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EBS/85/190

CONFIDENTIAL

August 13, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Israel - Exchange Arrangements and Exchange System

There is attached for the information of the Executive Directors a paper on recent changes in the exchange arrangements and exchange system of Israel.

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

Att: (1)

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INTERNATIONAL MONETARY FUND

ISRAEL

Exchange Arrangements and Exchange System

Prepared by the European Department and the Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by Brian Rose and J.T. Boorman

August 13, 1985

In the attached communications, the Israeli authorities have informed the Fund of the introduction of a plan for economic stabilization which comprises a number of economic policy measures. The steps already implemented include a devaluation of the shekel and modifications to Israel's trade and payments system, a marked increase in prices of subsidized goods and services and of other goods whose prices are controlled, a curtailment in the indexation of short-term financial assets, and a tightening of monetary policy. The authorities have also announced their intention, as part of the plan, to effect budget cuts and to introduce fiscal measures aimed at boosting revenues, as well as to secure a reduction in real wages. The various measures were taken out of concern for the pressures threatening the agreement on prices and incomes which had been reached between the Government and the employers' and employees' organizations in February 1985; as explained in the recent staff papers for the 1985 Article IV consultation with Israel (SM/85/118, 4/26/85, and SM/85/129, 5/10/85), this agreement (or so-called second package deal) was to apply for an eight-month period from February 1985 with provision for a review in July if desired by any of the three signing parties. This package deal is now replaced by the plan for economic stabilization.

Further details with respect to the measures contained in this plan are as follows:

1. On July 1, 1985, the shekel was devalued by 15.8 percent (as measured in terms of the foreign currency equivalent of one shekel); on that date, the representative rate was IS 1,500.00 = US$1, as against IS 1,262.40 = US$1 on June 28. Recent movements in the real effective rate of the shekel are indicated in Chart 1.

2. In conjunction with the devaluation, the requirement for a non-interest-bearing deposit of 15 percent for one year on a range of imports--which had been extended until November 30, 1985--was eliminated; the remaining import deposit requirement on 50 commodities considered luxury items was reduced from 45 percent to 30 percent and will continue to be cut, as announced in February 1985, by 3 percent a month until February 1986. No

decision has been made regarding the exchange rate insurance scheme, but in their communication of August 2 to the Fund, the Israeli authorities stated that the general intention was to review this scheme with the aim of scaling it down.

3. Prices of subsidized goods and services, and of other goods whose prices are controlled, were raised by between 30 percent and 100 percent, while increases in prices of other goods and services were permitted up to a limit of 17 percent, or higher if agreed with the appropriate Ministry. Following these adjustments, prices are to be frozen for a period of three months. An increase of 14 percent is to be paid on July wages to all wage-earners up to a limit of about IS 722,000 (approximately US$480). On September 1, a one-time lump-sum payment equivalent to 12 percent of wages will be paid that is not to form part of future wages. Further wage compensation compounding to a total of 12 percent will be paid in three installments, comprising 4 percent in both December 1985 and January 1986 and 3 1/2 percent in February 1986. The cost of living adjustment mechanism--which has not been applied since April--is to be changed from October 1985 so that compensation amounting to 80 percent will be paid either when the cumulative increase in the consumer price index reaches 4 percent or after an interval of three months, whichever is the earlier. As explained in SM/85/118 (4/26/85), page 9, the rate of compensation was previously set at 80 percent when the cumulative rate of inflation reached 12 percent. Together, these various measures are expected to result in a reduction in real wages.

4. Budget cuts and fiscal measures aimed at boosting revenues were announced by the Government to ensure that initial projections for the reduction in the budget deficit for 1985/86 (beginning April 1) would be realized. With the fiscal position having shown slippage in the first quarter of the fiscal year, the recent measures were aimed at securing a cut in the budget deficit to the originally projected 9 percent of GNP (after allowing for foreign grants) compared with 20 percent in 1984/85. Measures include an immediate cut in subsidies, a reduction in the number of public sector employees, and implementation of a new tax law boosting revenue from corporate taxes; the value added tax--which had been increased from 15 percent to 17 percent on June 1, 1985--has been returned to 15 percent with immediate effect.

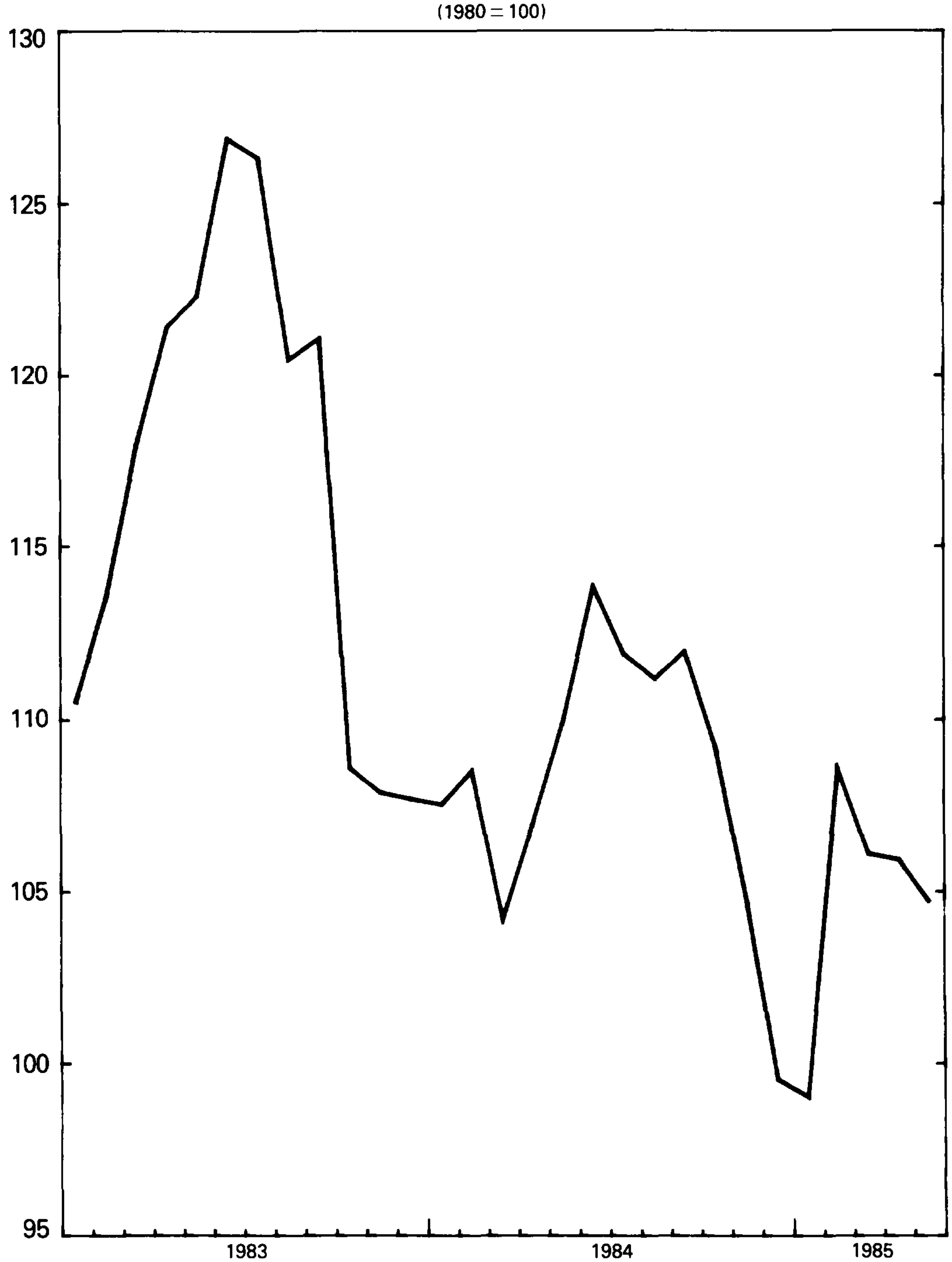
5. In a step aimed at cutting back on the indexation of liquid assets, new deposits in PATAM (i.e., foreign currency denominated) accounts of less than 12 months' maturity can no longer be effected in shekels, but must be lodged in foreign currency; withdrawals from existing PATAM accounts into shekels will continue to be permitted. Also with immediate effect, directed credit for exports will be denominated entirely in U.S. dollars (and not permitted in shekels as previously) and will be charged an interest rate equivalent to 2 percentage points over LIBOR. This elimination of the export subsidy on directed credit, as well as the cut in the import deposit requirement, are viewed as steps toward a unification of effective exchange rates. In measures aimed at tightening monetary

CHART 1

ISRAEL

REAL EFFECTIVE EXCHANGE RATE, 1983-85

(1980 = 100)



Source: Standard developed in connection with the Fund's Information Notice System (based on consumer prices).

policy, the banks' liquidity requirements on unlinked short-term assets were increased at the beginning of July by 4 percentage points, and by a further 8-17 percentage points on July 11 depending on the maturity range of the unlinked assets; two further increases totaling 15 percentage points were effected on July 25 and August 1. The Bank of Israel has also reaffirmed its policy of maintaining a high level of real interest rates.

The economic situation in the first half of 1985 proved weaker than earlier expected. The return to high rates of inflation (19.4 percent in April, 6.8 percent in May, and 14.9 percent in June) reflected the difficulties in implementing the second package deal which called for a controlled increase in prices of nonsubsidized goods. Real wages were higher than earlier envisaged--chiefly as a result of an unexpected increase in the first quarter of 1985 when a significant decline had been projected--although they fell sharply in June. Exports were 6 percent higher in the first half of 1985 when compared with the same period a year earlier, which represented a rate of growth broadly in line with earlier staff projections for the year as a whole; on a similar comparison, civilian imports (i.e., excluding defense equipment) fell marginally over the first half of 1985, and the civilian trade deficit continued the decline begun in 1984. However, gross official reserves also declined further, to US$2.4 billion by end-June, equivalent to a little less than two months of imports of goods and services.

The staff is not in a position to give a full assessment of the likely impact of the recent policy steps described above, particularly given the lack of detail at this time concerning certain budgetary measures. As noted in the report for the 1985 Article IV consultation (SM/85/118), the staff believes that implementation of a comprehensive stabilization program is essential to deal with the underlying causes of Israel's economic problems. While the measures aimed at ensuring the projected cuts in the budget deficit for 1985/86 are to be welcomed, the staff remains of the view, expressed in SM/85/118, that the budget cuts envisaged by the authorities for 1985/86 are insufficient. The staff supports the authorities' intention to secure a substantial cut in real wages and continues to believe that the various other steps outlined in the recent report for the 1985 Article IV consultation are necessary for an effective stabilization program. The measure reducing the attractiveness of linked liquid assets--which supports earlier steps in this direction--is to be welcomed, especially in view of the important role of financial indexation in the inflationary process and the greater scope for monetary and exchange rate policies that would be afforded by a winding down of indexation arrangements. The staff views the reduction in the import deposit requirement and cuts in subsidies on exports as appropriate moves toward unification of effective exchange rates. The measure described in paragraph 2 above represents the simplification of a multiple currency practice which is subject to Fund approval under Article VIII, Sections 2 and 3 of the Articles of Agreement, and which is unapproved. The staff is of the view that these actions and the exchange rate devaluation are a welcome step toward the elimination of multiple currency practices and exchange restrictions maintained by Israel. In the meantime, no action by the Executive Board is proposed.

Attachments

JULY 1, 1985

TO: INTERNATIONAL MONETARY FUND, WASHINGTON, D.C.

ATTN: MR. J.J. POLAK, EXECUTIVE DIRECTOR

DEAR MR. POLAK,

PRESSURES WHICH THREATENED THE AGREEMENT FOR PRICE STABILIZATION HAVE PROMPTED THE GOVERNMENT TO IMPLEMENT A COMPREHENSIVE PLAN STRAIGHT AWAY WITHOUT WAITING FOR THE AGREEMENT TO EXPIRE AT THE END OF JULY. THE PRINCIPAL OBJECTIVES OF THE PLAN ARE A SUBSTANTIAL CUT IN THE BUDGET DEFICIT, A REDUCTION IN REAL WAGES, AN INTEGRATION OF EXCHANGE RATES ACCOMPANIED BY A DEVALUATION AND A REDUCTION IN THE AMOUNT OF LINKED SHORT-TERM FINANCIAL ASSETS. THE DETAILED MEASURES WILL BE COMMUNICATED TO YOU AS SOON AS THE FINAL DECISIONS ARE REACHED. IN THE MEANTIME I WOULD LIKE TO INFORM YOU THAT AS PART OF THIS PLAN THE BANK OF ISRAEL HAS TODAY INCREASED THE SELLING PRICE OF THE US DOLLAR TO 1500 ISRAELI SHEKELS. THIS REPRESENTS A DEVALUATION OF 18.8 PERCENT RELATIVE TO THE EXCHANGE RATE ON THE 28TH JUNE.

FURTHER MEASURES WHICH CAME INTO EFFECT TODAY ARE THE FOLLOWING AMENDMENTS TO THE GENERAL PERMIT:

1. DEPOSITS OF ISRAELI SHEKELS IN CURRENT PATAM ACCOUNTS ARE DISCONTINUED. EXISTING DEPOSITS CAN BE CONVERTED INTO SHEKELS AT ANY TIME BUT NO NEW DEPOSITS IN ISRAELI SHEKELS CAN BE MADE.

2. DEPOSITS OF FOREIGN CURRENCY IN CURRENT PATAM ACCOUNTS ARE PERMITTED. THIS FACILITY WILL ENABLE EXPORTERS TO HEDGE THEMSELVES AGAINST PRICE INCREASES AND WILL ATTRACT DEPOSITS FROM RECIPIENTS OF TRANSFERS FROM ABROAD AS WELL AS FOREIGN CURRENCY HELD BY THE PUBLIC.

3. DEPOSITS OF ISRAELI SHEKELS IN PATAM ACCOUNTS FOR A MINIMUM PERIOD OF TWELVE MONTHS ARE NOT AFFECTED BY THESE MEASURES.

KIND REGARDS
DR. MOSHE Y. MANDELBAUM

BANK OF ISRAEL

JULY 8, 1985

TO: INTERNATIONAL MONETARY FUND, WASHINGTON, D.C.

ATTN: MR. J.J. POLAK, EXECUTIVE DIRECTOR

DEAR MR. POLAK,

FURTHER TO MY TELEX OF JULY 1, HERE ARE THE MAIN MEASURES WHICH COMPRISE THE EMERGENCY PLAN FOR ECONOMIC STABILIZATION WHICH WAS APPROVED BY THE GOVERNMENT.

1. PRICES AND WAGES

THE PRICES OF SUBSIDIZED GOODS AND SERVICES, AND OF OTHER GOODS WHOSE PRICES ARE CONTROLLED, WERE RAISED BY RATES VARYING FROM 30 TO 100 PERCENT. OTHER PRICES WERE ALLOWED AN INCREASE OF 17 PERCENT. FOLLOWING THESE INCREASES, PRICES WILL BE FROZEN FOR A PERIOD OF THREE MONTHS. DURING THIS PERIOD, COST OF LIVING ADJUSTMENT AGREEMENTS WILL BE SUSPENDED. AN ALTERNATIVE SPECIAL COMPENSATION TO BE GIVEN IN JULY TO ALL WAGE EARNERS WILL RESULT IN SUBSTANTIAL WAGE EROSION. THE COMPENSATION TO THOSE EMPLOYED IN THE PUBLIC SECTOR WILL BE THREE PERCENT LOWER. THE EXCHANGE RATE OF THE SHEKEL WILL CHANGE IN ACCORDANCE WITH CHANGES IN NOMINAL WAGES.

2. EXCHANGE RATE POLICY

THE DEVALUATION OF THE SHEKEL IS ACCOMPANIED BY A REDUCTION IN THE RATE OF THE VALUE ADDED TAX FROM 17 TO 15 PERCENT AS WELL AS A LOWERING OF THE IMPORT DEPOSIT REQUIREMENT BY 15 PERCENTAGE POINTS. IN ADDITION, DIRECTED CREDIT FOR EXPORTS WILL NOW BE ENTIRELY DOLLAR DENOMINATED AND WILL BE CHARGED WITH AN INTEREST RATE EQUIVALENT OF THE EURO-RATE PLUS 2 PERCENT. ALL THESE MEASURES ARE AIMED AT AN INTEGRATION OF EXCHANGE RATES.

3. BUDGETARY MEASURES

THE GOVERNMENT ANNOUNCED BUDGETARY CUTS AMOUNTING TO SOME 450 MILLION DOLLARS IN ANNUAL TERMS, AS WELL AS FISCAL MEASURES TO INCREASE ITS REVENUE BY SOME 280 MILLION DOLLARS. THE BUDGETARY CUTS WILL BE ACCOMPANIED BY A 3 PERCENT REDUCTION IN THE NUMBER OF THOSE EMPLOYED IN THE PUBLIC SECTOR.

4. MONETARY POLICY

THE PHASING OUT OF CURRENT PATAM ACCOUNTS IS ACCOMPANIED BY MEASURES INTENDED TO RESTRICT MONETARY EXPANSION. THE BANK OF ISRAEL HAS INCREASED

THE LIQUIDITY REQUIREMENTS OF UNLINKED SHORT TERM ASSETS AND AT THE SAME TIME APPLIED MORE STRINGENT CONDITIONS FOR MONETARY LOANS TO THE BANKING SYSTEM. THE BANK OF ISRAEL WILL CONTINUE TO MAINTAIN A HIGH LEVEL OF REAL INTEREST RATES.

BEST REGARDS

DR. MOSHE Y. MANDELBAUM
GOVERNOR, BANK OF ISRAEL

ATTACHMENT

AUGUST 2, 1985

TO: INTERFUND, WASHINGTON, D.C.

ATTENTION: MR. L.A. WHITTOME

IN REPLY TO YOUR TELEX OF JULY 24, THERE FOLLOWS EXPLANATIONS TO THE POINTS WHICH YOU RAISE:

A. THERE IS NO DEPARTURE IN THE EMERGENCY PLAN FROM THE EXCHANGE RATE MANAGEMENT POLICY. SPECIFICALLY, NO REVALUATION OF THE EXCHANGE RATE IS PLANNED.

B. A COMPENSATION OF 14 PERCENT WILL BE PAID ON JULY WAGES (UP TO A LIMIT OF SOME ISRAELI SHEKELS 722,000). ON SEPTEMBER 1, A ONE-TIME COMPENSATION OF 12 PERCENT WILL BE PAID. (THIS INCREMENT WILL NOT FORM PART OF FUTURE WAGES). A FURTHER COMPENSATION, AT A COMPOUNDED RATE OF 12 PERCENT, WILL BE PAID IN THREE INSTALLMENTS OF 4 PERCENT, 4 PERCENT AND 3 1/2 PERCENT, AT THE BEGINNING OF DECEMBER, OF JANUARY, AND OF FEBRUARY, RESPECTIVELY. THE COST OF LIVING ADJUSTMENT MECHANISM WILL BE CHANGED AS OF OCTOBER 1985 SO THAT WHENEVER THE CPI REACHES 4 PERCENT (OR AFTER AN INTERVAL OF THREE MONTHS, WHICHEVER IS EARLIER), A COST OF LIVING ADJUSTMENT COMPENSATION, OF 80 PERCENT OF THE CPI, WILL BE PAID.

C. IT IS NOT YET POSSIBLE TO GIVE AN ESTIMATE FOR THE FISCAL YEAR 1985/86 OF THE EFFECT OF THE FISCAL MEASURES INCLUDED IN THE EMERGENCY PLAN. HOWEVER, IT IS EXPECTED THAT THESE MEASURES WILL BRING THE DEFICIT IN LINE WITH THE NATIONAL BUDGET TARGET OF 9 PERCENT OF GDP.

D. (I) THE EFFECTIVE LIQUIDITY REQUIREMENT OF ALL UNLINKED SHORT-TERM ASSETS WAS INCREASED AT THE BEGINNING OF JULY BY 4 PERCENTAGE POINTS. THE LIQUIDITY REQUIREMENT WAS AGAIN INCREASED, ON JULY 11, BY BETWEEN 8 AND 17 PERCENTAGE POINTS, DEPENDING ON THE MATURITY RANGE OF THE UNLINKED ASSETS. ON JULY 25, THE EFFECTIVE REQUIREMENT WAS INCREASED BY A FURTHER 10 PERCENTAGE POINTS, AND AN INCREASE OF ANOTHER 5 PERCENTAGE POINTS CAME INTO EFFECT ON AUGUST 1.

(II) ON JULY 25, THE BANK OF ISRAEL LOWERED THE RATE OF INTEREST ON BOTH LIQUIDITY DEPOSITS AND MONETARY LOANS BY 3 PERCENTAGE POINTS. THIS STEP WAS TAKEN IN ORDER TO NARROW THE MARGIN BETWEEN THE LENDING AND BORROWING INTEREST RATES. AT THE BEGINNING OF JULY, THE DRAWING FACILITY IN THE TWO LOWER TRANCHES OF THE MONETARY LOAN, I.E., THE "REGULAR" AND "SPECIAL" LOANS, WERE TEMPORARILY SUSPENDED. HOWEVER, THIS FACILITY WAS RESTORED ON JULY 25.

AS FOR THE EXCHANGE RATE INSURANCE SCHEME, THE EMERGENCY PLAN DOES NOT SPECIFY ITS FINAL STATUS. HOWEVER, THE GENERAL INTENTION IS TO REVIEW THIS SCHEME WITH AN AIM OF SCALING IT DOWN.

WITH BEST WISHES

DR. MOSHE Y. MANDELBAUM
GOVERNOR, BANK OF ISRAEL