introduced in July 1985 had been a significant step toward the re-establishment of order in the Israeli economy following several years of recurrent balance of payments and inflation crises that had been addressed in only a rather piecemeal fashion. As illustrated in the useful Appendix to the staff report, Israel's stabilization program was similar in a number of respects to that undertaken by Argentina; most notably, it involved a substantial reduction in the public sector deficit and a link to the U.S. dollar, which provided an important discipline. Monetary policy had also been severely tightened, and it was clear that the support provided in the early stages of the program by a strict financial policy was an important factor in distinguishing the latest program from its many predecessors. In that context, the temporary control of wages and prices, while not the ideal response to inflation in most situations, could clearly play an important role in reducing inflationary expectations when there was a risk of hyperinflation.

The initial results of the Israeli program were encouraging, especially the impressive reduction in inflation, Mr. Fox continued. Also encouraging was the fact that the economy was proving far more resilient to the adjustment measures than had first been feared. Growth was turning out to be higher than originally estimated, and unemployment at present was less than it had been when the package had been initiated. Still, inflationary expectations and inflation must be reduced further, and the revival of growth must be consolidated into a more durable trend. In the circumstances, it was essential to build on the early successes and maintain the momentum of the plan, particularly as it was entering the more difficult second stage. Past experience in Israel showed that at the first signs of relaxation, external pressures could quickly reappear and change the course of economic policy.

The next stage of Israel's program must introduce greater flexibility in the determination of prices and wages, Mr. Fox noted. Such flexibility was difficult to achieve, but progress thus far was encouraging, particularly the recent agreement between employers and the trade union on a cost-of-living increase that had begun to unwind at least some of the enhanced indexation provisions introduced in August 1985. The wage agreement was certainly a move in the right direction, not only for its disinflationary effects but also in view of the generally excessive level of real wages throughout the economy.

In indicating to employers that the cost of any large increase in wages would be offset by devaluation and possibly by a reduction in the payroll tax, the authorities had provided little or no incentive for employers to resist large wage increases, Mr. Fox remarked. At the same time, the authorities' threat to employees to reduce the real value of any nominal increase by a further devaluation might actually have encouraged the large increases that the authorities were attempting to avoid. Rather than weakening the financial discipline imposed on companies--and the recent decision to increase assistance to firms in financial difficulty was a further example of that weakening--the Government had a crucial role to play in ensuring financial discipline by maintaining a firm fiscal and monetary stance.

On the 1986/87 budget, Mr. Fox said that the envisaged further reduction in the deficit of 3.5 percent of GNP should confirm the declining trend initiated in 1985/86, and on the cumulative reduction under the program of 11 percentage points was undoubtedly impressive. But the deficit before grants were taken into account was very high; and, with a prospective reduction in foreign grants in 1987, further reductions in the deficit would be necessary if the public debt was at least to be stabilized while at the same time allowing room for tax cuts--which were essential to restoring incentives--and greater private access to capital markets to allow investment.

The use of transfers and subsidies to influence production, investment, and exports was widespread in Israel and should be reduced, Mr. Fox considered. The budgeted reduction in those areas was therefore welcome. Overall, however, nondefense expenditure was planned to fall by only 1 percent of GNP in 1986. While the cut would be larger to the extent that the contingency reserve was not fully used, substantial further expenditure cuts would be necessary for the foreseeable future if the authorities' fiscal objectives were to be met. In that context, he would be interested in what scope the authorities saw for privatization of the very large number of nonfinancial public enterprises. On a related matter, he considered the allowance in the budget for a contingency reserve to be a prudent measure similar to the one that, together with a move toward budgeting in cash rather than volume terms, had been introduced by the U.K. authorities in their effort to improve financial discipline at an early stage of the U.K. medium-term financial strategy.

An intensified fiscal effort would also be needed if the burden on monetary policy was to be reduced, Mr. Fox commented. Firm monetary restraint was essential if a renewed burst of inflation was to be avoided as wages were liberalized, prices decontrolled, and subsidies further reduced. However, because the budgeted decline in the fiscal deficit was little more than the prospective reduction in foreign grants, the budget implied a continued high domestic financing requirement that placed the authorities in a quandary. As the staff had noted, continued government borrowing from the Bank of Israel, combined with a balance of payments surplus, would result in monetary growth inconsistent with the effort to maintain downward pressure on inflation. Moreover, the decision to reduce interest rates in March 1986--which had left deposit rates negative in real terms--had exacerbated the financing problem. Yet attempts to reduce monetary growth by higher government bond sales, which the authorities had suggested as an option, was not only contrary to the objective of reducing the burden of government debt; it would also tend to place upward pressure on interest rates and risk increasing external pressures on liquidity. The only way to resolve the problem was through a further tightening of fiscal policy. For the future, as the staff projections showed, anything less than full implementation of the 1986/87 budget followed by further expenditure cuts in subsequent years would rapidly lead to an unsustainable overall deficit.

While the emergence in 1985 of a current account surplus had been due mainly to a change in U.S. assistance from loans to grants, the underlying improvement in the balance of payments--better reflected in the basic balance--had nevertheless been substantial at more than $1 billion, mainly reflecting the narrowing in the civilian goods and services deficit, Mr. Fox went on. However, it was disappointing that there had been no further improvement thus far in 1986. The recovery in real wages seemed to have led to revival of imports, while exports had stagnated. That latter development suggested that the assumption of an 8 percent export volume growth in 1986 might be optimistic, and he would be interested in hearing whether the staff had updated its balance of payments projections. In conclusion, the Israeli authorities had taken a number of bold actions designed to achieve a lasting improvement in economic performance, and the preliminary results had been promising. However, the task the authorities had set for themselves was an ambitious one, and further work would be needed. He could support the proposed decisions, including that recommending nonapproval of the various exchange restrictions and multiple currency practices in Israel. He encouraged the authorities to set a timetable for their early elimination.

Mr. Puro observed that since the previous Article IV consultation with Israel, economic developments in the Israeli economy had been positive. Although the vigorous stabilization program had not been fully implemented as planned, it was cause for hope that given the more favorable external environment of late, the country could break the vicious circle of inflation, deficits, and devaluations. The authorities should strive to adhere to the program, modifying and strengthening measures where necessary to place the economy on a path toward sustained growth in the medium term.

Israel's fiscal deficit was at the root of the economy's problems, and sustained growth seemed impossible without the benefit of a more balanced fiscal development, Mr. Puro continued. Despite the recent impressive reductions in the fiscal deficit, further progress was required. As there seemed to be a need for a reduction in the tax burden in the medium term, deficit reduction should be based mainly on expenditure cuts. In that connection, there appeared to be ample scope for realizing savings through the curtailment of subsidies and transfer payments, and it was questionable whether the recent assistance to enterprises in financial difficulty was prudent. Such assistance could in his view serve to delay the necessary structural adjustment. On the potential for expenditure cuts in other areas, he agreed with the staff's suggestion to reduce the Government's purchases of goods and services in order to release real resources for use by the private sector. In addition, a cautious line should be taken with respect to public sector wages.

A reduced budget deficit with greater emphasis on demand-reducing measures should provide greater room for flexibility in monetary policy, Mr. Puro considered. Such flexibility could be further enhanced with less inflationary incomes settlements and with accompanying reductions in inflationary expectations. Within a cautious line of monetary policy, the existing room for maneuver should be used to lower interest rates to facilitate the financing of investments necessary for Israel's structural adjustment and future economic growth.

The gearing of fiscal and monetary policies toward reducing inflation should be supported by exchange rate policies, Mr. Puro considered. Stability in the dollar/sheqel rate had continued for nearly one year, and the staff was calling for greater flexibility in the rate. However, the full rationale behind the staff's advice was somewhat unclear, as was the degree of adjustment called for in the rate, and he would appreciate further clarification by the staff. An interesting question in the exchange rate area concerned what the Israeli authorities should do when the dollar stopped falling on world markets, a situation that might be near at hand. Because of its still rapid inflation, Israel might begin losing competitiveness in all markets and, as was well known, exports were vital to economic growth in Israel. How could export growth be maintained in such a situation without the sheqel being devalued? And what would be the consequence for the effort to reduce the rate of inflation? Finally, the steps taken by the Israeli authorities since July 1985 toward liberalization of the restricted trade and payments system were welcome. However, the system was still complex, and the remaining restrictions might be rather easy to circumvent. In the wake of the success of stabilization policies, there would seem to be room for further relaxation of the payments system, a comprehensive plan which should be prepared before the next Article IV consultation with Israel.

Mr. Ortiz observed that several lessons could be drawn from the Israeli experience since the application of the current innovative program. First, it was clear that economic indexation did not rid an economy of the evils of inflation. It was also clear that a gradualist approach to reducing inflation had proved frustrating on occasion to economic policymakers. Given the nature of inflation, which usually included a mixture of real and inertial elements, attempts to reduce it through a typically monetarist approach of the sort often applied in Fund programs had sometimes proved unsuccessful and quite costly.

As observed by Mr. Polak, the aim of the July 1985 economic stabilization plan had been simultaneously to tackle the problems of inflation and the real imbalances in the economy, Mr. Ortiz continued. Of course, those disequilibria were not unrelated; indeed, the main culprits of inflation had been the large government deficit and the loss of the monetary "anchor" implied by a system that automatically linked the exchange rate to the price level while offering an accommodating supply of liquid assets. It should perhaps be observed that that linkage had been the main force behind the escalation of inflation in Israel, since real budget deficits, while high, had remained more or less stable during the ten-year period in which inflation had escalated from 50 percent to 500 percent. Since the inflation rate contained an important element of inertia, it had not been deemed sufficient to suppress the "real causes of inflation." In that respect, in addition to eliminating or drastically reducing the real budget deficit, the program had needed a nominal anchor or fixed point that could serve to credibly break the inertial element of inflation. It was interesting to note that the authors of the stabilization plan had not chosen to utilize the monetary aggregates as the anchors of the system but had chosen to rely on an exchange rate freeze and wage and price controls. That was not to say that monetary policy was unimportant but only that the authorities had chosen to place emphasis on the control of overall credit rather than focusing on levels of the monetary aggregates, since money demand should presumably increase substantially with disinflation--thus permitting the Government to cancel part of the internal deficit through noninflationary money emission--although it was hard to predict by how much. Another indication of the favorable reaction of the public to the program was the reversal of capital outflows, a development that had been helped by the attractive prevailing real interest rates. Those rates were, however, clearly unsustainable and were cause for concern among the program's designers.

The results of the application of the program thus far were encouraging; indeed, they had surpassed even the most optimistic expectations of the creators of the program, Mr. Ortiz commented. It appeared that the inflation inertia had been effectively broken, while an impressive reduction in the budget deficit and an improvement in the balance of payments had been achieved. He was encouraged to note from the supplementary paper that economic growth had also turned out to be considerably higher than earlier estimated, owing mainly to a smaller than envisaged contractionary effect of the program on private fixed investment. Those developments should ease somewhat the concerns about the unemployment situation in Israel and had probably contributed to the recently agreed satisfactory wage settlement. Of course, economic activity, employment, and the continued success of the program would depend largely on future wage developments. The recent wage settlement by the Trade Union Federation and the Manufacturers' Association was satisfactory because wage compensation due to inflation had been less than complete. However, if the Government was to stop utilizing inflationary financing and the economy was gradually to rid itself of its dependence of foreign assistance, the resources to finance economic growth must be found. Without in any way minimizing the efforts made by the Israeli authorities, he noted that foreign grants, excluding those for defense, had been quite large. Including the special assistance for 1986 and 1987, those grants more than covered the total interest bill on the external debt. Labor productivity had been declining and, in the circumstances, the staff had correctly pointed out that real wages were too high. Consumption must be gradually reduced while investment was encouraged; if it was not possible to proceed at a faster pace in the generation of real investment resources through budgetary means, wages would have to be moderated in the future for economic growth to resume.

He was pleased to note that the authorities were continuing in their effort to adjust expenditures in the 1986/87 budget, Mr. Ortiz commented. However, as the authorities had acknowledged, their efforts would not be sufficient to stabilize total debt, a goal that should nonetheless remain a central objective of overall fiscal policy. If fiscal policy was constrained by indications that further expenditure cuts would be difficult to implement--given Israel's particular situation and priorities--and if the tax burden was already too high, credit policy must remain tight for the near future, exerting upward pressure on real interest rates and, consequently, on the ability of the economy to sustain a faster pace of economic activity.

An important point to be made in relation to the budgetary correction effort, and one that had direct relevance for the forthcoming seminar discussion on the measurement of fiscal deficits, was the fact that indexation of domestic debt in Israel--which was high by any standards at more than 150 percent of GDP--was not included in the budget, Mr. Ortiz observed. Only interest payments on an inflation-adjusted principal were included in the budget, so the interest payments items in Table 2 of page 21 of the staff paper--equivalent to 14 percent of GDP for 1985 and 1986--should be seen as real interest plus payments on the external debt. The stabilization effort was thus aimed at correcting the real budget deficit--as it should be--and it was clear that since the amortization component of the debt due to inflation had not been exerting pressure on aggregate demand and should justifiably have been excluded from the budget and, hence, from the definition of the budget deficit. In conclusion, he joined Mr. Weitz in calling for a staff study of the experience of those countries that had instituted programs to deal with hyperinflation. Paradoxically, the success that those countries were experiencing in reducing the very high rates of inflation in their countries might lead one to the conclusion that it was better to catch pneumonia than the common cold, since the cure for the more serious problem was apparently easier to find.

The Deputy Director of the European Department replied that the Israeli authorities themselves had expressed interest in a study by the Fund comparing their experience with that of other countries attempting to deal with the problem of hyperinflation. On other matters, he recalled that most Directors had underlined the need for a further effort to strengthen fiscal policy to stabilize the economy in the short term and to deal with the problem of private investment and the public debt over the longer run. There was no doubt that private investment presented a long-term problem for Israel, although the decline in 1985/86 should perhaps be seen in the context of the two years of very strong growth that had been achieved in 1982 and 1983. If the economy was to be revived, there must be a recovery of private investment, the main obstacles to which had been mentioned by a number of Directors. One such problem was the high rate of corporate taxation; another was the use of price controls, which in certain cases tended to discourage private investment. More generally, the fiscal situation in Israel was largely responsible for high real rates of interest, and the Government held a quasi-monopoly on medium-term credit, either from banks or through the financial market, a market that was closed to private firms and reserved exclusively for the Government. That problem was of concern to the Israeli authorities, who recognized that the solution demanded a further improvement in the fiscal situation.

In response to those who had questioned the prospects for a reform of the capital markets in Israel, the Deputy Director replied that the capital markets had experienced a severe setback in 1983 when the stock market had nearly collapsed in the wake of problems with the shares of the banks. Since that time, recovery had been slow. While the staff had not been made fully aware of the authorities' plans for further recovery, it had discussed with them the need to progressively make room for private firms to enter the bond market, which should not be left exclusively to the public sector. It was perhaps relevant in that respect to recall that much public investment was financed by government assistance through the budget in the form of various types of incentives. Such an approach was not in the long run a desirable one. Specifically, as some speakers had mentioned, the current practice of channeling resources to enterprises in financial difficulty was not conducive to a recovery of private investment, at least in those sectors where a recovery of private investment was being sought.

A question had been raised by Mr. Dallara about whether the staff's statement that the authorities no longer viewed indexation as a protection against high inflation was consistent with the staff's acceptance of the maintenance of indexation in certain sectors, the Deputy Director recalled. He himself saw no inconsistency; the staff believed that indexation had not protected the authorities from the effects of inflation and that the economy had been hurt by high rates of inflation despite indexation. Among the reasons for that view was the argument that, in a situation of high inflation, it was difficult to follow developments in relative prices and to see whether a change in price was related to the general price level or was in fact a change in relative price. In that respect, it became difficult for businessmen, for example, to determine whether the goods they were buying were too expensive or reasonably priced. In addition, high inflation usually meant variable inflation, and the instability in the rate had made the management of the economy difficult, particularly in the area of interest rate and exchange rate policy. At the same time, the authorities were not quite prepared to eliminate indexation entirely, particularly for long-term private financial savings, which might be adversely affected by the elimination of indexation, at least until the economy had experienced a situation of low inflation for some time.

The recent agreement between the Trade Union Federation and the Manufacturers' Association was more favorable than the previous one, in the sense that the trigger for indexation was higher, the Deputy Director noted. In the past, a cost of living adjustment had taken place whenever the cost of living had increased by 4 percent; that trigger had been raised to 7 percent, and the period for adjustment had been lengthened. In that respect, there had been a reduction in the degree of indexation. It was too early to give an answer to those who had queried the effects of the latest wage agreement, since the general agreement had to be supplemented by sectoral agreements, which normally provided for an increase in wages beyond the straight cost-of-living adjustment. Much would depend on whether those sectoral agreements resulted in a real wage increase and whether any sectoral differentiation was created. In passing, he noted that such differentiation would be desirable in Israel, particularly with respect to the public sector.

Prospects for exports were difficult to clarify, the Deputy Director continued. Performance in the first few months of 1986 had been disappointing, with some sectors having faired worse than expected, particularly electronics. The staff's estimates were for a rather lower rate of growth than that suggested by the authorities, who were projecting a rate of growth of 8 percent. The staff's projected rate of 4-5 percent seemed more consistent with the experience of recent years when Israel had managed to make sizable gains in market shares. The revisions in projections in the supplementary paper would affect the results of the medium-term scenario to some extent but not in a significant way.

The staff had taken up with the authorities the matter of privatization of some public sector enterprises, the Deputy Director remarked. Unfortunately, a number of those enterprises could not be sold easily; the intention of the authorities was to improve their position to make them more attractive for buyers.

Exchange rate policy in Israel was a difficult matter, the Deputy Director continued. An effective peg to the U.S. dollar would provide the best guarantee against inflation, although there was general agreement that the maintenance of such a peg was probably an ambitious target. And if the target was not credible, speculation could begin building, and overvaluation of the real effective exchange rate could cause problems for the trade balance. Another option for the authorities was the free float, although the Israelis had rejected that approach because the market was too narrow and the rate would be too volatile. On balance, the staff felt that it would probably be appropriate at present for Israel to adopt targets for inflation as guidelines for monetary, budget, and exchange rate policies, all of which would be adjusted according to the target. The exchange rate had been approximately NIS 1.5 to the dollar for some time, and the staff had been concerned that that rate could become a psychological barrier and that there might be some advantage in having the rate move up and down so that its movement beyond the pegged rate of NIS 1.5 to the dollar would be less likely to encourage speculation. In that respect, the staff favored somewhat greater month-to-month variation in the exchange rate. However, so far, there had not been much change in the real effective exchange rate since the introduction of the stabilization program, probably because the peg to the dollar had benefited Israel as the dollar had depreciated vis-à-vis other currencies.

An interesting question on monetary policy had been raised by Mr. Ortiz, the Deputy Director recalled. Professor Fischer and Professor Dornbusch, in a recent study of stabilization programs since World War I, had concluded that, where those programs were successful, they had been followed by a "remonetization" of the economy. That is, the authorities had had to provide sufficient money to accommodate an increase in the demand for money resulting from the lower rate of inflation and a reduction in inflationary expectations. To some extent, that process was going on in Israel, although as some Directors had indicated, it would be dangerous to move too far toward "remonetization," since the success of the stabilization program could not yet be called permanent. Much remained to be done in the area of fiscal and wage policy, and a too expansionary monetary policy at present could be dangerous.

The staff representative from the Exchange and Trade Relations Department, responding to comments by Mr. Ortiz, noted that the price and exchange rate freeze in Israel provided a nominal anchor in the adjustment effort and gave a signal to the public that the authorities were serious about the overall stabilization effort and that they would employ monetary and financial policies as necessary to ensure that the adjustment effort was successful. Nonetheless, the authorities would eventually need to return to an environment of changing relative prices, which would be difficult if the wage and price structure were controlled for too long a period.

Mr. Polak observed that the Article IV consultation discussion had produced a broad endorsement by Directors of the policies followed by the Israeli authorities over the past year. Any success in halting hyperinflation could perhaps be described as miraculous, although the description was particularly apt in the case of Israel, where the odds of success originally had not been high. The Government of National Unity was composed of two main political parties with sharply different views on many matters, including economic questions. The Government tended to spend heavily, not only for defense, but also for a wide range of social purposes, and there was great sensitivity to the risk of unemployment. The experiment to reduce hyperinflation had, moreover, been undertaken against a background of past failures to achieve stabilization. The authorities' success in the latest effort had been achieved on the basis of a "crash" program that had, nonetheless, been carefully crafted in advance in a manner similar to those implemented in Argentina and Brazil.

Of course, the Israeli authorities still faced a challenge in bringing their stabilization plan to fruition, Mr. Polak continued, and they were convinced of the need to continue their efforts in a wide range of policy areas. The fear that had arisen several months previously that the rescue operation of certain large companies close to bankruptcy might jeopardize the fundamental strategy had abated, and the authorities had come to realize that lasting growth could not be obtained merely by bailing out bankrupt enterprises.

The wage accord mentioned in the supplementary paper was an indication of the broad support within the economy for the stabilization plan, Mr. Polak noted. Some Directors had expressed regret that the Government had not abandoned indexation entirely, but he agreed with those who felt that such abandonment was not possible at the present stage of the stabilization program. It was necessary to give assurances that important reductions in real income would be compensated even though, with the low inflation rates being registered at present, it might take a number of months before the threshold was reached, so that the indexation would not be so active. Indexation for short-term assets was being phased out; for longer-term assets, the Government had been put in the position of choosing whether to continue to permit indexation or to face a large demand for the automatically indexed assets, i.e., foreign exchange.

The current budget was still affected to some degree by indexation, although it was no longer a budget in real or in dollar terms, Mr. Polak remarked. The budget for 1987 was intended to be entirely on a nominal basis. Directors had correctly pointed out that additional budgetary action would be necessary as a basis for the stabilization program. Such action should include further expenditure cuts and, where possible, tax reductions.

In response to Mr. Ortiz's comments on the choice of the authorities not to commit themselves in advance to monetary targets, Mr. Polak observed that in a situation of rapid disinflation, one could not know precisely what the demand for money would be. In Israel's case, an effort had been made to establish credit policy on the basis of careful and continuing observations by those managing the stabilization program. The inflationary atmosphere was being studied on a weekly basis to see to what extent monetary and credit policy could be changed and how fast the real rate of interest could be reduced. As he saw it, the authorities had been successful in carrying out what was essentially a trial and error exercise. In the absence of a rigid monetary anchor--which, as the staff had correctly noted, did not mean taking no action on monetary policy--there had been a need for an exchange rate anchor, and the peg of the new sheqel to the dollar had worked out well in Israel in present circumstances, owing to the counteracting forces of two basic weaknesses in the peg. The first was that the dollar was a relatively small proportion of the proper currency basket for Israel, so that the pegging to the dollar was in effect pegging to the wrong basket. Second, with some residual inflation in the system, pegging to the right basket would probably have been impossible. Those two weaknesses had canceled one another with the depreciation of the dollar, which had been a fortunate occurrence for the Israeli stabilization program. In that respect, one could not assume that continuing the new sheqel/dollar peg would be a permanent solution to the Israeli exchange rate problem.

The Chairman made the following summing up:

Executive Directors welcomed the significant improvement in Israel's economic situation since the previous Article IV consultation. They endorsed the comprehensive stabilization program introduced in July 1985 following unsuccessful attempts at dealing with high rates of inflation and large balance of payments deficits through measures tending to have only temporary effects. Directors commended the wide-ranging nature of the new stabilization effort, which was aimed at dealing simultaneously with Israel's two main economic problems of inflation and the balance of payments. The severely restrictive fiscal and monetary policies, in association with price and wage control measures, formed the foundation for the present program and distinguished it from earlier stabilization attempts where those essential ingredients were lacking. The broader-based approach was strongly supported by Directors who felt it provided greater promise for dealing with Israel's adjustment problems and offered better prospects for lasting results.

The comprehensive approach had already yielded impressive results, Directors noted. The rate of inflation had declined rapidly, and the external position had strengthened markedly, with a significant improvement on goods and services account and a halt to substantial private capital outflows. Moreover, Directors observed that according to the latest data, the pace of economic growth in 1985 had been distinctly higher than earlier anticipated.

Directors considered it essential that the stabilization program be maintained and consolidated in the period ahead. They emphasized, in particular, that the fiscal deficit, already cut significantly since the introduction of the program, must be reduced further, largely through additional expenditure cuts, so as to restrain domestic demand and avoid recourse to monetary financing and/or further increases in the public debt. Directors welcomed the reduction in grants, transfers, and subsidies already implemented and agreed that further steps toward their elimination were desirable, especially when aimed at cutting back on assistance to nonviable enterprises. Directors felt that a lower budget deficit should also be achieved by curtailing the Government's purchases of final goods and services in order to release real resources for use by the private sector, particularly for export growth. Directors hoped that improvement of the fiscal position would allow some alleviation of the tax burden to improve the prospects for investment growth. A cut in corporate taxation would provide a needed boost to investment activity.

Directors indicated their belief that the tight monetary stance had contributed importantly to the stabilization effort and they stressed that a continuation of that stance was essential. In that context, some Directors questioned the recent reduction in interest rates and stressed the need for a very cautious approach toward lowering interest rates, which should lag the decline in inflation. The sharp cut in central bank financing of the fiscal deficit was a welcome development, Directors agreed, and the further steps toward reducing the attractiveness of linked short-term financial assets were seen as facilitating a more effective monetary policy.

Directors noted that real wages in the business sector, after a temporary decline following the introduction of the stabilization program, had returned to their preprogram level. It appeared that real wages were well beyond levels that could be justified by productivity performance and ran the risk of aggravating employment problems and complicating the adjustment task. The wage agreement recently reached between the employers' and employees' associations on cost-of-living compensation would lead to a cut in real wages only if necessary restraint was imposed on separate awards. Directors felt that wage restraint was critical to the success of the stabilization effort, particularly in the public sector, if manpower was to be shifted to private enterprises with higher productivity. In that context, Directors observed with interest that it was widely accepted in Israel that, henceforth, economic growth should emanate from the private sector. To that effect several Directors stressed the importance of a timely dismantling of administrative controls over economic activity.

Several Directors felt that strictly enforced inflation targets could play important roles as guidelines for fiscal, monetary, and exchange rate policies and would improve the consistency and effectiveness of those policies. Such targets could help secure a permanent reduction in the rate of inflation, especially if accompanied by further steps toward deindexation of the Israeli economy.

Directors welcomed the authorities' policy of maintaining Israel's external competitiveness to help sustain the improvement on external account, and they supported the official policy of relying on expansion of exports rather than restrictions on imports as a basis for improving the balance of payments. However, they noted that the exchange system remained complex and restrictive and urged steps toward its liberalization and simplification.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Israel's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1986 Article XIV consultation with Israel, in the light of the 1986 Article IV consultation with Israel conducted under Decision No. 5392-(77/63), adopted April 29, 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.

Decision No. 8286-(86/86), adopted
May 21, 1986

2. STAFF COMPENSATION - 1986 ADJUSTMENT

The Executive Directors, meeting in restricted session, considered a memorandum from the Managing Director on the 1986 staff compensation review, including recommendations for adjustment (EBAP/86/90, 4/11/86; and Sup. 1, 4/14/86). They also had before them a communication on the same subject prepared by the Staff Association Committee (EBAP/86/114, 5/19/86).

The Executive Directors agreed to continue their discussion at 3:00 p.m.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/85 (5/19/86) and EBM/86/86 (5/21/86).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/113 (5/16/86) is approved.

APPROVED: February 6, 1987

LEO VAN HOUTVEN
Secretary