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April 26, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Israel - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Israel. A draft decision appears on page 20.

It is proposed to bring this subject to the agenda for discussion on Friday, May 24, 1985.

Mr. R. P. Hicks (ext. 7187) or Mr. Boote (ext. 8812) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the 1985 Consultation with Israel

Approved by L.A. Whittome and J.T. Boorman

April 24, 1985

I. Introduction

A staff team consisting of Messrs. de Fontenay (EUR), Kreis (FAD), Hicks (EUR), Boote (EUR), and Mayer (EP-EUR), with Ms. Montgomery (EUR) as secretary, held Article IV consultation discussions in Jerusalem and Tel Aviv during March 3-18, 1985. The Israeli representatives included officials of the Bank of Israel and the Ministries of Finance, Commerce and Industry, Economy and Defense. The mission had discussions with the Prime Minister, Mr. Peres, the Minister of Finance, Mr. Moda'i, the Minister of Economy, Mr. Ya'akobi, the Minister of Commerce and Industry, General Sharon, and the Governor of the Bank of Israel, Mr. Mandelbaum. Meetings were also held with the heads of the Manufacturers' Association, the Bankers' Association, and the Histadrut Labor Federation. Mr. Polak, Executive Director for Israel, and Mr. Steinberg, Advisor to the Executive Director, attended some of the meetings.

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

II. Background

The expansionary fiscal policy pursued since 1981, which contributed to a rapid growth of domestic demand, the policy of slowing down the depreciation of the shekel against the U.S. dollar, and the fall in foreign demand all combined to produce a marked worsening of the balance of payments for the third consecutive year in 1983. During the three years 1981-83, Israel's net external debt 1/ increased by 54 percent in U.S. dollar terms.

The growth of private consumption averaged 8 1/2 percent per annum in 1981-83 and that of public consumption, boosted since mid-1982 by the

1/ Defined as gross external liabilities minus foreign assets of commercial banks, Bank of Israel's reserves, holdings of other monetary institutions and export credits.

cost of military operations in Lebanon, was also rapid over this period. A sizable increase in the tax burden, however, contained the overall budget deficit (after grants) to around 15 percent of GNP. Growth of output remained well below its rate of the early 1970s, while inflation averaged 120 percent in 1980-82 and remained at that (annual) rate in the first three quarters of 1983.

In October 1983, the deterioration in the external position led to a change of policy. The shekel was devalued by 19 percent against the U.S. dollar, price subsidies were cut back, and reductions in other expenditures were announced. At the same time, the policy of allowing the real exchange rate to appreciate to reduce inflation was abandoned. The immediate result was a sharp run-up in the rate of inflation to more than 190 percent by year-end.

At the conclusion of the 1984 Article IV consultation with Israel (EBM/84/85, 6/1/84), the Chairman's summing up noted that Executive Directors had focused on the considerable and persistent economic imbalances facing the authorities and the fact that these had become more pressing in 1983. The need to implement a comprehensive package of policies to correct those problems was thus seen as having become urgent.

Directors viewed as of fundamental importance the attainment in 1984 of the authorities' target of an improvement in the external balance on goods and services account and expressed considerable concern about recent and prospective developments in prices. A reduction in the budget deficit in FY 1984/85 was seen as a prerequisite, both for achieving a meaningful improvement in the external position and for halting the acceleration of inflation.

III. Recent Economic Developments 1/

Israel's economic difficulties came to a head in 1984 although some of the underlying trends were improving. The shift in policy in the last quarter of 1983 which succeeded in reversing the rising trend of domestic demand was pursued for most of 1984 and resulted in an improved current account position of the balance of payments. Nevertheless, prices soared at an annual rate in excess of 1,000 percent in September-October before a wage-price freeze went into effect, while unrecorded capital outflows were largely responsible for a deterioration of the overall balance of payments and substantial losses in reserves.

Both private and public consumption (excluding direct defense imports) fell in real terms in 1984 (Table 1). Private consumption was affected by the 1983 stock market collapse, which resulted in a 30 percent real

1/ High and variable rates of inflation mean that calculations in real terms and comparisons to GNP need to be viewed with extreme caution. The same caveat applies to figures in U.S. dollars, which are also affected by large variations in the rate of depreciation of the shekel.

cut in the value of privately held financial assets, and by measures which raised the price of imports or reduced their availability through intensified trade restrictions. Although real disposable income increased, the effect on consumption was more than offset by a rise in the savings rate. Gross investment also fell in 1984, partly in reaction to advanced purchases of equipment and vehicles in 1983 in expectation of a devaluation. The improvement in the foreign balance--in real terms civilian imports of goods and services fell by 5 percent and exports rose by 13 percent--offset the impact of the decline in domestic demand and GDP is estimated to have continued to grow at a moderate rate (1.6 percent). This was insufficient to prevent a rise in the unemployment rate from 4.5 percent on average in 1983 to 5.9 percent in 1984.

Balance of payments developments in 1984 presented a sharp contrast between the improvement on current account and the worsening in the capital account and in the external reserves position. The civilian trade balance, 1/ which had deteriorated by almost US$500 million in 1983, is estimated to have improved by more than US$1 billion in 1984 (Table 3 and Chart A). Exports benefited from the recovery of foreign demand as well as from the improvement in competitiveness, and the coming on stream of new productive capacity geared to export markets. Imports were reduced by the slack in domestic demand (which also encouraged exports) and by intensified exchange and trade restrictions and import deposits. Large increases in military imports and in interest payments on the external debt were partly compensated by an increase in official transfers so that the current account deficit was reduced by almost US$600 million to the equivalent of 7 1/2 percent of GNP.

On the capital account, however there was a sharp deterioration in both long-term and other (mainly unrecorded) capital transactions, resulting in a loss of reserves of US$600 million. For long-term capital the reduction in inflows by about US$1 billion reflected the exceptional inflows of 1983 associated with the support by banks of their share prices. The unrecorded capital outflows were apparently related largely to speculative purchases of foreign exchange by the public in the second and third quarters of 1984, when concern was mounting about the external value of the shekel and the possibility that after the July elections measures would be taken by the new government that could impair financial savings.

The real effective exchange rate, although varying considerably during the year, was in 1984 on average 7 percent lower than in 1983; it depreciated by a similar percentage through the year (January-December) (Chart B). Interpretation of this overall depreciation must take account of the strength of the U.S. dollar as the shekel appreciated against the main European currencies (Chart C). The authorities indicated that this situation had made it difficult to promote export growth in European markets.

1/ Excluding military imports, which are financed mainly by official transfers, but including military exports.

On average, the price level rose by 374 percent in 1984, compared with 146 percent in 1983 (Table 2). 1/ These averages conceal, however, wide variations in the rate of inflation during the period (Chart D). The large devaluation and subsidy cuts of October 1983 raised the average rate of inflation in the fourth quarter of 1983 to 406 percent (at an annual rate). Around the time of the July general elections, the rise of controlled prices was slowed again but thereafter prices soared to a monthly rate of increase in excess of 24 percent by October, due to expectations of a price freeze, more rapid depreciation of the shekel, renewed subsidy cuts and the imposition of import controls. In the three-month period commencing from the beginning of November 1984, "Package Deal I"--in the form of a wage-price freeze--was in effect and reduced the recorded rate of inflation to low levels in December and January. With the end of the freeze, and further large cuts in subsidies, prices again rose sharply in February and March 1985, which led to the imposition of a two-month price freeze starting April 1.

IV. Policies in 1984 and in early 1985

Economic policy for most of 1984 gave primacy to an improvement in the external position, continuing the shift in emphasis away from reducing inflation. The implementation of this policy was affected by the July 1984 general elections and the subsequent change of government. With the advent of a government of national unity and the surge in inflation in September and October greater priority was again given to tackling inflation.

1. External policy

While the prime aim of exchange rate policy in 1984 was to maintain the overall competitiveness of the Israeli economy, there were sharp variations in the real effective exchange rate during the year. In part this reflected the variability of inflation during the year but also changes in the relative priority attached to external competitiveness and domestic inflation. For example, from March to June the shekel appreciated in real terms, thus generating substantial foreign currency purchases by the public as a devaluation was widely expected after the election. The authorities responded to these outflows, which were reflected in a sharp fall in the reserves, both by raising shekel interest rates and intensifying exchange restrictions.

2. Fiscal policy

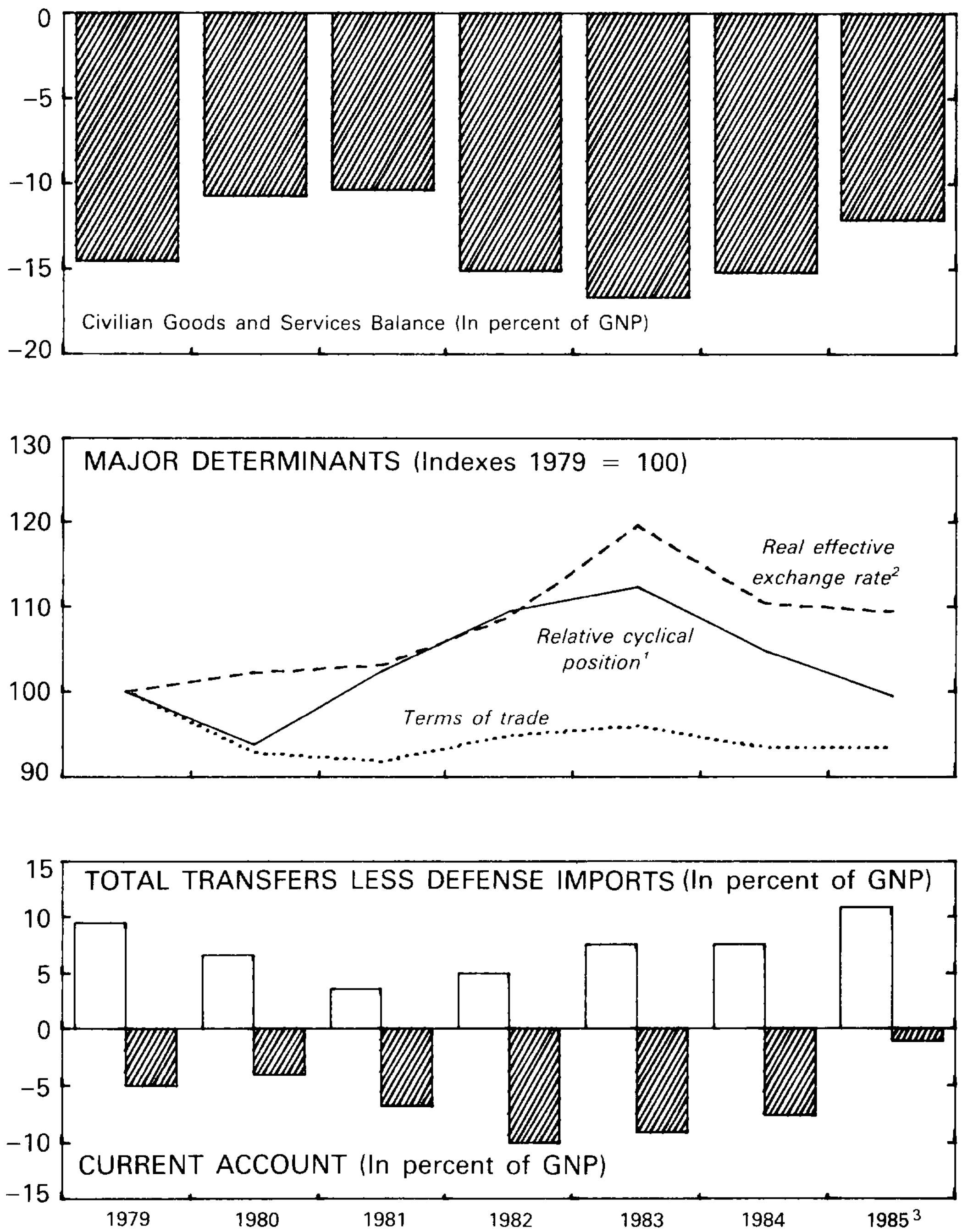
Domestic government consumption fell by 4 percent in 1984, partly reflecting various discretionary measures, including a freeze on new contracts, taken by the new government in September 1984 to curb expenditure. Government expenditure, excluding direct defense imports, however,

1/ For the influence of monetary and credit developments on inflation see Table 6 and the Recent Economic Developments paper.

CHART A

ISRAEL

MAJOR DETERMINANTS OF THE EXTERNAL CURRENT ACCOUNT



Source: Information provided by the Israeli authorities and Staff estimates.

[1] Ratio of index of real domestic demand in Israel to index of real domestic demand in partner countries, with latter index weighted by partners' import share.

[2] Standard index from the Fund's Information Notice system.

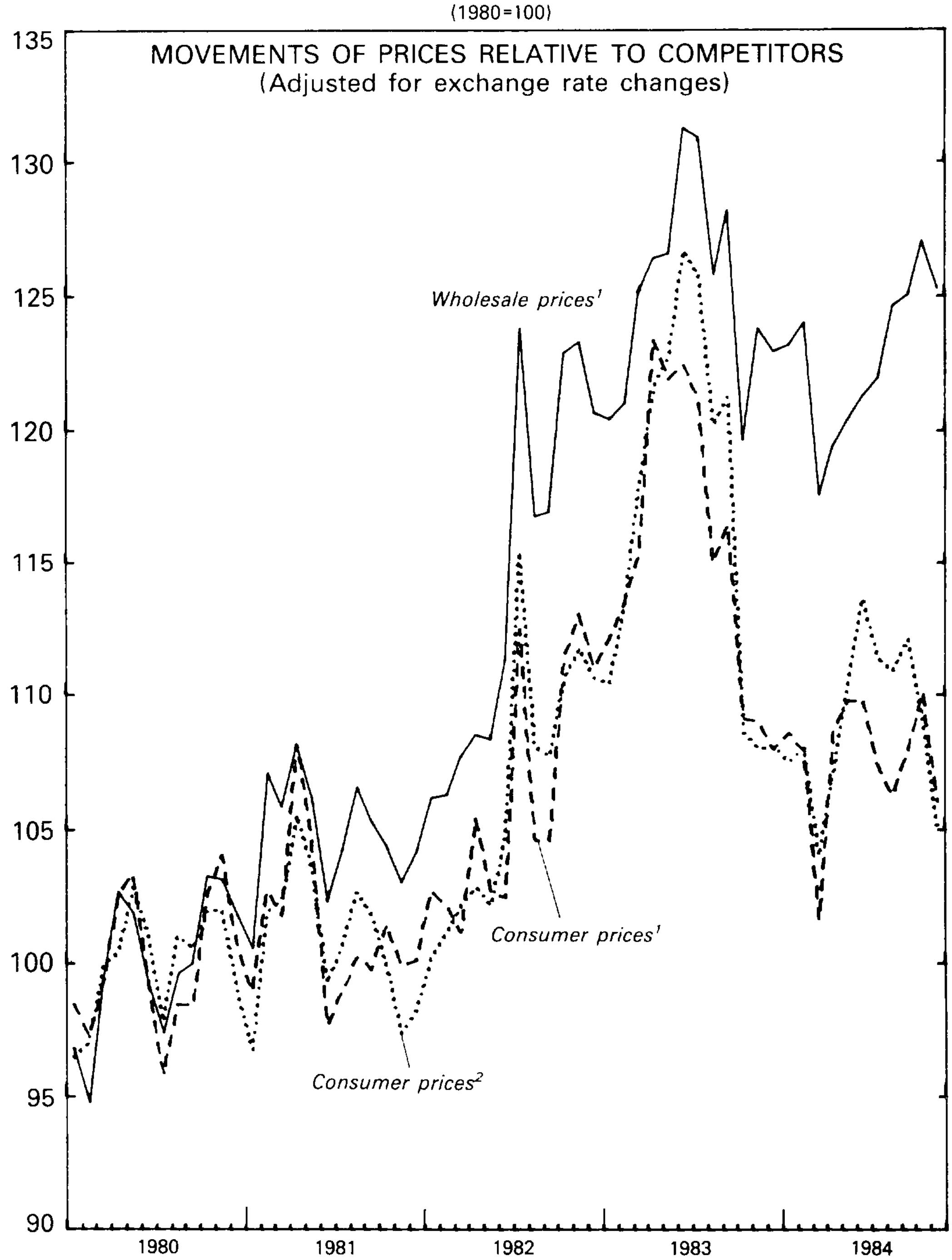
[3] Forecast

CHART B

ISRAEL

INDICATORS OF EXTERNAL COMPETITIVENESS

(1980=100)



Sources: Staff calculations based on IMF, *International Financial Statistics* and *Direction of Trade Statistics Yearbook 1982* and *Statistical Abstract of Israel 1982*.

[1] Based on 1981 bilateral trade weights excluding diamonds.

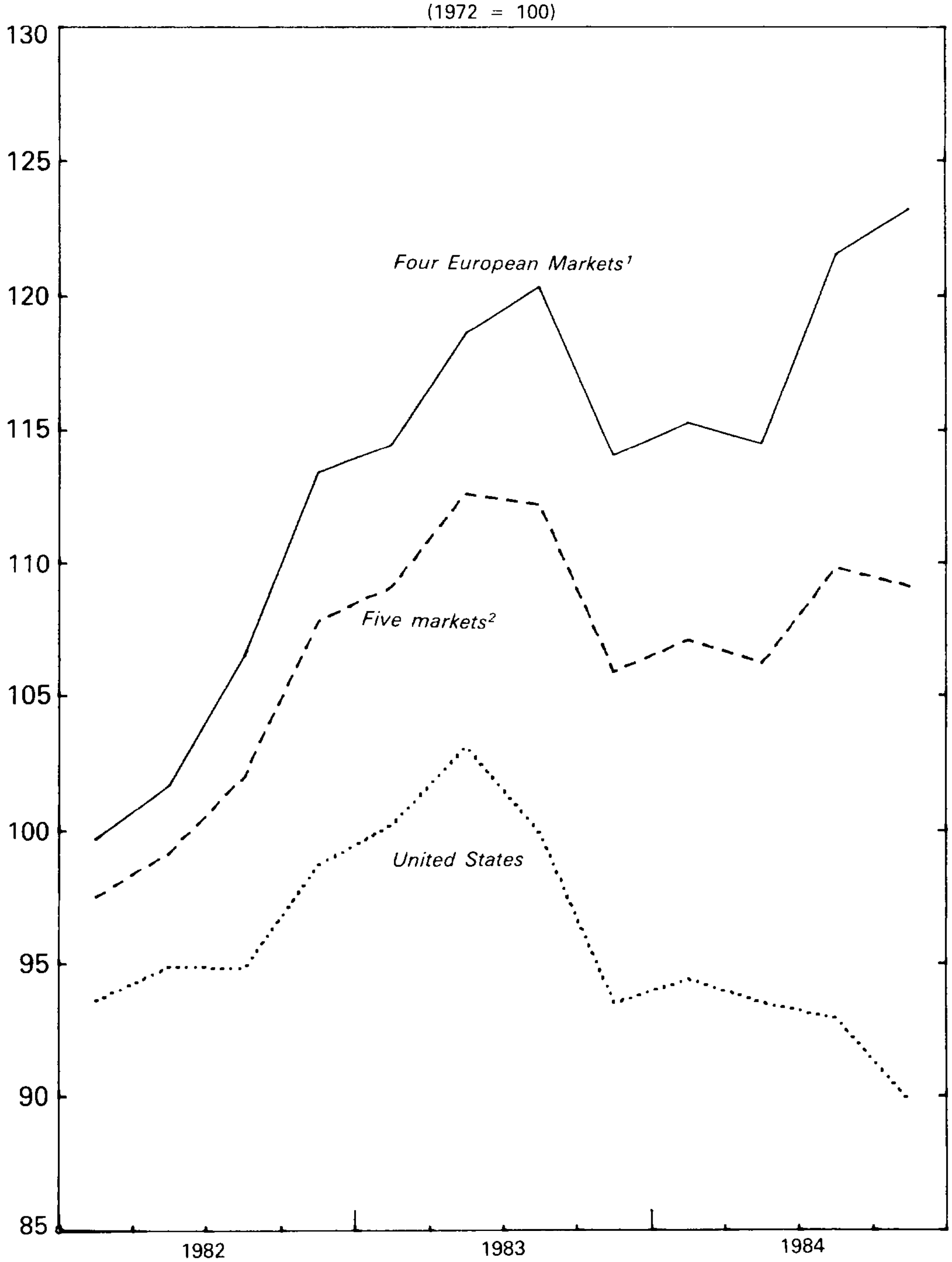
[2] Based on standard index developed in connection with the Fund's Information Notice System.

CHART C

ISRAEL

MOVEMENT OF PRICES OF INDUSTRIAL GOODS RELATIVE TO PRICES IN MAJOR MARKETS, CORRECTED FOR EXCHANGE RATE CHANGES, 1982–1984

(1972 = 100)



Source: Data provided by the Bank of Israel.

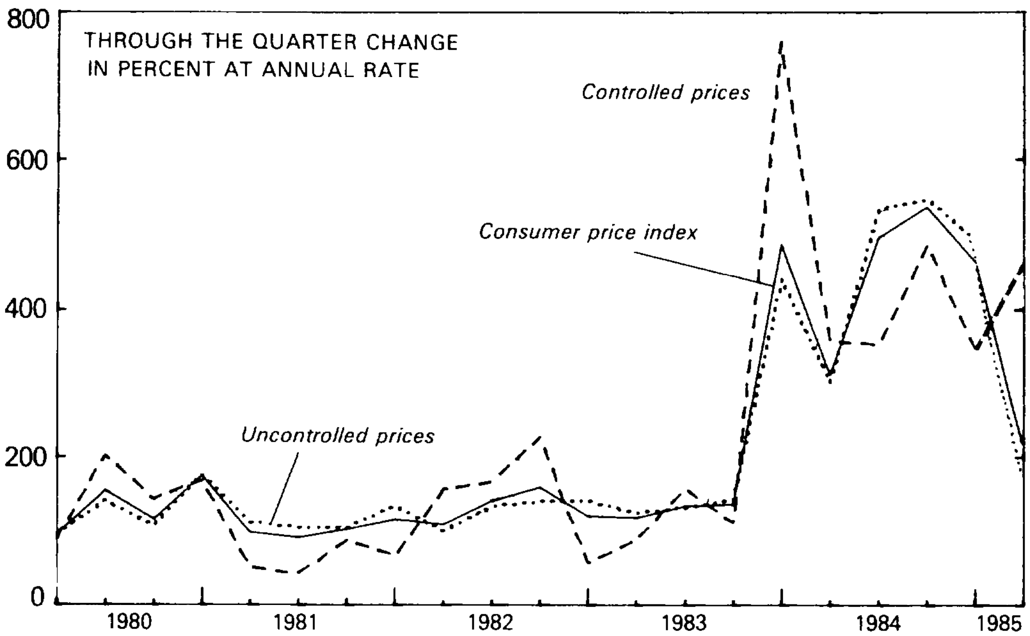
[1] United Kingdom, Germany, France, Netherlands.

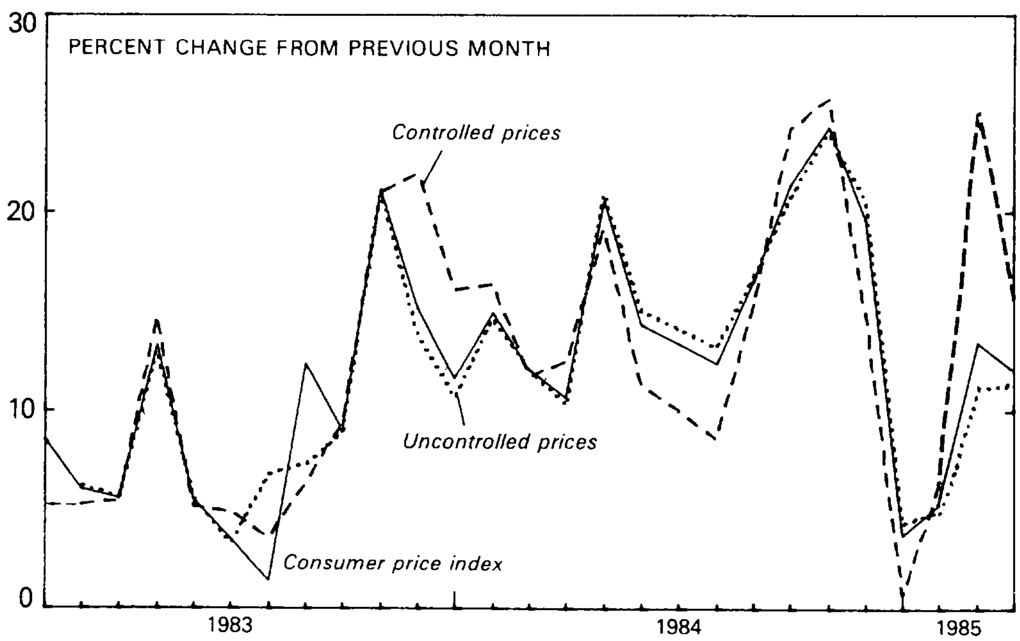
[2] United States, United Kingdom, Germany, France, Netherlands

CHART D

ISRAEL

CONSUMER PRICES





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

is estimated in the 1984-85 fiscal year (beginning April 1) to have exceeded budget proposals by around US$1.2 billion. 1/ This substantial overrun occurred in two main areas: higher expenditures on subsidies (US$0.5 billion) largely due to the holding down of prices of subsidized goods before the July election and in the first package deal, and higher interest and amortization payments on government debt (US$0.6 billion). Large wage awards to public sector employees before the election also boosted expenditure.

Overall cash expenditures--including defense imports--instead of falling by 6 percentage points of GNP compared to 1983-84 as envisaged in the original budget proposals, are estimated to have risen by 6 percentage points to almost 79 percent of GNP (Table 5). Revenues were below budget proposals, with the outturn for the year now estimated at around 45 percent of GNP, compared with the original proposal of 47 percent and the 1983-84 level of 50 percent. The decline in revenues reflects the adverse impact of higher inflation on tax collections, the reduced profitability of banks following the October 1983 stock market collapse, and a fall in nontax revenues only partly offset by new taxes on imports and foreign travel.

The overall government deficit during 1984-85, excluding grants, is estimated to have increased by 11 percentage points to 34 percent of GNP (Chart E). The financing requirement, however, is estimated to have risen by only 4 percentage points to around 19 1/2 percent of GNP, as a result of the switch of foreign military aid from loans to grants. Credit from the Bank of Israel is estimated to have increased to over 11 percent of GNP (from 7 percent in 1983-84) and accounted for more than three-fifths of the financing requirement.

3. Monetary policy

Monetary policy has been constrained by the continuing large fiscal deficits, the high level of domestic debt (over 150 percent of GNP) and the widespread indexation of both liquid and less liquid financial assets. For these reasons, policy has not attempted to curb inflation by controlling monetary growth: rather the growth of monetary aggregates has accommodated inflationary surges. The focus of monetary policy has been to curb credit growth to the private sector, while discouraging the provision of credit outside the banking system. The main instrument of monetary policy has been interest rates: in setting short-term interest rate levels, the Bank of Israel also paid attention to capital outflows as well as developments in the real economy.

A high level of real interest rates, averaging over 3 percent per month on shekel overdrafts, was maintained during 1984 although there was considerable fluctuation in rates from month to month partly reflecting the

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1/ Direct defense imports were also considerably above budget proposals as equipment ordered in earlier years arrived in 1984-85; virtually all of these imports are financed by foreign loans and grants.

variability of inflation and expectations concerning the exchange rate; real interest rates reached a peak of nearly 8 percent per month in July as expectations of a devaluation were widespread. The Bank also continued its policy of trying to expand the shekel base for monetary operations by increasing the public's holdings of unlinked shekel deposits and reducing the interest subsidy on export credits in shekels. Despite the high real level of interest rates, bank lending grew by 10 percent in real terms in 1984 (Table 6). Nor did higher interest rates succeed in checking foreign currency purchases which remained substantial--total purchases by the private sector during 1984 were around US$2.2 billion.

A factor contributing to capital outflows during 1984 was probably the public's satiety with government debt in its portfolio of financial assets. The Government attempted to pursue a much more active funding policy in 1984, particularly in the second half of the year and for the first time, government debentures were sold by tender, permitting interest rates on these bonds to be fixed by public demand rather than by administrative decision. Nevertheless, there were still net redemptions of debt.

4. Price and incomes policies

Policy toward wages during 1984 was very much influenced by political considerations. Higher rates of inflation prompted a switch from quarterly to monthly cost of living payments in April 1984. Before the July elections, large wage awards were made, particularly in the public sector. The average wage level in the public sector in 1984 is estimated to have risen, on average, by 2 percent in real terms over 1983, while it fell by 3 percent in the business sector (Chart F).

The acceleration of inflation in the third quarter of the year, and particularly in October, led to a sharp erosion of real wages which was instrumental in the Histadrut agreeing to the first package deal. The key ingredients of this first package deal--signed by the government, the employers, and the Histadrut--were a three-month freeze on the prices of goods and services (with prices of imported goods frozen at the November 5 exchange rate) and cost of living indexation payments over the period at two-thirds of the normal compensation for inflation, partly offset by a 5 percent reduction in employees income tax for three months from February 1985. The first package deal was successful in its prime aim of lowering the rate of increase of prices, thus giving a breathing space for more fundamental measures. However, the freezing of prices while the exchange rate continued to depreciate entailed a large increase in government expenditure on subsidies, as well as distortions in relative prices.

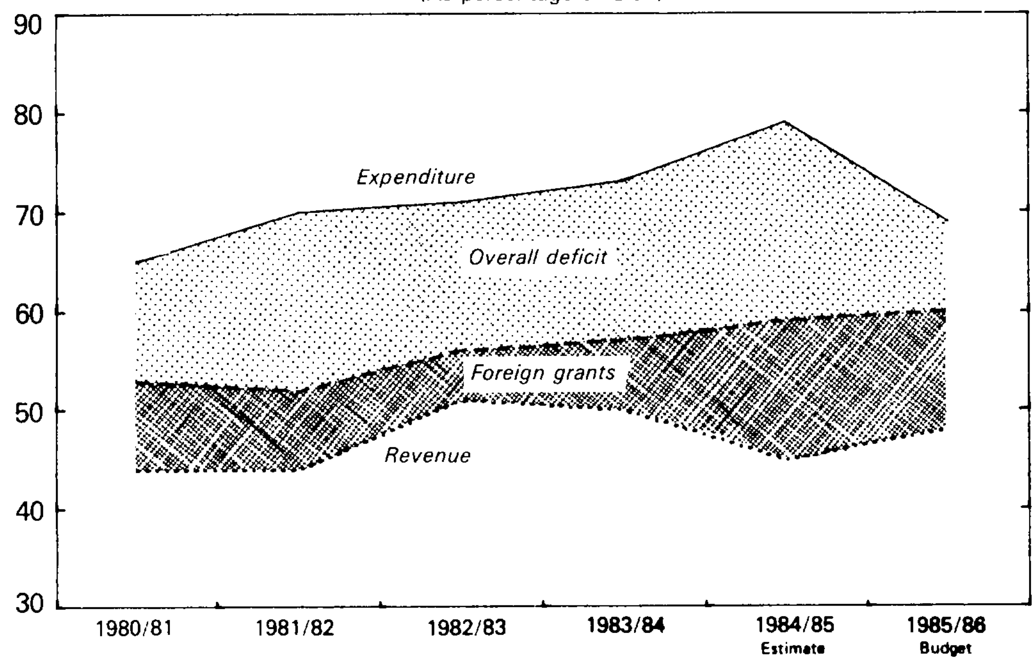
The second package deal, which took effect from February 4, 1985, provided for a significant increase in the prices of subsidized goods in order to reduce government expenditure on subsidies, while workers agreed to forego the element of cost of living adjustment related to these higher prices of subsidized goods. Increases in prices of nonsubsidized goods were subject to approval: the intention was that the price of these

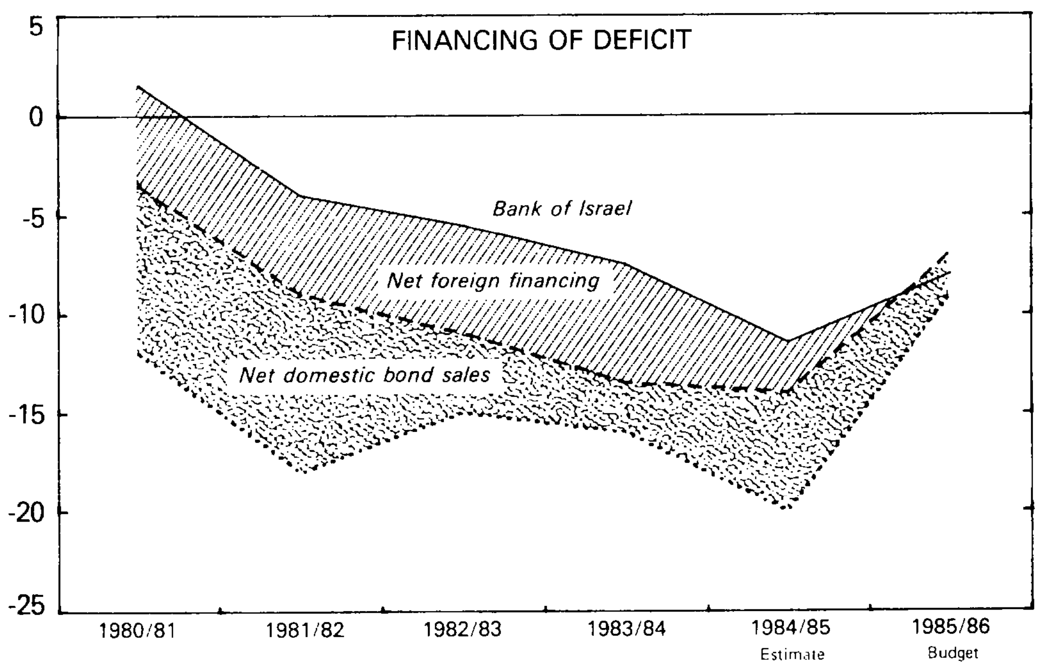
CHART E

ISRAEL

CENTRAL GOVERNMENT OPERATIONS

(As percentage of GNP)[1]





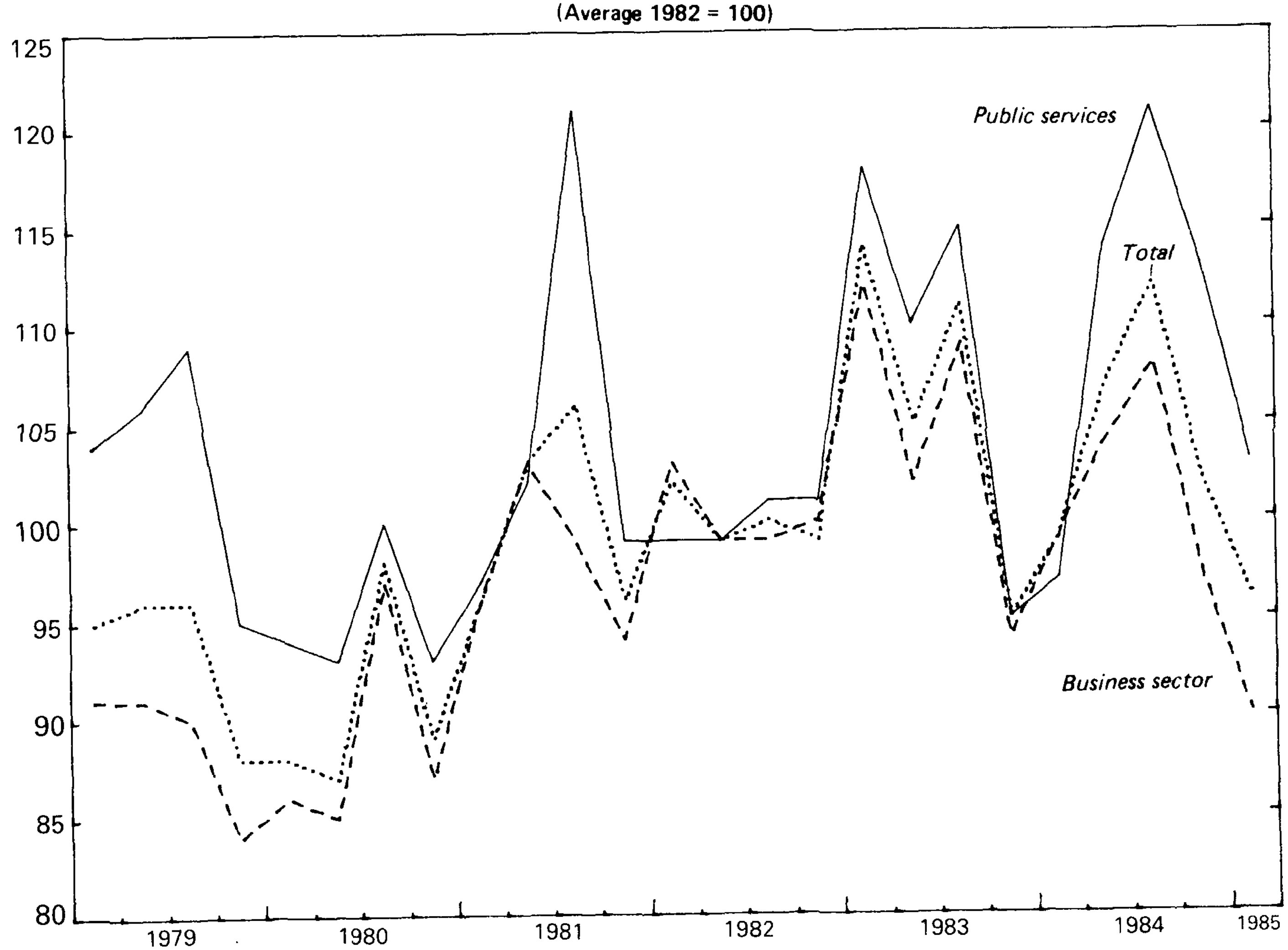
Source: Data provided by the Ministry of Finance.
[1]GNP data adjusted to fiscal year (April-March) basis.

CHART F

ISRAEL

REAL WAGES

(Average 1982 = 100)



Source: Data provided by the Bank of Israel

goods would be allowed to rise by between 3 percent and 5 percent monthly though with some larger "catching up" increases in February. The 13 1/2 percent increase in prices in February 1985, though not unexpected, led to pressure for a return to a more rigid form of arrangement which culminated in a new price freeze to begin on April 1 for a period of two months. The price freeze did not apply to subsidized goods and services or to indirect taxes and the cost of living arrangement returned to a compensation of 80 percent of the full consumer price increase. The intention was that another adjustment of prices would take place at the beginning of June, followed by a further two-month price freeze.

5. Trade policies and exchange restrictions

The authorities emphasized that they supported a liberal world trading system and favored minimizing domestic trade barriers and export subsidies. However, given the special geographical and political situation of Israel, there was a need for government assistance to exporters particularly for the development of infrastructure and marketing. The authorities saw the March 1985 initialing of the Free Trade Agreement with the United States as of major importance in enabling the export of a wide new range of products to a large potential market. The impact of the agreement would be gradual, as it provided for three rounds of cuts in tariffs and subsidies in the period up to 1995. The authorities confirmed that it was their intention to effect the reduction in export subsidies required under the agreement across the board and not merely for exports to the United States.

The authorities also attempted in 1984 to check capital outflows and protect the reserves by the introduction and intensification of various trade and exchange restrictions. Apart from the renewal of the 2 percent import levy, the 1 percent levy on the purchase of foreign exchange and the 15 percent non-interest-bearing import deposit requirement, a series of new measures were taken to curb imported goods. In July 1984 the provision of foreign exchange for the prepayment of imports was suspended and in October, a six-month ban was imposed on the import of some 50 commodities considered luxury items and replaced in February 1985 by a 60 percent non-interest-bearing deposit requirement to be reduced by 3 percent a month until February 1986. Various measures were also taken to curb invisible imports and outflows of capital, including a 15 percent tax on imported services, an increase in the travel tax to US$150 per person per journey, a reduction in the travel allowance from US$2,000 to US$1,000 per journey, the abolition of the allowance for foreign gifts and support payments except for students, and a ban on the voluntary prepayment of foreign obligations. Israel also maintains an exchange rate insurance scheme for export proceeds--to which exporters may choose to subscribe--which maintains a purchasing power parity rate of exchange for exports by adjusting proceeds for the cumulative difference between the domestic rate of inflation and the depreciation of a weighted average of bilateral exchange rates for the shekel over a specified period of time. The losses resulting from the operation of the scheme, which in 1984 were estimated at US$250 million, have been fully met from the government budget.

While some restrictions have been an important source of revenue, the authorities emphasized that it was their policy to improve the balance of payments by increasing exports rather than curtailing imports. It was debatable how much import deposit requirements and similar measures reduced total imports or merely led to a switch from one category of imports to another: some of the measures notably the ban on imports of luxury goods had been introduced for mainly psychological reasons to underline Israel's difficult foreign exchange position. Equally, the authorities stressed that while there were no immediate plans to change current exchange control restrictions, they were seen as temporary measures.

V. Policy Issues

1. The balance of payments and external debt

Israel has experienced endemic balance of payments difficulties and built up a large external debt over recent years. Total external debt in 1984 was larger than GNP and gross debt service was equivalent to 41 percent of exports of goods and services (28 percent for net debt, i.e., after allowing for the income on Israel's foreign assets) (Table 4). The bulk of central government debt and over half of total debt represents the counterpart of military imports but over the past ten years the deficit on civilian goods and services account has increased considerably due in part to the higher cost of oil imports. The financing of investment needed for the country's development has also contributed to the debt build-up but the increase in foreign debt has been faster than that of investment, suggesting that part of the foreign borrowing has supported public and private consumption.

In 1984 the current account position improved and a further improvement is in prospect in 1985 due to the projected restraint on domestic demand and increase in official transfers. So long as the cuts in the 1985-86 budget are fully implemented, the authorities' goal of achieving a current account surplus in order to reduce both the external debt and reliance on foreign assistance could be within reach. The structure of the external debt is also especially favorable, with short-term debt representing only 15 percent of the total (Table 4), and if the adjustment effort is pursued steadfastly over the medium term, a marked reduction in the debt service ratio could be achieved (see Section VII). Nevertheless, the authorities are aware that the balance of payments situation remains vulnerable. The current account position could again deteriorate rapidly if demand restraint is eased or if competitiveness is not maintained, and the capital account remains sensitive to changes in expectations, savings incentives, or the size of the budget deficit.

2. Inflation

During the past year, inflation reached levels where control over business and budgetary accounts expressed in local currency became virtually impossible. The movement away from the shekel as a unit of account accelerated and the U.S. dollar was widely used for that purpose. Indeed, the exchange rate came to be an important indicator for price adjustments in the economy. The costs of large and erratic fluctuations in the inflation rate in terms of disruption to business activity, problems for financial management and loss of efficiency became increasingly evident and led to pressure for a more active anti-inflation policy.

The Israeli representatives agreed that the high but stable inflation rates prevailing in 1979-82 had costs for the economy, though these were difficult to quantify. The rapid expansion of financial services, although included in GDP, probably reflected attempts by businesses and households to cope with inflation. The proliferation of financial instruments, most of which were indexed either to the CPI or the dollar, had permitted a relatively high rate of saving in Israel but the additional resources required in the financial sector were apparently at the expense of more productive activities. In Israel, the Government gains little, if anything, from inflation as the bulk of the public debt is indexed, tax collections are adversely affected, and the part of the monetary base due to central bank lending to the Government has declined in terms of GDP.

The Israeli representatives noted that in the 1970s and the earlier part of the 1980s the rate of inflation had been relatively stable for periods covering several years, but jumped in stages to successively higher plateaus (Chart D). While they accepted the relationship over time between liquidity creation to finance the budget deficit and the rate of inflation, in the short run they noted that surges in inflation had mainly resulted from "price shocks" such as devaluations, increases in energy prices, or cuts in subsidies. There was thus also an indirect relationship between public finances and the rate of inflation to the extent that deficits contributed to a deterioration of the balance of payments which eventually required a corrective devaluation. The indexation of the bulk of financial assets meant that any price increase, whatever its origin, was automatically accommodated by an increase in liquidity and financial wealth. Wage indexation, however, does not bear a prime responsibility for the inflation process: indexation is only partial. 1/ Rather, trends in real wages have depended on discretionary wage awards and on variations in the rate of inflation.

The relative stability of inflation during fairly long periods was more difficult to explain. Factors such as attempts at stabilizing the exchange rate or prices of subsidized commodities, or limits to credit expansion in nominal terms probably played a part. The situation since the end of 1983, characterized by highly erratic changes in the rate of inflation, seemed to confirm that, in the absence of such factors, inflation was inherently unstable and potentially explosive.

1/ Eighty percent when the cumulated rate of inflation reaches 12 percent or 90 percent if the monthly rate of inflation exceeds 25 percent.

3. Domestic debt

The persistent large budget deficits have resulted in the build-up of an extremely high level of domestic debt. At end-1983, total domestic debt was estimated at around US$35 billion, over 150 percent of GNP. This large debt overhang has significantly increased the difficulty of implementing effective fiscal and monetary policies. Attempts at reducing the budget deficit have been constrained by the sharply rising share of interest payments in expenditures. The ability to target any monetary aggregates has been vitiated not only by widespread indexation of financial assets but also by the size and high degree of liquidity of the domestic debt. While precise data are not available, a large portion of the domestic debt at end-1984--perhaps up to 50 percent--was de facto liquid, in contrast with the very favorable maturity structure of the external debt.

The size and liquidity of the domestic debt have made it increasingly difficult to refinance. Total interest and maturity payments are projected to continue at around US$3 billion a year in the next three fiscal years; a particular problem will arise in 1988-89 when payments of up to US$8 billion are projected, the precise amount being contingent on the price of bank shares under the government support arrangement. The authorities accepted that it will be difficult even to roll over internal debt over the next few years. It was arguable whether the current level of internal debt to GNP was close to the maximum sustainable ratio, though clearly the ability to maintain this ratio depended on the overall economic position. A particular problem was the dominance by government of the capital market: at end-1984, following the bank share support arrangement and the collapse of the Israeli stock market, over 90 percent of the public's financial assets were liabilities or potential liabilities of the Government. The major potential alternative to government-backed assets was foreign exchange. These difficulties in managing the current level of domestic debt underlined the need for a substantial immediate reduction in government deficits.

4. Structural problems

Major structural problems have arisen in Israel in recent years which have weakened the economy's responsiveness to changes in market conditions, reduced productivity, and lowered growth. In considerable part, these difficulties have stemmed from the public sector's expanding role in economic activity, both directly as a major employer and indirectly through subsidies, transfers and taxation. As regards employment, a particular feature of past years has been the large volume of labor absorbed into the public services. The flexibility to deal with this problem is restricted to a considerable degree by institutional arrangements in the labor market which make it difficult to fire or redeploy redundant staff. These arrangements reflect a particular sensitivity about sustaining employment, but the authorities recognize that efforts will be needed to ensure that labor moves toward more productive forms of activity.

The character of Israel's system of taxes and regulations has also acted as an important disincentive to a more efficient allocation of resources. Incentives to work have been seriously inhibited both by the heavy tax burden on wage earners and by the large gap between take home pay and employers' labor costs, while the scope for matching employees' remuneration with productivity performance has been correspondingly weakened. For employers, the extensive array of subsidies and grants has had a major impact on the allocation of resources and many industries--including some large public corporations--would clearly not be viable without the aid of these support mechanisms. In part these subsidies have resulted from a persistent overvaluation of the shekel, with the effect on exports compensated by subsidies and on imports by tariffs, levies and import deposits. The various structural problems have not only had a directly adverse effect on the economy's growth potential and productivity performance, but also appear to have diminished Israel's attractiveness to foreign investors.

VI. Policies for the Period Ahead

1. General

The Israeli authorities accepted that the character of Israel's economic problems ruled out piecemeal solutions. The practice of attempting to deal with one problem at a time, be it the balance of payments or inflation, had not produced satisfactory results. The new Government of national unity attached a high priority to improving Israel's economic position with measures--such as the recent package deals--commanding the support of both the labor and employers' federations.

There was a fairly broad consensus in Israel that a sharp cut in the budget deficit was a prerequisite in order (1) to reduce domestic demand and thus the current account deficit; (2) to avoid fueling inflation by the injection of a large amount of liquidity into the economy; and (3) to stop the vicious circle of public debt servicing and budget deficits reinforcing each other. Given the high burden of taxation, it was accepted that the bulk of the deficit reduction should take the form of cuts in government expenditure, difficult though these were to achieve. The authorities viewed the 1985/86 budget as a major step toward stabilization, though they did not rule out additional measures in the second half of the calendar year after the forthcoming Histadrut elections. In their view, the deficit could not be cut drastically over a short period and they hoped that circumstances would become more favorable in the not too distant future for a reduction of defense spending.

The authorities saw the need for fiscal policy to be supported by a restrictive monetary policy and they proposed to continue to maintain real interest rates at high levels. They had taken some steps to discourage holdings of index-linked short-term assets and envisaged the possibility of further such measures, which had the merit of increasing the scope for both monetary and exchange rate policy. Given the dominance by the

Government of the capital market, they emphasized the need to proceed carefully to avoid damaging the creditworthiness of government instruments which could have an adverse effect on savings and produce capital outflows.

The authorities accepted that, after the large gains recorded in recent years, some reduction in real wages was needed to improve Israel's competitiveness. Such a reduction would mitigate the impact of the stabilization measures on employment as well as benefit the fiscal position. Exchange rate policy would continue to be aimed at preserving and, when possible, enhancing the competitiveness of the Israeli economy in order to channel the resources freed by the reduction of consumption into the production of tradable goods.

2. Fiscal policy

The financing requirement for the 1985/86 budget is to be cut by over one half from 1984-85 levels to 9 percent of GNP (Table 5). Various revenue measures are projected to yield revenues equivalent to about 3 1/2 percentage points of GNP, with a net increase in total revenue--reflecting cuts in other revenue sources--of about 3 percent of GNP (see Recent Economic Developments). On the expenditure side (excluding direct defense imports) the 1985/86 budget proposes cuts amounting to slightly above US$1 billion, equivalent to about 5 percent of GNP. These efforts are concentrated in a reduction of subsidies by approximately US$650 million, cuts in education and health services of US$200 million, and curtailment of expenditures in other areas by about US$200 million. Subsidies for oil products and electricity were completely eliminated in February 1985, while subsidies for basic foodstuff and public transportation are targeted to be reduced in early fiscal year 1985/86 to about one-third of the average level in the previous fiscal year.

Notwithstanding the reduction in the deficit, credit requirements from the Bank of Israel are projected to amount to the equivalent of US$1.9 billion (9 percent of GNP) because of net amortization of foreign debt and a substantial decline in net domestic borrowing from the nonbank public. Legislation has been proposed which would limit and eventually prohibit monetary financing of the budget deficit by the Bank of Israel.

The Israeli representatives emphasized that the proposed budget was extremely tight and there were many pressures to increase expenditure and eliminate or postpone some of the proposed tax measures. They stressed that significant expenditure reductions had been made, particularly given that actual budget outturns for FY 1984/85 were well above the budget levels originally presented and that the burden of debt service payments had continued to rise.

The authorities outlined the measures that have been taken to improve implementation of the budget. First, the Cabinet had approved specific cuts for individual ministries, as well as general cuts in subsidies and transfers. Second, a new budget law extends budget control over the financial operations of local authorities, universities, and other decentralized agencies which are supported financially by the Government, and limits access of these bodies to bank credit. Finally, the law increases penalties for overspending. However, the budget remains presented in constant prices and actual shekel expenditures are adjusted in line with various price indices.

3. Monetary and external policies

Monetary policy in 1985 is intended to complement fiscal policy by maintaining both nominal and real interest rates at high levels so as to restrict the growth of credit to the private sector. The levels of nominal rates required will obviously depend on the success of the package deals in reducing inflation. Policy continues to aim at reducing the spread between debit and credit interest rates in order to discourage disintermediation, and expand the shekel base for monetary policy operations.

The authorities intend to continue their current exchange rate policy of maintaining and, when possible, enhancing competitiveness. The latest price freeze agreement effective since April 1, 1985 permits continued adjustment of the exchange rate. The authorities were well aware that, without measures to curb inflation, a large nominal depreciation of the shekel was unlikely to result in a sustainable real devaluation.

VII. Outlook

1. Short-term

In 1985, the authorities expect to continue their policy of compressing domestic demand, all the components of which are forecast to decline for the second successive year, although the projected fall of 2 1/2 percent is considerably less than in 1984 (Table 1). Investment is projected to fall by 10 1/2 percent, due in considerable part to restraint in government investment activity. A projected decline in public consumption (excluding defense imports) by a further 1 1/2 percent in 1985 is consistent with budget estimates, and would involve cuts in both the wage and nonwage components. Private consumption is projected by the authorities to fall only marginally in 1985. Real private disposable incomes are expected to fall in 1985 because of higher tax payments, proposed cuts in subsidies and a modest drop (2 percent) in real wages, but the private savings ratio is also projected to ease back somewhat after a major recovery in 1984. With the compression of domestic demand expected to be more than offset by an improvement on external accounts, real GDP is forecast to rise marginally by around 1 percent in 1985. However, this slow pace of economic growth is expected by the authorities to be insufficient to absorb additions to the labor force, so that the unemployment rate is projected to climb further to about 7 1/2 percent on average over the year. There is no official forecast for inflation in 1985; Israeli representatives hoped that it would be below half of the 1984 rate.

The fall in domestic demand is projected by the authorities to result in a further decline (by about 1 1/2 percent) in nondefense imports in 1985. By contrast, growth in the volume of exports--while less buoyant than in 1984--was expected to reach 7 1/2 percent with benefits again derived from improved external competitiveness and enlarged productive capacity, particularly in high technology and related goods where significant investment has been undertaken in recent years. In sum, the improvement in the civilian trade account is seen to result mainly from an overall reduction in real domestic absorption and a further modest improvement in market shares. With the net services account expected to strengthen a little in 1985, the deficit on civilian goods and services account is projected to decline by about US$700 million to US$2.7 billion (12 percent of GNP) (Table 3).

Defense imports, which have typically shown much volatility in recent years, are projected by the authorities to increase by 44 percent for the second successive year. Intergovernmental transfers, however, are expected to rise substantially as a result of enlarged grants from the United States amounting to US$1.2 billion in economic aid (excluding any emergency assistance) and US$1.8 billion in military aid. The recent decline in private and other transfers is expected to be halted in 1985 so that total transfers are projected to offset most of the total deficit on goods and services account. Largely because of the better trade performance and enlarged transfer receipts, the current account deficit is projected to show a substantial improvement, declining by more than US$1.4 billion to US$250 million (1.1 percent of GNP); if emergency economic assistance is received from the United States, the current account could be in surplus. Gross medium- and long-term capital inflows are expected to be markedly lower in 1985--principally because U.S. military assistance will be provided as grants rather than as loans--and are projected to be broadly in line with loan repayments. Altogether, these forecasts imply a general stabilization of Israel's net external debt position in 1985.

In presenting these projections for 1985, the authorities emphasized their essentially normative character. In particular, the forecasts were based on the critical assumption that the Government's proposed budget would be voted and implemented without significant modification. Furthermore, the accompanying policies would also need to be carried out as planned, especially the maintenance of international competitiveness.

2. Medium term

The authorities stated their major goals for the medium term as a reduction in inflation, the revival of economic growth, and the consolidation of the balance of payments and external debt situation. Important assumptions underlying the medium-term projections are (1) continuing restraint of domestic demand, in particular of public consumption, and (2) a somewhat larger share of Israeli exports in world trade than in recent years. This required further cuts in the budget deficit and a flexible exchange rate policy in the years ahead.

Medium-term balance of payments and external debt projections, which rest on the envisaged policies, are given in Table 7. Under the "adjustment scenario," the civilian goods and services deficit would stabilize and, reflecting the high level of U.S. grants, the current account would turn into a surplus and the debt service ratio would fall. With moderately lower export growth rates (Scenario II), there is still a slight improvement in the civilian goods and services deficit, but this is not enough to prevent a rising balance of payments gap, and external debt continues to increase. Where sluggish export growth is combined with a moderate increase of imports resulting from less restrictive domestic policies (Scenario III)--both the civilian goods and services deficit and external indebtedness continue to increase. Both variants would sooner or later lead to an untenable position.

Budgetary projections are based on three possible scenarios for the coming years (Table 8). An "adjustment" scenario assumes that all the fiscal policies announced in the 1985/86 budget would be implemented fully and on time, and the same positive trends would continue in the following years. On that basis, the budget deficit would decline to less than 2 percent of GNP in the later years, and be financed entirely from sales of domestic bonds, eliminating completely any financing needs from the Bank of Israel. Notwithstanding this favorable projection, the cost of government interest payments as a proportion to GNP remains high and declines slowly; therefore, the burden of cutting the deficit falls disproportionately on noninterest expenditure.

Under the two alternative scenarios, which contemplate only partial adjustment and no adjustment at all, performance of the Central Government operations would be quite different. Under the first scenario, the deficit would be maintained at about 6 percent of GNP, resulting in relatively high rates of inflation and pressure on the balance of payments. Under the no-adjustment scenario, inflation would most likely accelerate and push down the economy to an untenable position with rapidly deteriorating internal and external imbalances.

VIII. Staff Appraisal

In 1984, Israel's long-standing economic difficulties reached the crisis stage. Capital outflows accelerated and threatened to reduce official reserves below what the authorities consider the minimum acceptable level. Inflation, which in the last quarter of 1983 had risen well above the 100-130 percent plateau where it had stabilized since 1979, soared after mid-1984 to levels which entail serious costs to efficiency and economic activity.

These developments took place while--and in part because--the policies followed in previous years, which had produced a serious deterioration in the current account of the balance of payments, were being corrected. The policies of boosting demand and slowing the depreciation of the shekel to stabilize inflation were abandoned in the last months of

1983 and in 1984--with the exception of a relapse prior to the general election of July 1984. Public and private consumption, which had increased rapidly in 1981-83, declined in 1984. This, together with a more competitive exchange rate, resulted in a marked improvement in the trade balance and in the current account of the balance of payments. However, the large injection of liquidity resulting from the budget deficit, combined with some delays in adjusting the exchange rate, contributed to capital outflows which were only checked by the large devaluations in October 1983 and September 1984. These produced sharp bursts of inflation which were fully accommodated by an increasing money supply, as the bulk of financial assets is indexed on the CPI or the exchange rate.

The government which took office in September 1984 acted promptly to avert the risks of hyperinflation and of a foreign exchange crisis and to buy time to deal with the underlying causes of Israel's main economic problems. In these respects, it has been successful; but in the view of the staff, some of the measures implemented, viz., a negotiated two-phase wage-price freeze and exchange restrictions, do not correct the economy's basic imbalances and can only provide temporary relief. The freeze has also had the undesirable effect of raising the budget deficit and producing sharp variations in the rate of inflation with potentially destabilizing results.

The staff strongly favors a comprehensive stabilization program which would address the underlying causes of Israel's economic problems. In the past, Israeli governments have tried to deal separately with the balance of payments and inflation problems so that the measures intended to relieve one problem aggravated the other. A comprehensive stabilization program for Israel should include substantial immediate cuts in the government budget, which are indispensable both from a macroeconomic and monetary perspective, a discontinuation of indexation for short-term assets, and a price objective backed with corresponding nominal targets for both monetary expansion and budgetary allocations. Once linkages have been removed for short-term assets, a stabilization program should also include a devaluation at least sufficient to remove both restrictions on imports and subsidies on exports.

The Israeli authorities have, however, opted for a more gradual approach to solving Israel's economic problems and have emphasized the benefits of building a social consensus for the required measures. The key ingredients of the authorities' approach are "package deals" with the social partners supported by cuts in government expenditure, high real interest rates and the maintenance of external competitiveness. It is, however, in the nature of a gradualist approach that it requires continued and consistent progress toward the ultimate goal. The record in Israel, as well as the experience of other countries, inevitably raises doubts about whether such a goal will be achieved, and the staff sees little chance for lasting success unless more far-reaching measures than those currently proposed by the Israeli authorities in the areas of fiscal, monetary and wages policy are taken.

Fiscal policy is a key area. The authorities have targeted domestic expenditure cuts of around US$1 billion, equivalent to almost 5 percent of GNP, for the 1985-86 fiscal year, with around two-thirds of this reduction resulting from lower spending on subsidies. The 1985-86 budget proposals imply recourse to Central Bank financing equivalent to about 9 percent of GNP, a worrisomely large addition to the monetary base, particularly in the light of the planned reduction in the absorption of liquidity through the balance of payments. Equally, given the extremely high level of domestic debt, it is doubtful whether the authorities will be able to roll over maturing debt on the scale assumed. For these reasons, the staff considers that the budget cuts proposed by the authorities are insufficient and that further cuts of a roughly equivalent order of magnitude are required. Moreover, there are worrying signs that the 1985-86 budget figures, as in previous years, may not be met: the Knesset has already reduced some proposed budget cuts, some revenue measures were not enacted and some of the adjustment of the prices of subsidized goods was postponed. In the staff's view, a higher budget deficit than proposed would threaten achievement of external targets.

Budgetary control in periods of high and variable inflation remains a major problem. The authorities are to be commended for the steps they have taken to improve budgetary management, but there is a need for further measures to improve control, and to replace the current practice of presenting the budget in constant prices which only serves to validate inflation by limiting appropriations in line with an inflation target.

The staff supports the legislation proposed by the authorities to limit and eventually eliminate monetary financing of the budget deficit by the Bank of Israel, especially as it underscores the central importance of further budget deficit reductions. Meanwhile, the steps taken by the authorities in 1984 in order to secure larger debt sales, lengthen the maturity of the debt, and to reduce the liquidity of longer-term debt are to be welcomed. Of particular importance are more variable long-term interest rates, higher costs of withdrawal from long-term saving schemes and greater reliance on sales of marketable instruments by tender.

The authorities are to be praised for maintaining high real interest rates during 1984 and early 1985 despite strong pressure for reductions in interest rates. The steps taken to discourage investment in short-term index-linked assets, to increase the shekel money base, and to reduce the segmentation of credit markets are also to be welcomed. The operation of monetary policy has, however, been made very difficult by the size of the budget deficit and of the public debt. The current operation of monetary policy--which mainly controls the real growth of credit to the private sector--combined with the indexation of liquid assets has resulted in the growth of monetary aggregates accommodating inflation. The staff believes that an essential step for monetary control would be the elimination of CPI or dollar linkages for liquid assets and their replacement by flexible interest rates on all such assets. But a sustained reduction in inflation will only be possible when borrowing from the Bank of Israel to finance the budget deficit is sufficiently reduced to permit control over some nominal monetary aggregates.

The authorities have expressed their concern that more drastic measures would result in rising rates of unemployment. It must be realized, however, from the example of other high inflation countries, as well as Israel's recent experience, that in the absence of action to deal with inflation, unemployment is likely to rise in any event. The rise in unemployment associated with stabilization, however, could be checked if wage and salary earners accept some reduction in their real earnings after the substantial gains made since 1981. The authorities' official forecast suggests a 2 percent reduction in average real wages for 1985: these forecasts imply a disappointingly large rise in real wages during the course of 1985. The staff is concerned by the continued rise of wage costs in excess of productivity in the private sector and by the even faster rise of wages in the public sector. An explicit policy of wage containment in the public sector would have the twin advantages of reducing public expenditure and of encouraging the needed transfer of resources to the traded goods sector.

The authorities have emphasized their determination to maintain Israel's competitiveness. The staff agrees that it is essential that exchange rate policy continues to be decided on grounds of external competitiveness and should be reviewed in the light of progress towards the external targets for 1985.

Finally, the staff is concerned about the proliferation of implicit exchange rates due to the maintenance of trade and exchange restrictions and the resulting misallocation of resources and encouragement to capital outflows. The staff hopes that, as soon as changes in the present indexation arrangements permit, the authorities will adjust the exchange rate so as to eliminate both import restrictions and export subsidies. There is also a general need to reduce the increasingly pervasive involvement of the Government in economic activity in Israel and to enhance employees' incentives to work by easing the tax burden.

Over the past year the Israeli authorities have introduced or intensified various exchange restrictions and multiple exchange rate practices. These actions were taken in response to concern about declines in official reserves and government revenues and are intended to be temporary. The measures currently in force, which involve exchange restrictions subject to Article VIII, Section 2, are the suspension of the residents' allowance for foreign transfers for support payments and gifts, and the foreign currency travel allowance of US$1,000 per person per trip, while the imposition of a 15 percent tax on imported services gives rise to a multiple currency practice under Article VIII, Section 3. Israel also maintains an exchange rate insurance scheme for export proceeds which has given rise to exchange transactions being conducted at effective exchange rates differing by more than 2 percent from the generally applicable exchange rate. The losses from the operation of this scheme have been fully met from the government budget. Although available data suggest that the official subsidy has diminished in recent months, it is not possible to foresee whether or not it would be eliminated. The scheme could therefore give rise to a further multiple currency practice subject to Fund approval under Article VIII, Section 3. In the present circumstances of Israel, Executive Board approval of the exchange restrictions and multiple currency practices is not being proposed, and the staff is of the view that the authorities should adopt policies that would permit a return to a liberal exchange and trade system, including the operation of any exchange rate insurance scheme on a self-financing basis.

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

The following draft decision is proposed for adoption by the Executive Board.

Proposed Decision

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Israel, in light of the 1985 Article IV consultation with Israel conducted under decision No. 5392-(77/63), adopted April 24, 1977 (Surveillance Over Exchange Rate Policies).

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

Table 1. Israel: Demand and Supply

	1980	1981	1982	1983	1984	Official Forecast 1985
	(Percentage change at constant prices)					
Private consumption	-2.9	10.9	7.2	7.0	-5.6	-0.5
Government consumption 1/	3.5	0.8	4.8	4.8	-3.9	-1.5
Domestic defense expenditure	(7.8)	(0.7)	(8.6)	(8.1)	(-6.9)	(-1.8)
Other	(-1.2)	(0.9)	(0.4)	(0.8)	(0.0)	(-1.1)
Gross domestic investment	-15.2	-7.1	14.6	8.0	-9.2	-10.6
Gross domestic expenditure	-4.5	4.7	8.1	6.7	-5.9	-2.6
Exports of goods and services	6.3	4.4	-3.2	2.2	12.6	7.7
Aggregate demand	-1.7	4.6	4.6	5.5	-0.9	0.4
Imports of goods and services 1/	-10.7	8.1	11.1	11.4	-4.7	-1.5
GDP at market prices	3.1	2.8	1.0	1.8	1.6	0.8
	(In percent of GDP at current prices)					
Gross domestic expenditure 1/	107	107	113	115	109	104
Private consumption	59	61	63	65	62	61
Domestic defense expenditure	13	14	15	15	14	14
Other government consumption	12	12	12	12	12	12
Gross domestic investment	23	21	24	23	21	18
Foreign balance	-7	-7	-13	-15	-9	-4
Exports of goods and services	46	46	41	39	45	48
Imports of goods and services 1/	53	53	53	54	54	53

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

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

Table 2. Israel: Prices and Wages

(Change in percent)

	1980	1981	1982	1983	1984	March 1985
Yearly average 1/						
Consumer prices	131	117	120	146	374	405
Wholesale prices	135	123	126	144	397	415
GDP deflator	127	126	121	149	376	...
Real wages (as income) 2/	-3	10 1/2	-1/2	6	-2	...
Real wages (as cost) 3/	-5 1/2	8 1/2	-3	2 1/2	-3	...
Real unit labor costs	-7	0	7	4	-4	...
Through the year 4/						
Consumer prices	133	102	132	191	445	412
Wholesale prices	138	105	138	202	447	398

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

1/ Changes in the annual average for the calendar year, except for the final column which compares the average for the year ending March 1985 with the average for the comparable period a year earlier.
2/ Average wages per employee post deflated by the consumer price index.
3/ Average wages per employee post deflated by the net domestic business sector product deflator.
4/ December on December change, except for the March 1985 column which shows the percentage change over the corresponding month of the preceding year.

Table 3. Israel: Summary Balance of Payments

(In millions of U.S. dollars)

	1980	1981	1982	1983	1984 1/	1985 2/
Exports	5,799	5,907	5,560	5,511	6,128	6,539
Nondefense imports	-7,327	-7,251	-7,336	-7,765	-7,321	-7,138
Civilian trade balance	-1,528	-1,344	-1,776	-2,254	-1,193	-599
Net services	-597	-851	-1,529	-1,855	-2,209	-2,068
Civilian goods and services	-2,125	-2,195	-3,305	-4,109	-3,402	-2,667
In percent of GNP	(10.7)	(10.4)	(15.1)	(16.7)	(15.2)	(12.1)
Direct defense imports	-1,655	-2,160	-1,520	-1,000	-1,464	-2,103
Intergovernmental transfers	1,493	1,345	1,197	1,555	2,061	3,320
Private and other transfers	1,474	1,582	1,421	1,304	1,112	1,200
Current account	-813	-1,428	-2,207	-2,250	-1,693	-250
In percent of GNP	(4.1)	(6.8)	(10.1)	(9.1)	(7.6)	(1.1)
Medium- and long-term capital (net)	1,243	1,246	1,213	2,227	1,247	88
Official	(1,373)	(1,292)	(1,228)	(1,173)	(1,267)	(238)
Private (nonbanks)	(-130)	(-46)	(-15)	(1,054)	(-20)	(-150)
Commercial banks (net)	121	736	1,626	224	-100	-100
Short-term capital (net)	-76	163	44	-537	584	...
Official	(-107)	(220)	(43)	(-413)	(395)	(...)
Private	(31)	(-57)	(1)	(-124)	(189)	(...)
Errors and ommissions	6	-222	120	205	-638	...
Overall balance	481	495	797	-131	-600	...

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

1/ Provisional.
2/ Staff estimates based on official forecasts.

Table 4. Israel: Selected External Debt Data

	1980	1981	1982	1983	1984	1984
	(In millions of U.S. dollars; end period)					
Gross debt	22,101	24,606	28,203	29,629	29,819 1/	
Adjusted gross debt 2/	16,237	18,319	20,988	22,741	23,366	
In percent of GNP	(82.1)	(87.0)	(95.9)	(92.2)	(104.6)	
Net debt 3/	11,640	13,370	15,475	17,889	20,094 1/	
	(In percent of total)					(In millions of U.S. dollars)
Adjusted gross debt, by debtor						
Government sector	73	72	68	67	70	16,327
Private sector	24	25	29	29	28	6,544
Other 4/	3	3	3	4	2	495
Adjusted gross debt, by creditor						
Foreign governments and international institutions	48	47	45	46	47	10,949
State of Israel bond-holders	17	16	15	15	14	3,344
Foreign banks and other	35	37	40	39	39	9,073
Adjusted gross debt, by maturity						
Long-term (5 years +)	75	74	71	70	70	16,463
Medium-term (1-5 years)	14	13	14	16	15	3,440
Short-term	11	13	15	14	15	3,463
	(In percent of exports of goods and services) 5/					
Debt service						
Gross debt	31.5	37.6	43.8	40.3	40.8	
Adjusted gross debt	28.1	26.4	30.7	29.2	32.7	
Net debt	21.9	21.4	24.6	24.0	28.3	
	(In percent of total current receipts) 5/					
Debt service						
Adjusted gross debt	21.0	19.9	23.5	21.9	24.4	

Source: Information provided by the Israeli authorities.
1/ End-September.
2/ Gross debt minus foreign assets of commercial banks.
3/ Adjusted gross debt minus official reserves and export credit provided.
4/ Deposits with Bank of Israel against deposits of foreign residents and deposits of banks abroad.
5/ Excluding investment income.

Table 5. Israel: Developments of Summary Budget Transactions, 1980/81-1985/86

(In percent of GNP)

	1980/81	1981/82	1982/83	1983/84	Estimate 1984/85	Budget 1985/86
Total revenue	44.3	44.6	51.2	50.0	44.7	47.9
Tax revenue	35.7	36.7	40.5	39.3	37.2	39.6
Nontax revenue 1/	8.6	7.9	10.7	10.7	7.5	8.3
Total expenditure and net lending	64.8	70.5	71.1	72.8	78.9	69.3
Transfers and subsidies	18.4	21.9	19.8	19.0	20.4	17.5
Interest payments 2/	5.9	9.5	11.8	12.2	14.0	15.0
Defense	24.1	22.4	21.3	22.0	25.8	18.9
Domestic expenditure	(12.8)	(13.2)	(14.9)	(12.3)	(12.0)	(10.5)
Purchases abroad	(11.3)	(9.2)	(6.4)	(9.7)	(13.8)	(8.4)
Other current expenditure	8.0	8.2	9.7	9.5	8.7	8.3
Capital expenditure 3/	8.4	8.5	8.5	10.1	6.5	6.6
Unallocated	--	--	--	--	3.5	2.9
Budget balance	-20.5	-25.9	-19.9	-22.8	-34.2	-21.9
Foreign grants	8.9	7.5	5.2	7.2	14.6	12.3
Financing requirement	-11.6	-18.4	-14.7	-15.6	-19.6	-9.1
Financing						
Foreign borrowing (net)	4.9	5.3	5.3	5.8	2.9	-1.6
Domestic bond issues (net) 4/	8.3	9.3	3.9	2.4	5.3	2.0
Net credit from Bank of Israel	-1.6	3.8	5.5	7.4	11.4	8.7

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

1/ Excludes Bank of Israel profits and sales of bonds to the National Insurance Institute.

2/ Excludes computed interest payments to the Bank of Israel.

3/ Includes support purchases of bank shares in 1983/84.

4/ Includes sales of bonds to the National Insurance Institute.

Table 6. Israel: Selected Monetary and Credit Developments

(End period; except where stated)

	1980	1981	1982	1983	1984
	(Nominal percentage change over previous year)				
Monetary base					
M4 base	147	94	120	256	421
Due to (in percentage points)					
Automatic indexation related increments	122	91	114	204	380
Discretionary factors					
Public sector injection	33	32	36	82	107
Directed Bank of Israel credit	20	-20	-19	13	9
Loan to banks	--	-1	2	15	9
Other	3	8	2	-1	-5
Less net foreign currency purchases by private sector	-31	-17	-16	-57	-79
M4	148	95	132	215	435
	(Real percentage change from previous year) 1/				
M4 base	6	-4	-5	22	-4
Monetary aggregates					
M4	6	-3	--	8	-2
Money supply (M1)	-14	-12	-9	-20	-17
Time deposits and CD's	19	60	68	-11	2
Patam deposits	5	1	-4	44	12
Tradable government bonds	14	-12	-7	-17	-25
M4 plus bank shares (M5)	17	13	15	-19	13
Liquid and medium-term financial assets	17	15	37	-30	13
Total financial assets 2/	14	16	30	-20	11 3/
Credit aggregates					
Bank credit to the private sector	-3	-8	1	-18	10
Directed credit 4/	4	-12	-18	-6	13
Nondirected credit	-7	-5	13	-23	9
Medium- and long-term credit	-12	13	22	23	16 3/
Total credit	-7	1	11	4	14 3/
	(As a percentage of GNP, 5/ year average)				
Total financial assets	149	154	195	192	198 3/
Government liabilities in total financial assets	121	118	128	157 6/	179 3/6/

Sources: Information provided by Bank of Israel; and staff calculations.

1/ Nominal rate deflated by consumer price index.
2/ Includes social insurance and life insurance funds.
3/ Provisional estimates.
4/ Credit granted on preferential terms, virtually all for exports.
5/ GNP comparisons are heavily distorted by the rate of inflation and can only be taken as broad order of magnitude showing the direction of trend. Calculations based on dollar conversions would show significantly lower percentages.
6/ Includes bank shares under the October 1983 arrangement as a contingent government liability; if these shares are excluded, the percentages are 147 for 1983 and 164 for 1984.

Table 7. Israel: Medium-Term External Debt Scenarios 1/

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

	1984	1985	1986	1987	1988
		I. "Adjustment Scenario"			
Civilian goods and services account	-3.4	-2.7	-2.2	-2.1	-2.1
Defense imports	-1.5	-2.1	-2.0	-2.0	-1.8
Total transfers	3.2	4.5	4.4	4.4	4.1
Current account	-1.7	-0.3	0.2	0.3	0.2
Net medium- and long-term capital	1.2	0.1	--	-0.1	-0.1
Short-term borrowing (including commercial banks)	0.5	0.1	-0.1	-0.2	--
Increase in international reserves	-0.6	-0.1	--	--	0.1
External debt 2/ (end-year)	23.4	23.6	23.5	23.2	23.1
Short-term debt	3.5	3.6	3.5	3.3	3.3
Medium- to long-term debt	19.9	20.0	20.0	19.9	19.8
Debt in percent of GNP	105	107	104	100	95
Short-term debt in percent of GNP	15	16	15	14	13
Debt service in percent of exports of goods and services 3/	33	30	28	26	25
		II. "Sluggish Export Growth"			
Civilian goods and services account	-3.4	-2.9	-2.6	-2.8	-3.2
Debt in percent of GNP	105	108	107	106	106
Short-term debt in percent of GNP	15	17	18	20	24
Debt service in percent of exports of goods and services 3/	33	31	29	29	29
		III. "Domestic Expansion"			
Civilian goods and services account	-3.4	-3.4	-3.5	-3.7	-4.3
Debt in percent of GNP	105	110	113	115	120
Short-term debt in percent of GNP	15	20	24	30	38
Debt service in percent of exports of goods and services 3/	33	32	32	32	33

Source: IMF staff.

1/ Main assumptions underlying Scenario I are: an annual average growth of GNP in 1985-88 around 2 percent, export growth around 6 percent, and import growth around 2 percent. United States aid to Israel (excluding emergency aid) is assumed to decline slightly toward the end of the projection period. Private medium- and long-term loans falling due are rolled over while there is a moderate net redemption of public medium- to long-term loans every year; reserves increase slightly in 1988. In Scenario II, annual average growth of exports is around 4 percent, while Scenario III combines the lower export growth with higher civilian import growth (3 percent per annum on average in 1985-88).

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

3/ Excluding investment income.

Table 8. Israel: Medium-term Central Government Operations Scenarios, 1984/85-1989/90 1/, 2/

(In percent of GNP, unless otherwise indicated)

	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90
			I. "Adjustment scenario"			
Assumptions						
Revenue	44.7	47.9	48.5	48.7	48.7	48.3
Expenditure	78.9	69.3	67.0	65.9	62.8	60.2
Budget balance (deficit (-))	-34.2	-21.4	-18.5	-17.2	-14.1	-11.8
Foreign grants	14.6	12.3	14.9	14.2	12.6	10.8
Overall deficit 3/	-19.6	-9.1	-3.6	-3.0	-1.5	-1.0
Net foreign financing	2.9	-1.6	-0.9	-1.3	-0.3	-0.3
Net domestic bond sales 4/	5.3	2.0	2.0	1.8	1.8	1.3
Net credit from Bank of Israel	11.4	8.7	2.5	2.5	--	--
Average real rate of interest on government debt (percent)						
Foreign	9.4	10.5	10.3	9.7	10.2	10.3
Domestic	5.0	5.3	6.2	6.9	6.5	7.1
Changes in real GNP (percent)	0.4	--	2.0	3.0	4.0	4.0
Results						
Government interest payments 5/	14.0	15.0	15.8	15.7	14.4	14.4
Other government expenditure	64.9	54.3	51.2	50.2	48.4	45.8
Government debt	188.0	208.0	204.0	198.0	191.0	185.0
			II. "Partial adjustment" scenario			
Revenue		47.2	48.2	48.0	47.9	47.9
Expenditure		70.4	69.0	68.2	66.1	64.3
Overall deficit 3/		-10.9	-5.9	-6.0	-5.6	-5.6
Government interest payments 5/		15.0	15.8	15.8	14.7	14.7
Other government expenditure		55.4	53.2	52.4	51.4	49.6
			III. "No adjustment" scenario			
Revenue		47.2	48.0	48.0	48.0	48.0
Expenditure		70.4	74.8	75.0	74.4	75.1
Overall deficit 3/		-10.9	-11.9	-12.8	-13.8	-16.3
Government interest payments 5/		15.0	15.8	16.0	15.4	16.1
Other government expenditure		55.4	59.0	59.0	59.0	59.0

Source: IMF staff.

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

2/ Starting with fiscal year 1985/86 all projections are made at first-quarter 1985/86 prices.

3/ Deficits after accounting for foreign grants.

4/ Includes purchases of bonds by the National Institute.

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

Israel: Fund Relations

(As of March 31, 1985)

I. Membership Status

(a) Date of membership: July 12, 1954

(b) Status: Article XIV

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 446.6 million

(b) Total Fund holdings of Israel shekels: SDR 446.6 million (100 percent of quota)

III. Stand-By Arrangements approved since 1974

(i) One year stand-by arrangement for SDR 32.5 million (25 percent of quota) approved on November 8, 1974. Fully disbursed; cancelled on February 14, 1975.

(ii) One year stand-by arrangement for further SDR 32.5 million (25 percent of quota) approved on February 14, 1975. Fully disbursed.

(iii) One year stand-by arrangement for SDR 29.25 million (22.5 percent of quota) approved on October 20, 1976. Utilization: SDR 12 million.

IV. SDR Department

(a) Net cumulative allocation: SDR 106.36 million.

(b) Holdings: SDR 64,341 (0.06 percent of net cumulative allocation).

B. Nonfinancial Relations

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

VI. The Board concluded the 1984 Article IV Consultation on June 1, 1984 with the following decision:

"1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Israel, in the light of the 1984 Article IV

Consultation with Israel conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Israel continues to maintain a liberal system of payments and transfers for current international transactions."

Israel is on the standard 12-month consultation cycle.

Israel--Statistical Issues

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

		Latest Data in April 1985 IFS
Real Sector	- National Accounts	1983
	- Prices	February 1985
	- Production	November 1984
	- Employment	November 1984
	- Earnings	November 1984
Government Finance	- Deficit/Surplus	1982) annual
	- Financing	1982) data
	- Debt	1978) only
Monetary Accounts	- Monetary Authorities	October 1984
	- Deposit Money Banks	November 1984 (partial)
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	February 1985
	- Merchandise Trade: Prices	Q3 1984
	- Balance of Payments	Q3 1984
	- International Reserves	January 1985
	- Exchange Rates	February 1985

During the past year, the reporting record of the IFS correspondent has been good.

2. Outstanding statistical issues

a. Money and banking

Data for deposit money banks published in the Bank of Israel's Banking Statistics differ substantially from those reported in IFS and consultation reports. A comparison of both sets of data reveals major differences in sectorization of accounts and in balance sheet totals for the two sources.

b. Government finance

IFS includes only annual data on government finance; debt data are available only through 1978. Data in IFS correspond to the time series reported in the GFS Yearbook. The presentation for Israel in the 1984 Yearbook includes data in the statistical and derivation tables for the consolidated central government through fiscal year 1982 and data on outstanding debt through 1978. The Yearbook also includes data on the operations of local governments through 1981, with the exception of data on outstanding debt.

In discussions with the Israeli delegation at the 1984 Annual Meetings, a technical assistance mission on government finance statistics was proposed around mid-1985. The objectives of this mission would be to reconcile fiscal and monetary statistics, assist in the compilation of debt data, resolve a number of coverage questions of interest, particularly to the Central Statistical Office, and explore further the possibilities for monthly data.

c. International banking

Israel was originally invited to participate in the Fund's international banking statistics project, together with 37 other international banking centers, in March 1982.

In recent correspondence, the Israeli authorities have informed the Fund that they are preparing to report annual data on interbank foreign currency deposits, at the time they are published, but only in the same detail as in the Examiner of Banks' Annual Statistics of Israel's Banking System.

d. Composition of official foreign exchange reserves

Israel does not report the composition of its holdings of official foreign exchange reserves on the Bureau's quarterly confidential questionnaire.

Israel--Basic Data

Population (end-year estimate 1984):	4.2 million
GNP in 1984 (market prices):	IS 6,486 billion (US$22.344 billion)
GNP per capita in 1984:	US$5,320

Origin of GDP in 1984 (at factor cost)	(In percent of GNP)
Agriculture, forestry and fishing	11
Industry, mining and quarrying	28
Construction	12
Transportation and communications	13
Finance, trade, and services	36
GDP of the business sector	100

	1980	1981	1982	1983	1984 1/	Official forecasts 1985
			(Annual percentage change)			
National accounts (at constant prices)						
GDP	3.1	2.8	1.0	1.8	1.6	0.8
Gross domestic expenditure 2/	-4.5	4.7	8.1	6.7	-5.9	-2.6
Private consumption	-2.9	10.9	7.2	7.0	-5.6	-0.5
Government consumption 2/	3.5	0.8	4.8	4.8	-3.9	-1.4
Gross domestic investment	-15.2	-7.1	14.6	8.0	-9.2	-10.6
Prices, wages and employment						
Consumer prices (end-year)	133.0	101.5	131.5	190.7	444.9	...
Wholesale prices (yearly average)	135.1	122.7	125.8	144.5	396.5	...
Real wages per employee post 3/	-3.2	10.4	-0.3	6.1	-1.9	-2.0
Unemployment rate (in percent)	4.8	5.1	5.0	4.5	5.9	7.4
			(In percent of GNP)			
Budget aggregates (fiscal years)						
Expenditures	64.8	70.5	71.1	72.8	78.9	69.3
Of which:						
Defense	24.2	22.4	21.3	22.0	25.8	18.9
Interest payments	5.9	9.5	11.8	12.2	14.0	15.0
Revenues	44.3	44.6	51.2	50.0	44.7	47.9
Foreign grants	8.9	7.5	5.2	7.2	14.6	12.3
Deficit	11.6	18.4	14.7	15.6	19.6	9.1
			(Real percentage change; 3/ end of period)			
Monetary developments						
Liquid financial assets (M4)	6.4	-5.6	0.1	8.4	-1.8	...
Total financial assets of public	16.5	15.4	37.3	-30.1	12.7	...
Bank credit to private sector	-7.4	-8.2	0.5	-17.6	10.2	...
			(Annual percentage change)			
External sector						
Exports, f.o.b. (in U.S. dollars)	21.9	1.9	-5.9	-0.9	11.2	6.7
Imports, f.o.b. (in U.S. dollars)	13.4	4.8	-5.9	-1.0	0.2	5.2
Of which:						
Nondefense	8.2	-1.0	1.2	5.8	-5.7	-2.5
Export volume	9.8	5.1	-0.9	-1.9	13.3	7.7
Import volume 2/	-11.5	2.8	10.9	6.1	-4.3	-1.5
Terms of trade 2/	-7.2	-1.1	3.3	1.1	-1.2	--
Nominal effective exchange rate 4/	-51.3	-47.0	-47.0	-61.4	-81.6	...
Real effective exchange rate 4/	2.7	-1.8	12.6	-2.3	-3.3	...
			(In percent of GNP) 5/			
Current account deficit	4.1	6.8	10.1	9.1	7.6	1.1
Debt outstanding 6/	111.8	116.8	128.9	120.1	132.0	...
Gross official reserves, end-year (in months of total imports)	3.0	2.9	3.1	2.9	2.4	...
Gross debt service (as a percentage of exports of goods and services)	31.5	37.6	43.8	40.3	40.8	...

1/ Provisional estimates.
2/ Excluding direct defense imports.
3/ Deflated by consumer price index.
4/ Based on the standard index (using consumer prices) developed in connection with the Information Notice System; fourth quarter over fourth quarter.
5/ GNP figures in U.S. dollars reflect the overvaluation of the shekel in recent years, particularly in 1982 and 1983; the percentages therefore arguably understate somewhat the underlying position.
6/ Gross external liabilities.