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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/80

3:00 p.m., May 24, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe
C. H. Dallara	
	S. Kolb, Temporary
	G. E. L. Nguyen, Temporary
M. Finaish	M. Z. M. Qureshi, Temporary
	M. Sugita
	B. Goos
J. E. Ismael	
R. K. Joyce	L. Leonard
A. Kafka	
	H. Fugmann
E. I. M. Mtei	A. Abdallah
	M. A. Weitz, Temporary
	E. M. Taha, Temporary
	J. E. Rodrîguez, Temporary
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuâldez
	H. Alaoui-Abdallaoui, Temporary
A. K. Sengupta	V. Govindarajan
N. Wicks	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant
V. C. Wall, Assistant

Also Present

Administration Department: G. E. Gondwe. African Department: K. G. Dublin, C. Enweze, D. E. Syvrud. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; T. R. Boote, W. L. Hemphill, R. P. Hicks, P. C. Hole, W. E. Lewis, A. López-Claros, T. H. Mayer, D. C. L. Nellor, E. Spitaeller, H. O. Schmitt, T. M. Ter-Minassian, H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Director; J. T. Boorman, E. H. Brau. Fiscal Affairs Department: V. Tanzi, Director; G. M. Bartoli, M. I. Blejer, E. S. Kreis, C. Schiller. IMF Institute: R. Manfredi-Selvaggi, Participant. Legal Department: W. E. Holder, J. M. Ogoola, S. A. Silard. Advisors to Executive Directors: S. M. Hassan, J. Hospedales, J.-C. Obame, T. Sirivedhin, A. Steinberg, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, J. R. N. Almeida, I. Angeloni, W.-R. Bengs, J. J. Dreizzen, C. Flamant, V. Govindarajan, N. Haque, G. D. Hodgson, M. Lundsager, K. Murakami, A. Mustafa, E. Olsen, W. K. Parmena, D. J. Robinson, A. A. Scholten, L. Tornetta, A. J. Tregilgas.

1. ITALY - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/79, 5/24/85) their consideration of the staff report for the 1985 Article IV consultation with Italy (SM/85/119, 4/26/85; and Cor. 1, 5/23/85). They also had before them a report on recent economic developments in Italy (SM/85/127, 5/10/85; Cor. 1, 5/23/85; and Sup. 1, 5/22/85).

Mr. Zecchini stated that after the coming referendum the political climate would be much clearer and conducive to the corrective measures that, as his authorities were fully aware, would have to be introduced. They were not merely waiting for the completion of the referendum; they had also been considering corrective measures and studying their implications. Because there had been no precise quantitative indication in early 1985 of the extent of the deviations from the planned course of the economy, he was not in a position to give more details about the likely measures. Those measures would be a function of the extent of the deviations, but in some major areas, like public finances, the quantitative information needed to formulate the appropriate measures was not yet available.

His authorities did not think that short-term measures alone would achieve the desired adjustment effects, Mr. Zecchini continued. There were some structural problems that required long-term measures, and his authorities were certainly striving to achieve the political consensus required to make structural adjustments. For example, the Minister of the Treasury had presented a document updating the Government's plan for fiscal adjustment that had reaffirmed the underlying objectives and defined the path of adjustment. That document had had some interesting quantitative aspects. For example, it was clear that in the next 18 months the state deficit would have to be cut by the equivalent of 2-3 percent of GDP. At the same time, some of the guidelines that had been established for framing public budgets would have to be respected, and the following principles should be adhered to: check the growth of expenditures while maintaining at least a stable ratio of revenue to GDP; link at all layers of government the authority to spend with the responsibility to finance those expenditures; pursue a pricing policy for public services that was consistent with the fiscal policy stance; and restructure the tax system to achieve a better balance between direct and indirect taxation.

Some of those main courses of action had an important bearing on the working of the economy and the institutional framework within which fiscal policy was carried out, Mr. Zecchini went on. For example, the problem of the dichotomy between the authority to spend and the responsibility to finance that expenditure was embedded in the Italian constitution. Therefore, any action regarding that institutional setup would require a political consensus much stronger than that envisaged for the other measures in the fiscal adjustment program.

In 1984, the authorities for the peripheral entities had allowed an expansion of their budget deficits, financing them by drawing down their bank deposits and increasing their borrowing, Mr. Zecchini remarked. However, two unusual circumstances had put that development in a perspective different from what it appeared to be. The first had been the anticipation of the expiration, by the end of 1984, of a law providing for the state's taking over the service of the debt when capital expenditures were incurred by authorities for peripherial entities. The second factor had had to do with the transformation of previous debts of health units vis-à-vis their suppliers and the banks. To the extent that those debts had already existed before 1984, they had simply re-emerged under a different form. The question whether the target for the ratio of revenue to GDP was sufficiently ambitious needed to be answered in two contexts--one economic, the other political. In fact, that question could best be answered through a compromise or merger of those two contexts.

It was clear that a limit had to be set for the deficit of the social security system, Mr. Zecchini noted. To that end, the Minister of the Treasury thought that the benefits of the social security system over and above a given predetermined standard should be limited and that individuals should resort to private insurance companies in order to secure the additional benefits that each considered appropriate. Such major changes would undoubtedly be subject to considerable public debate.

One of the issues in monetary policy was what constituted the appropriate target for monetary aggregates--what was liquid and what was not, Mr. Zecchini remarked. The definitions of money, quasi-money, and total liquidity were not simple even in well-developed economies. Although treasury bills and certificates were liquid, the degree of liquidity of those two financial instruments was not the same. In 1984 and the first part of 1985, the authorities had been attempting to reduce the substitutability between those two instruments in the portfolios of the household sector. They had done so by changing some of the features of those financial instruments. In particular, the maturity of financially indexed treasury certificates had been raised from seven to ten years, and the frequency of the indexation mechanism reduced from annually to semiannually. The volume of newly issued fixed-rate treasury certificates had been increased and their maturity raised from two to three years. In addition, with a view to reducing the public debt service burden, the spread between the interest rates on treasury certificates and short-term money market rates had been lowered.

In relation to the conduct of monetary policy, Mr. Zecchini said, M-2 was regarded less as a target than as one of the indicators of the degree of liquidity of the economy's financial wealth. The desired evolution of M-2 and total domestic credit was translated into operating targets for bank reserves, the aggregate on which the monetary authorities focused in performing their monthly operations.

More generally, it was still an open question whether interest rates or quantitative targets were the most useful indicators of the degree of restrictiveness of monetary policy, Mr. Zecchini remarked. In 1984, real interest rates had been increasing, and, in the light of that indicator, monetary policy could be described as having been moderately restrictive. It was too early to draw any conclusions from developments in the first few months of 1985, when an extraordinary factor--the reduction in the tax deductibility of government securities--had played a role in the increase of liquidity. That measure had led to a near freeze of all securities held by the banks. Therefore, if past trends were assessed on a monthly basis, their significance was to some extent blurred.

The level of employment in the early 1980s had not decreased significantly, Mr. Zecchini commented. The rise in the overall unemployment rate had to be explained largely by the increases in the labor force. Contrary to past trends, in 1984 there had been a decline in youth unemployment. It was clear that there were some rigidities in the labor market; it was also clear that the Government had tried to do something about them. In particular, a law approved by the Parliament in December 1984 allowed the enterprises to hire workers on an individual and selective basis rather than following the order of the list of unemployed workers. In addition, a new practice concerning "solidarity contracts" had been introduced, and new measures had been implemented to promote apprenticeship schemes to facilitate the hiring of young workers.

Many questions had been raised about the possibility both of deindexing wages with respect to increases in indirect taxation and of lengthening the period between adjustments under the scala mobile, Mr. Zecchini continued. The degree of indexation provided by the scala mobile was already less than half the actual rate of inflation. More important, the Government was looking at the problem of indexation within a much larger framework, including the entire compensation structure, the relative share of direct and indirect labor costs, and the new bargaining phase for the three-year collective wage contracts. Decisions on modifications of the scala mobile had to be considered within that larger framework.

A weakness in the external current account had emerged in December 1984 and early 1985, Mr. Zecchini noted. A differential in the growth of domestic demand in Italy and its main trading partners had probably played a role in that weakness. Domestic demand had apparently decreased in Italy in the first quarter of 1985, but the decrease had been even larger in the country's main trading partners. Moreover, Italy had recently managed to specialize in exports that were relatively less price sensitive.

Italy had retained some barriers to capital movements on the basis of a safeguard clause whose application, authorized by the EC at end-1984, was due to expire at end-1987, Mr. Zecchini indicated. Italy should be able to make the corrections to enable it to eliminate the barriers in the time allotted. At the same time, there had been discussions within the EC on liberalization of capital movements that concerned all EC member countries.

The relative strength of the lira in 1984 had been attributable in part to the favorable interest differential but also to a new appreciation of the coherence of the authorities' policies, Mr. Zecchini remarked.

The energy program had not been carried out on schedule, Mr. Zecchini indicated. However, that did not mean that the program had been abandoned. The timing of the implementation of the program had perhaps not been optimal, but the resistance of some groups to the construction of new nuclear power plants had eroded in 1984. More importantly, a basic instrument in the energy policy was pricing, which had been used consistently over time.

The substantial rise in productivity in 1984 had not been due to a very large extent to cyclical factors, Mr. Zecchini said, especially not for the industrial sector. A rationalization of production processes had been going on for years. A significant role had been played by the increased ability of firms to adjust the size of their work force to their actual labor needs.

The Acting Chairman made the following summing up:

Directors welcomed the improvement in Italy's economic performance during 1984, particularly the marked deceleration in the rate of inflation. Output and disposable income had increased; the financial position of enterprises and investment had improved considerably; and the external position had remained broadly satisfactory. The strengthened cohesiveness of economic policies in the first half of 1984 was seen to have been instrumental in this respect. Directors regretted, however, that the momentum toward fiscal correction had been allowed to weaken in the course of the year, leading to a further increase in the deficit of the General Government relative to GDP. Developments in recent months seriously threatened the achievement of the Government's 1985 target for inflation and a desired current account outcome unless adequate corrective actions were taken without delay.

Directors stressed that a sustained reduction in the fiscal deficit remained an essential condition for the maintenance of balanced growth over the medium term, consistent with a further convergence of the inflation rate in Italy with those of its main trading partners and also consistent with a satisfactory external position. Directors commended the Italian authorities for their pursuit in the past few years of a stance of monetary policy consistent with a deceleration of inflation and urged them to continue on such a course in 1985. Directors also noted the positive consequences of the shift away from quantitative ceilings on bank credit to a market-oriented system requiring more flexible and positive real interest rates. The growth of the money base, which in recent months had accelerated, should be brought back into line, a number of Directors stated. They stressed, however, that monetary policy should be supported with adequate fiscal restraint and that an absence of fiscal restraint would lead over time to a number of costs, including higher positive real interest rates, upward pressures on the real exchange rate, a larger public debt burden, and reduced scope for a sustained growth of investment and output. Therefore, Directors urged the Italian authorities to implement quickly a package of measures aimed at containing the public sector deficit in 1985 to the extent needed. Directors commended the authorities for the recent adoption of a package of tax measures aimed at broadening the tax base, reducing evasion, and distributing the tax burden more equitably, and they encouraged the authorities to proceed further in this direction.

Directors also encouraged the authorities to increase efforts to curtail public expenditures. Such efforts could include institutional reforms in expenditure decision-making procedures as well as restraint in such areas as personnel expenditures, pensions, and social transfers more generally. It was also suggested that the burden of public enterprises on the budget could be reduced through greater efficiency, with the latter to be achieved in part through more competition and privatization.

Directors welcomed the adoption in 1983 and 1984 of measures aimed at reducing wage indexation, which had contributed to a marked deceleration in labor costs. However, they also stressed the urgent need to reduce rigidities--including those which limited wage differentiation--that characterized the labor market in Italy. This was all the more important given the overall rate and the structure of unemployment, including relatively high youth unemployment. Directors endorsed the Government's objective of keeping wage increases in 1985 to the target rate of inflation and urged the authorities to continue their efforts to secure the social partners' agreement to actions that would permit the realization of this objective. Measures to reduce the degree of indexation further, such as those mentioned in the staff report, were supported by many Directors. The continued moderation of labor costs was seen as essential for the maintenance of an adequate level of competitiveness within the constraints on exchange rate policy posed by Italy's participation in the European Monetary System (EMS), as well as for a recovery of employment over the medium term.

While recognizing that Italy's relatively low external debt and debt service ratio and its strong reserve position afforded it some room for maneuver on the external side in the near term, Directors stressed that the prompt implementation of a coordinated adjustment was needed to stave off the threat of the emergence of an unsustainable current account deficit. Directors encouraged the Italian authorities to pursue policies aimed at improving productivity and reducing energy dependence to ease the external constraint on growth. They also urged the authorities to pursue a more liberal trade policy and to proceed further with the liberalization of capital movements as the balance of payments improved. Italy's commitment to increase the level of ODA through the end of the decade was commended.

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

2. ISRAEL - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Israel (SM/85/118, 4/26/85; Cor. 1, 5/21/85; and Sup. 1, 5/23/85). They also had before them a report on recent economic developments in Israel (SM/85/129, 5/10/85).

Mr. Polak made the following statement:

This year's Article IV consultation with Israel took place a few months after the new Government of national unity was formed and while that Government was attempting to cope with mounting economic and social problems. Inflation, which had been relatively stable at about 130 percent per annum between 1980 and the last quarter of 1983, soared to a record high of above 1,000 percent, annualized, by the end of 1984, and the external position remained very precarious. Dwindling reserves and growing social unrest forced the new Government to take immediate measures to calm the situation.

To this end, the authorities turned to a social contract, an idea supported by a number of Executive Directors in last year's discussion. This approach was intended to reduce the surging inflation with a series of wage-price freeze agreements with the Trade Union and the Manufacturers' Association. These agreements, which were accompanied by some tightening of the exchange controls, resulted in a drop of the inflation rate from a monthly average of 22 percent in September-November 1984 to 4.5 percent a month in the first freeze period of December 1984 and January 1985. The approach has been continued by new agreements concluded in February, which included some major agreed price increases; since then, inflation rates have risen again, to about 13 percent in February and March, and 19.4 percent in April.

Beyond introducing an emergency program, the new Government had to frame its strategy to tackle the fundamental imbalances in the Israeli economy. A comprehensive policy to this end was formulated in conjunction with the preparation of the budget for fiscal year 1985/86. The measures taken and the background developments are accurately described and discussed in the excellent staff report. The Israeli authorities generally agree with the presentation and analysis by the staff.

The Israeli authorities deliberated extensively on the choice of an economic strategy that would be both adequate to the task and feasible socially and politically. In a general sense the choice was between a shock treatment and a more gradual policy. Either strategy would have to be comprehensive, addressing the underlying causes of Israel's economic problems and aiming primarily and at the same time at the reduction of inflation and the improvement of the balance of payments.

A major reason why the Government opted for the gradual approach was its profound sensitivity to and concern about the high, and perhaps uncontrollable, unemployment that might have resulted from a more drastic policy. High unemployment might affect particularly the rural developing areas and might increase emigration from Israel of high-technology professionals; the former effect would endanger Israel's delicate political and social fabric, and the latter would hurt the most dynamic part of Israel's export industry. The Government's choice was facilitated by an improvement in the external position (including a decline in the civilian trade deficit), an increase in official aid received, and the favorable structure of Israel's external debt.

The decline in real private and public consumption in 1984--the first decline in the past four years--has contributed to the improvement in the underlying factors of Israel's current account. A resumption of fast export growth and a decline of civilian imports halved the civilian trade deficit from $2.4 billion in 1983 to $1.2 billion in 1984. Official aid also increased, but, since services and defense imports have gone up as well, the current account deficit was reduced by only one fourth, to $1.7 billion, the first decline of Israel's current account deficit in the past four years. Developments in the first four months of 1985 indicate that the improvement of the balance of payments is continuing, although at a slower rate than expected. The trade deficit was down in the first four months of 1985 by about $90 million, reflecting a 2.7 percent rise in exports and a 1.3 percent decline in imports, mainly of consumer goods, over the same period in 1984.

Exchange rate policy, which aims at maintaining Israel's competitiveness, resulted in a real effective devaluation of 7 percent on average in 1984 compared with 1983. However, due to the strong dollar, this achievement was not enough vis-à-vis the important European market, which accounts for about half of Israel's trade. The Government did not want to move faster for fear of the inflationary effects that would follow from an even steeper real depreciation.

The competitiveness of the Israeli economy has also been improved through declines in real wages in the second half of 1984 and in early 1985, after the increases in 1983 and early 1984. For 1984 as a whole, real wages were lower than in 1983, and the downward trend continued in the first quarter of 1985.

The usual method of calculating real wages overestimates their level when inflation accelerates. Generally, wages are paid at the end of the month (or the beginning of the following month), but their real level is obtained by deflating them by the average consumer price index (CPI) for the month. This creates an upward bias equivalent to two weeks' inflation, which increases as inflation accelerates, as it did in 1984. A revised calculation of real wages, which uses a price index for the end of the month, shows that real wages fell on average by 1 percent in the public sector and by 4 percent in the business sector, as against the 1 percent increase in the public sector and the 2 percent drop in the business sector (revised from the 2 percent rise and the 3 percent fall, respectively, cited in the staff report).

The decline of real wages in the first quarter of 1985, referred to in the staff report, is for the same reason overstated, by about 3 percentage points. Furthermore, this relatively low level could not be considered a stable level, because the first-quarter figures show the immediate technical impact of the wage freeze arrangements, real wages are characterized by sharp fluctuations even on a quarterly basis (Chart F), and seasonality analysis shows that the midyear wage level is generally higher than that of the rest of the year. Considering the significant decline that had already taken place at the end of 1984, and in the absence of the required supportive conditions in the labor market (due, in part, to the labor union elections in May 1985), the first-quarter figures cannot be taken as indicative of a new trend.

Recognizing that the budget is the key element for its stabilization program, the Government has taken several steps to reduce the public sector domestic deficit by boosting revenue and cutting expenditures. If all contemplated steps are implemented as scheduled, the financing requirements for the 1985/86 budget will be halved to 9 percent of GNP. To accomplish this far-reaching goal, several cuts in expenditure, particularly in subsidies, were immediately made; oil and electricity subsidies have been entirely eliminated, and other subsidies were cut considerably, with the declared intention being to continue this process.

Financing of the government domestic deficit by the Bank of Israel will be limited, and eventually eliminated, by the new legislation approved early this week by the Government and soon to be presented to the Knesset. This new law is intended to restore monetary control and make nominal targeting possible. At the same time, the Government took additional measures to keep the budget performance within its planned framework and to support the adjustment process further. These measures, of which the first four apply for a three-month period, include the following: most government contracts will be limited to 22.5 percent of the amounts authorized and to 45 percent for defense, residential construction, and investment incentives; new development credits from the Government and the Bank of Israel (except export credit) will be limited to 45 percent of the authorization; public sector wages will be frozen (except for a cost of living adjustment), and a freeze has been imposed on hiring new employees in the public sector; the tax on Israeli citizens traveling abroad will be doubled on May 27, 1985 to the shekel equivalent of $300 (adjusted monthly according to the CPI); the foreign currency allowance for Israeli citizens traveling abroad has been reduced from $1,000 to $800; the value-added tax will be increased from 15 percent to 17 percent by June 1, 1985; there will be a 10 percent reduction in income tax payments (up to a ceiling determined by the 50 percent marginal tax rate) for employees in the productive sectors (mainly manufacturing, agriculture, and tourism), while employers in these sectors will receive a 5 percent tax reduction--the last two measures still require Knesset approval, which is expected shortly; and rents in public housing will gradually increase and will eventually be indexed.

The staff recommendation to eliminate CPI or dollar linkages for liquid assets is fully endorsed by the authorities, who have already taken various measures in order to increase the unlinked shekel money base. However, the Israeli authorities feel that this process should be gradual, because in the absence of attractive unlinked alternatives there is a serious risk of a run on foreign exchange or a sharp increase in private consumption. However, the proposed elimination of linkages relates to liquid assets only, and it is not the authorities' aim to eliminate all indexation from the system until inflation has been brought down to a much lower rate. The present system of indexation is essential to sustain the high rate of savings.

Finally, two brief comments on two specific points raised by the staff.

The observation that about 50 percent of the domestic debt is de facto liquid is somewhat of an exaggeration, as it includes among the liquid assets those Provident Funds' accounts which have been open more than 15 years. Such funds are entirely illiquid for 15 years. After this period, holders can withdraw from their balances, but at a cost. If no withdrawals are made, new deposits can continue to be made to the account, which will enjoy the seniority of the original deposits and can thus be withdrawn at call, but, if there are withdrawals, any new deposit will have to be made to a new account, for a new period of 15 years.

> The growth of bank lending by 10 percent, despite high real interest rates, is explained by reintermediation of credit from the "gray" market to the banking system as a result of a narrowing in the gap between banks' borrowing and lending rates.

Mr. Joyce recalled that, during the previous Board discussion on Israel (EBM/84/85, 6/1/85), his chair had noted that although some progress had been made in a few areas of economic performance, the general trend was unfavorable and improvements were unlikely to occur in the absence of a fundamental change in the direction of policy. The new Government's proposals were impressive, but some of them had yet to be adopted by the Knesset; moreover, some other suggested measures were merely stopgaps. The authorities had understandably chosen a more gradualist approach than the staff had favored, but the staff had rightly stressed that the more gradual the approach, the longer the period of adjustment and the greater the danger that actual performance would deviate from expectations, the authorities' determination might falter, and the adjustment effort would be eroded.

Developments in 1984 demonstrated that inadequate fiscal policy was still the main problem facing the economy, Mr. Joyce continued. The authorities themselves had noted that enormous fiscal deficits had contributed to inflation both through the liquidity creation resulting from the financing of the budget deficit and through the gradual deterioration in the balance of payments and the subsequent need for sizable devaluations. The required large increases in controlled and subsidized prices and the sizable devaluation in 1984 had intensified the inflationary pressures, but the fiscal position was the main cause of inflation in Israel and must therefore be the primary target of policy action.

Some developments during 1984 had been positive, Mr. Joyce remarked. The civilian trade balance had improved by $1 billion, suggesting that there was still considerable scope for the economy to respond positively to appropriate price signals and adequate profit incentives. The new Government--which had taken office in September 1984--had shown considerable resolve in keeping economic conditions from worsening and in negotiating a wage and price freeze to break the inflationary cycle temporarily. Those measures must be followed by more comprehensive and durable action.

The thrust of the staff's policy recommendations for 1985 and beyond was appropriate, Mr. Joyce considered. The authorities recognized that past attempts to deal with a single issue--such as inflation or the balance of payments--in isolation from other problems had been unsuccessful. Given the severity of the imbalances in the economy, the strength of the adjustment effort recommended by the staff was appropriate.

However, as Mr. Polak had stressed in his opening statement, Israel's social fabric was unique, and the potential costs of unemployment--particularly the emigration of skilled manpower--might be significantly higher in Israel than in many other countries, Mr. Joyce remarked. At the same time, the dynamism of the economy referred to by Mr. Polak should permit more rapid adjustment in Israel than might well be possible elsewhere. Like many European countries, Israel had to overcome barriers from an aging capital stock and embedded social rigidities. While the political situation in Israel was different from that in European countries and imposed a major constraint on policymaking, delaying adjustment now would not make it any easier for the authorities to introduce stringent measures a year or so in the future.

Furthermore, the authorities should recognize that the present level of foreign aid flows might not be fully sustained in the future, Mr. Joyce went on. Massive economic assistance from the United States--well in excess of immediate defense needs--had enabled Israel to remain on a gradual path of adjustment, but the authorities could hope to stay on that path only as long as the U.S. aid flow continued. The recently adopted measures outlined in Supplement I to SM/85/118 as well as the stop-go freeze prices planned for 1985 were precisely the kinds of ad hoc piecemeal measures that the authorities should avoid; the Government planned to implement them because slippages in reaching the 1985 targets had already become apparent. The gradualist approach might well be found to be too little and too late.

The expenditure cuts proposed under the 1985/86 budget, equivalent to 5 percent of GDP, and the measures to increase revenues were welcome, Mr. Joyce said. However, further action was needed to reduce both the fiscal deficit and recourse to domestic credit, which was projected to finance a considerable share of the 1985/86 fiscal deficit. That prospect did not augur well for the effort to contain inflation, and the recently introduced bill to limit and eventually eliminate deficit financing by the Bank of Israel should be passed quickly.

He was pleased that the authorities had maintained interest rates at high real levels and were committed to deindexing short-term assets, Mr. Joyce said. In principle, he agreed with the staff that all assets should be deindexed, but he shared Mr. Polak's concern about the effect of that move on savings: a precipitous drop in the savings rate should be avoided. The staff had called for tightening the control over monetary aggregates, and he wondered whether the staff believed that stricter targets for nominal money supply growth were feasible in the present circumstances.

The 2 percent rise in average public sector real wages in 1984 had been disappointing, especially as private sector earnings had fallen in real terms, Mr. Joyce commented. Average real wages were expected to fall in 1985--a necessary element in the adjustment effort; price increases in early 1985 had already effectively led to a drop in real wages, but the projected increase over the rest of the year seemed both inconsistent with the required austerity and inappropriate in view of the rising unemployment. The authorities should contain wage increases, particularly in the public sector, thereby giving a clear signal to the private sector--including the unemployed--that the burden of adjustment was to be shared fairly across the economy.

The projected reduction in the 1985 external current account deficit was most welcome, and the authorities' determination to maintain competitiveness was crucial if the external debt were to be stablized at a realistic and manageable level, Mr. Joyce said. Exchange rate policy should provide for continuous adjustment of the rate, thereby avoiding the major dislocations of the previous two years and eliminating the need for export subsidies. The staff's medium-term adjustment scenario was the only one that would yield realistic and sustainable results.

The authorities must act to deal with Israel's critical situation, Mr. Joyce said. He hoped that they were prepared to take the difficult steps that would be required.

He wondered whether the staff had any additional information on the recently initialed free-trade arrangement with the United States, Mr. Joyce remarked. In addition, the staff should comment on the effect of its conclusion that the Executive Board should not approve Israel's multiple currency practices. The authorities had indicated that they had no immediate plans to eliminate those practices; they might well be right in concluding that the time was not ripe to remove the practices. Finally, the proposed decision was acceptable.

Mr. Dallara remarked that in recent years there had been some doubt whether the high but stable rate of inflation together with widespread indexation could continue without causing the economic situation to deteriorate further. Developments in 1984 had shown that the doubt had been fully warranted: the acceleration in the rate of inflation to 445 percent had triggered capital outflows, intensified the pressure on international reserves, made financial accounting increasingly difficult, disrupted domestic business activity, lowered confidence, jeopardized traditional efforts to protect real wages, and contributed to the unfavorable climate for domestic and foreign investment.

The piecemeal adjustment policies and the periodic shifts in policy priorities between fighting inflation and protecting the balance of payments had increased inflationary expectations, Mr. Dallara commented. The subsequent price freezes and price controls, limits on wage indexation, and trade and payments restrictions might buy some time but clearly would not deal with the underlying causes of the imbalances in the economy. The useful but limited measures recently adopted in response to the unexpectedly high rate of inflation in April 1985 were perhaps understandable in the circumstances, but they were a continuation of the inadequate piecemeal approach to policy. The authorities must adopt a comprehensive program of economic stabilization and structural reform. Their medium-term goals of sharply reducing inflation, restoring sustainable economic growth, and consolidating Israel's balance of payments and foreign debt position were appropriate. Achieving such an outcome would depend importantly on the maintenance of domestic demand restraint and on the achievement of strong export growth. The authorities should adopt a set of policies providing a framework in which such developments could take place. Reducing the budget deficit--especially by cutting public expenditures--and maintaining a flexible exchange rate policy would be particularly important.

Correcting the untenable fiscal situation was clearly the key to successful adjustment, Mr. Dallara went on. The financing of the fiscal deficit and the management of the large public debt presented immediate managerial problems, and the increasingly pervasive role of government in the economy was reducing the prospects for restoring both economic growth and price stability. The Government had become a major employer, having accounted for some 30 percent of employment in 1984. The consequent heavy tax burden--a disincentive to work and saving--had been reflected in the ratio of total government revenues to GDP of 45 percent in 1984 and in the ratio of taxes to GNP of 37 percent. Moreover, the large volume of government subsidies and transfers--equivalent to 21 percent of GNP and 27 percent, respectively, of total government expenditures in 1984--distorted resource allocation. During the previous discussion on Israel, the Executive Board had expressed its serious concern about the large size of the 1984/85 budget deficit, which had been expected to be equivalent to about 20 percent of GNP. In fact, the deficit had been equivalent to 34 percent of GNP, excluding foreign grants. Even when those grants were included, the deficit had been nearly 20 percent of GNP.

The fiscal outlook--including the 1985/86 deficit and the rollover of the large public debt--was uncertain and worrying, Mr. Dallara commented. Rising interest payments were expected to amount to some 15 percent of GNP in 1985/86. Moreover, there was a continuing danger of capital outflows; government debt was predominant in the liquidity holdings of the public, but foreign assets were the main investment alternative. If implemented as planned, the 1985/86 budget would result in a sharp drop in the ratio of the budget deficit--excluding grants--to GNP from 20 percent in 1984/85 to 9.1 percent in 1985/86. However, expenditures apparently were already substantially exceeding targets, while revenues were falling short. Additional adjustment measures might well be needed, and a further comment on the chances for their adoption would be helpful.

The staff's medium-term fiscal scenarios were not encouraging, Mr. Dallara said. Even on the basis of the most optimistic scenario, government expenditure in 1989/90 would still amount to more than 60 percent of GNP, and in all the scenarios except the most favorable one, the deficit excluding foreign grants would be in the range of 6-16 percent of GNP. The fairly broad consensus in Israel in favor of a sharp cut in the deficit mainly through expenditure cuts and a recognition of the need for stronger budgetary controls was welcome. However, the staff had concluded that additional budget cuts equivalent to those already proposed for the present fiscal year were needed and that budget control reforms--such as the presentation of budget items in constant prices rather than in nominal terms--had not yet taken place.

A further decline in real wages might be needed to contain unemployment, which might reach nearly 7 1/2 percent in 1985, Mr. Dallara remarked. Increases in real private sector wages in excess of productivity and sharp rises in public sector wages would impede productive investment and economic recovery in the medium term. Gross domestic investment had fallen by almost 14 percent in 1984 and was expected to decline further in 1985.

He had serious reservations about the efficacy of price controls in the present circumstances. The authorities hoped that the rate of inflation in 1985 would be half the rate recorded in 1984, but that hope might not be realistic; after all, the consumer price index had risen by more than 19 percent in April 1985.

For some time monetary policy had been based on the need to finance the fiscal deficits and the Bank of Israel had had to maintain a basically accommodating policy, Mr. Dallara commented. In managing the financing of the 1985/86 deficit and the rollover of outstanding public debt, the authorities must take great care to protect the Government's creditworthiness and to avoid capital flight. A more restrictive monetary policy was clearly needed to complement the measures designed to reduce the fiscal deficit. Financial reforms also were needed; some had been introduced in 1984, and others were planned for coming months. He welcomed the gradual imposition of limits on central bank credit to the Government, the plan to deindex liquid assets--especially short-term assets--and the introduction of flexible interest rates on shekel-denominated assets. Moreover, the Government's proposal to increase the independence of the Bank of Israel over the coming three years was encouraging. Prompt approval of that measure by the Knesset would significantly improve the effectiveness of monetary policy.

In the past, the shekel exchange rate had frequently been allowed to become overvalued, Mr. Dallara observed. The charts on pages 4b and 4c of the staff report suggested that the present exchange rate also might be inappropriate. The balance of payments had strengthened in 1984, but disconcerting trends had emerged in recent weeks. Even more important, any depreciation of the nominal exchange rate would clearly be short lived in the absence of substantial progress in reducing the rate of inflation.

The authorities' gradual approach to adjustment was designed to maintain a social consensus in favor of adjustment, Mr. Dallara commented. Of course, public support for difficult policy actions would contribute to the achievement of the authorities' economic goals. However, a consensus in favor of even stronger and bolder measures would increase the chances that the adjustment effort would succeed. The staff had correctly recommended substantial cuts in the budget deficit, discontinuation of the indexation of short-term assets, the establishment of price objectives based on nominal fiscal and monetary targets, and a devaluation sufficient to permit the elimination of import restrictions and export subsidies. The formulation and implementation of a comprehensive program of economic adjustment and reform were clearly needed. The program should contain the measures described by the staff and should be implemented promptly, forcefully, and persistently.

Mr. Weitz said that he broadly agreed with the staff appraisal. In 1984, the problems facing the economy had become particularly difficult. The combination of capital outflows and a high rate of inflation had been caused by the substantial imbalances in the public finances and resultant large injection of liquidity. A significant improvement in the fiscal situation should be the first priority of economic policy.

The authorities had stressed the need to build a social consensus in support of adjustments, Mr. Weitz continued. However, if the fiscal deficit were not contained, plans to implement a social contract would be unsuccessful. The staff had noted that the economic policy package of 1984, including a three-month price freeze, had achieved its main aim of lowering the rate of inflation, thus giving the authorities some breathing space to adopt more fundamental measures. However, the freezing of prices at a time of continuing exchange rate depreciation had led to a large increase in government subsidies and to distortions in relative prices. Given the recent increase in the rate of inflation, he wondered whether the authorities planned to implement similar policies in 1985.

A gradual path to adjustment, rather than a shock approach, seemed preferable, for the reasons given by Mr. Polak in his opening statement, Mr. Weitz said. The structure of Israel's external debt was favorable; short-term debt represented 15 percent of total debt. However, the balance of payments remained vulnerable: the external current account position could again deteriorate rapidly if demand restraint were eased or competitiveness were not maintained.

Nominal and real interest rates should be maintained at high levels to restrict the growth of credit to the private sector and to increase domestic savings, Mr. Weitz considered. Policies aimed at maintaining the flow of credit to the private sector in real terms would soon cause a rapid acceleration in the rate of inflation, a worsening of the external accounts, or both. Exchange rate policy should be consistent with the effort to improve the economy's competitiveness. The authorities should carefully review the progress made toward achieving the external targets for 1985 and make further corrections as necessary.

Mr. Goos said that he broadly agreed with the staff appraisal. The further deterioration in price performance, public finances, foreign exchange holdings, and the external capital balance was disappointing and worrying. In the circumstances, the resilience of the economy reflected in agriculture, exports, and the positive real growth rate was remarkable. Apparently, it was due to certain exogenous and exceptional factors, including considerable foreign assistance, the widespread use of the dollar in domestic transactions, and the array of dollar-indexed monetary assets. He agreed with Mr. Joyce that the authorities could not assume that those factors would recur in the longer run.

Notwithstanding the positive impact on the overall economic picture, including the reduced current account deficit in 1984, he shared the staff's assessment that the problems facing the economy had reached the crisis stage and warranted a decisive and comprehensive stabilization effort, Mr. Goos continued. The authorities had introduced a variety of adjustment measures in recent years--including the medium-term emergency program adopted in late 1984--to deal with the long-standing problems facing the economy. That program had originally been the most promising of the various adjustment steps, particularly as it had been based on a contract between the social partners. In fact, however, the measures had apparently failed to deal with the economy's underlying weaknesses, mainly because they had been unduly selective and gradual. The same conclusion was applicable to subsequent adjustment steps, although the most recently introduced measures seemed to contain an element of shock therapy that, given the hyperinflation in Israel, was more appropriate than the gradual approach to which the authorities apparently continued to adhere.

In the coming period, the authorities should implement a comprehensive and forceful stabilization program that would give priority to cutting the fiscal deficit drastically, reducing the worrying recourse to central bank financing, and deindexing the economy, including financial assets and incomes, Mr. Goos considered. Deindexation would greatly facilitate the implementation of an effective monetary policy. Priority also should be given to maintaining a realistic exchange rate policy aimed at securing international competitiveness. The authorities had admittedly already introduced significant measures that could lead to a considerable improvement in the economic situation. Moreover, the fact that those measures had been introduced despite the difficult political environment was evidence of the authorities' commitment to adjustment. Nevertheless, he hoped that the authorities would be able to adopt a comprehensive adjustment program along the lines of the staff recommendations.

Mr. Wicks said that the problems facing the economy had reached the crisis stage in 1984. Two developments were particularly worrying. First, the high rate of inflation had led to structural changes in the financial markets. As a result of the widespread application of indexation, most government liabilities had liquidity features that were normally characteristic of money. Government bonds, whose value amounted to 150 percent of GDP, constituted approximately 90 percent of private sector financial assets; it would be difficult to achieve further net sales. Second, under current budgetary procedures, an increase in the rate of inflation tended to result in a rise in budgetary expenditures and a fall in revenues in real terms. The rate of inflation and the budget deficit seemed, therefore, to be mutually reinforcing.

There was a clear need for comprehensive measures to improve the economic situation, Mr. Wicks went on. The partial measures adopted in previous years had merely exacerbated the problems facing the economy. The authorities' commitment to a comprehensive approach to adjustment was encouraging. Given the large size of the internal and external imbalances and the total debt, as well as the need to reduce inflationary expectations so that the series of price freezes could have a lasting effect, substantial measures should be introduced. The staff's medium-term fiscal scenarios underscored the likely serious consequences in the future of a failure to adopt such measures.

He shared the staff's concern about the adequacy of the authorities' gradualist approach to adjustment, Mr. Wicks continued. The political justification for that approach was understandable, but the authorities should be aware that the gradualist approach had not been successful in other countries and that the failure of their approach could have drastic consequences for employment and seriously strain the social and political fabric of the country.

A strong case could be made for much stronger short-term action than the authorities were planning, Mr. Wicks commented. The steps taken thus far were in the right direction, although a number of the proposed measures had not yet been passed and recourse to the Bank of Israel would remain substantial, particularly if the domestic debt could not be rolled over. He strongly endorsed the staff's conclusion that additional deficit reduction measures were required. Further comment by the staff on the latest fiscal measures would be helpful.

Wages were not the main cause of inflation in Israel, although wage policy had clearly contributed to the inflationary process, Mr. Wicks remarked. There was a clear need to restrain wages--particularly in the public sector--in order to reduce fiscal pressures, maintain competitiveness, combat unemployment, and reverse the decline in investment. At the same time, the authorities needed a controllable nominal monetary aggregate to ensure that monetary policy could help to reduce the rate of inflation. The staff's recommendation to deindex short-term liquid assets was understandable. At the same time, given the difficulty in selling government debt and what would already seem to be high real interest rates, he agreed with Mr. Polak that partial deindexation could provoke a further move into foreign exchange or a sharp drop in savings. A further comment on the potential usefulness of partial deindexation would be helpful.

The impressive export growth in 1984 underscored the importance of maintaining an appropriate exchange rate policy, Mr. Wicks commented. The appreciation of the shekel against EC currencies in 1984 might undermine Israel's market share in the EC market, particularly given the likely intensified competition following the enlargement of the EC in 1986. Finally, the proposed decision was acceptable.

Mr. Zecchini remarked that although the external current account position had improved somewhat in 1984, the overall performance of the economy had been unsatisfactory. Fiscal performance had been especially disappointing, as cash expenditures had exceeded the budgeted amount by 12 percent of GNP, and revenues had fallen short of the budgeted figure by 2 percent of GNP. Those developments had been only partly offset by a large increase in foreign grants, and the financing requirement had grown from 15.6 percent of GNP in 1983 to 19.6 percent in 1984. Growing government deficits had been financed increasingly by net credit from the Bank of Israel. Rising liquidity, depreciations of the exchange rate, and the high degree of indexation in the economy had combined to create an explosive inflationary spiral.

Recent wage freezes had dealt merely with the symptoms of inflation rather than the basic causes, Mr. Zecchini commented. The freezes, together with the benefits offered to workers, had increased the budget deficit. He strongly agreed with the staff that the authorities should implement a comprehensive stabilization program that would include a consistent set of fiscal, monetary, incomes, and exchange rate policies.

The authorities correctly believed that reducing the fiscal deficit was the key to the stabilization effort, Mr. Zecchini said. Their recent measures in the direction of containing the budget deficit were welcome, although the expenditure cuts and revenue increases in the 1985/86 budget should be seen as minimum targets. The authorities should firmly adhere to those targets, avoiding the large deviations that had occurred in the past. The staff was understandably concerned about the considerable central bank financing of the budget deficit, and the plan to reduce the deficit--excluding foreign grants--from 19.6 percent of GDP in 1984 to 9.9 percent of GDP in 1985 would represent a significant step toward adjustment. Larger reductions might not be feasible in the present fiscal year, but the authorities should aim to achieve them in subsequent years.

As the staff had noted on page 5, the decline in revenues reflected the adverse impact of higher inflation on tax collections, Mr. Zecchini remarked. Inflationary pressures were likely to continue, and it seemed advisable to correct the mechanisms through which revenues were negatively affected by inflation.

The formulation of monetary policy had been constrained by fiscal developments, Mr. Zecchini observed. Central bank financing of the public deficit had been growing: in 1981/82, central bank credit had covered just 20 percent of the financing requirement, but that figure had risen to 58 percent in 1984/85 and was expected to reach 95 percent in 1985/86. The proposed legislation limiting and eventually eliminating financing of the deficit by the Bank of Israel was therefore welcome.

The staff had recommended eliminating the indexation of liquid assets, Mr. Zecchini commented. However, in the light of the persistence of high and variable rates of inflation, such indexation was needed for the time being to sustain the demand for financial assets. The indexation could be reduced only when inflationary expectations were lowered following the adoption of tight fiscal and monetary policies.

The authorities had had limited success in reducing the external current account deficit, Mr. Zecchini said. In 1984, a more flexible exchange rate policy than in previous years had contributed to the authorities' success in adjusting the current account. Still, the shekel had depreciated vis-à-vis the dollar and appreciated against the main European currencies, even though Israel's trade with the United States constituted less than 30 percent of total trade while the share of trade with EC countries was much larger. The authorities should make more active use of the exchange rate in order to preserve and increase the competitiveness of Israeli exports.

The introduction and intensification of various measures that had given rise to exchange restrictions and multiple currency practices were a cause for concern, Mr. Zecchini commented. It was his understanding that those measures were merely temporary stopgaps; they should be eliminated as soon as possible.

Mr. Romuáldez expressed broad agreement with the staff appraisal. The piecemeal, gradualist approach to the problems facing Israel's economy had been inappropriate. In 1984, the authorities' policy effort had focused on the external position. As a result, while there had been some improvement in the external accounts, the rate of inflation had gone out of control, peaking at an annual rate of more than 1,000 percent in September-October 1984. In Israel, as in some other Fund members, the gradualist approach to adjustment had been overtaken by adverse developments resulting from deeply rooted imbalances in the economy. As a result, gradualism had compounded problems rather than solved them. It was in Israel's best interest to adopt a comprehensive and decisive adjustment strategy. The authorities should resist the temptation--which was strong because of substantial foreign aid--to postpone adjustment or to maintain the gradualist approach.

The authorities' fiscal policy should support their objective of avoiding a recurrence of the hyperinflation of 1984, Mr. Romuáldez continued. Government expenditures, excluding those on defense-related imports, had exceeded the 1984 budget by about $1.2 billion owing to overruns in subsidies in the period before the elections and during the price freezes and to overruns in amortization payments on government debt. Large wage increases for public sector employees also had been granted before the elections.

Some of the initial proposed budget cuts for 1985/86 reportedly had already been reduced, some proposed revenue measures had not been adopted, and some adjustments of prices of subsidized goods had been postponed, Mr. Romuáldez noted. Even the initial budget cuts had seemed insufficient in the light of the large domestic debt.

Monetary policy must be geared toward providing meaningful support for the fight against inflation, Mr. Romuáldez commented. Thus far, the growth of the monetary aggregates had accommodated rather than resisted inflationary pressures. The indexation of financial assets had aggravated inflation; the targeting of monetary aggregates had been rendered ineffective.

Because of the insufficient control over the monetary aggregates, the authorities should maintain high real rates of interest in the coming period, Mr. Romuáldez went on. However, they should also take forceful action to reduce the indexation of liquid assets and to maintain flexible interest rates for those assets. However, excessive dependence on interest rates alone to maintain monetary control might raise those rates above appropriate levels, thereby stifling private investment, which was already quite limited. He hoped that the legislation to restrict and eventually eliminate monetary financing of the budget deficit by the Bank of Israel would be passed. It could spell the difference between success and failure in the authorities' efforts to retain control over the monetary aggregates.

He was pleased that the authorities were determined to maintain Israel's competitiveness, Mr. Romuáldez remarked. However, there was no certainty that that objective would be well served in the long run--or even in the short run--by the trade restrictions or the multiple exchange rate practices. The authorities should eliminate the restrictions and maintain a more flexible exchange rate policy. Finally, the proposed decision was acceptable.

The Deputy Director of the European Department commented that although monetary targeting was certainly desirable in the present circumstances of Israel, the time did not yet seem ripe to introduce such targeting. Such an effort might well result in a serious squeeze on credit to the private sector, something that the authorities would certainly wish to avoid.

The recently initialed trade arrangement with the United States, to be implemented later in 1985, in effect established a customs union between the two countries under the relevant GATT Articles, the Deputy Director said. The arrangement provided for the progressive elimination of tariffs by the two countries until 1995, when all import duties would be removed. Most exports from Israel to the United States were already duty free. The Israeli authorities were fully aware that the new trade agreement should be managed in a nondiscriminatory fashion; Israel's trade with the United States should not benefit from special advantages other than those allowed by the GATT.

The budgetary outlook for 1985 was not promising, the Deputy Director commented. Planned expenditure cuts had been delayed, mainly because subsidies had had to be increased following the extension of the price freeze. In addition, some planned cuts in transfers to the health and education sectors had not been made; those cuts had been dependent upon increases in educational and health service fees that had not yet been approved by the Knesset, and the prospects for their adoption were uncertain. In addition, certain revenue measures in the budget had not yet been approved by the Knesset. The recently adopted fiscal measures mentioned by Mr. Polak in his opening statement did not significantly change the fiscal outlook.

The poor prospects for reducing the budget deficit had important implications for the prospects for inflation in Israel, the Deputy Director continued. The budget deficits and the large injection of liquidity resulting from deficit financing were clearly the main causes of inflation in Israel. Reducing the rate of inflation would be difficult in the absence of success in controlling the budget deficit. In the first four months of 1985, the inflation rate had been high, and the chances of halving the rate in 1985, as the authorities had initially projected, were not good.

The authorities had stated that exchange rate policy was designed to maintain the real effective exchange rate, the Deputy Director explained. Erratic fluctuations in the domestic rate of inflation made the exchange rate policy objectives difficult to achieve. In April 1985, when the rate of inflation had reached nearly 20 percent, the shekel had been devalued by 12 percent against the dollar; hence, there had been a real appreciation of the shekel. That movement might have been corrected in May, when the rate of inflation had decelerated somewhat. Any attempt to move beyond the policy of merely maintaining the real effective exchange rate could succeed only if it were supported by supplementary financial measures. Even if such measures were adopted, a real effective depreciation of the exchange rate might well be difficult to achieve because of pervasive indexation.

The staff had recommended eliminating the indexation of short-term liquid assets, the Deputy Director remarked. In the present circumstances, eliminating indexation of long-term financial assets would be undesirable; at the least, the rate of inflation must first be drastically reduced. The indexation of short-term liquid assets was tantamount to indexation of the money supply. As a result, the money supply automatically accommodated any price shocks or adjustments in the exchange rate, thereby making it impossible to maintain strict control over the money supply.

Indexation of short-term liquid assets could conceivably be replaced by free and variable interest rates, the Deputy Director went on. In that event, the interest payments on short-term deposits would be added to the total deposits held by the public. At the same time, deposit holders would no longer enjoy an immediate, automatic increase in deposits in response to an increase in the rate of inflation or a change in the exchange rate. For example, the absence of indexation, holders of 6-month or 12-month certificates of deposit would suffer a temporary loss in purchasing power following an unexpected increase in the rate of inflation.

There was already some partial indexation in Israel, the Deputy Director noted. For example, wages and certain types of previously issued government securities were partially indexed. The staff agreed with the authorities that a case could not be made for partial indexation of long-term financial assets. A high savings rate was needed, particularly under the present conditions of rapid inflation, uncertainty, and lack of confidence.

Responding to a further question, the Deputy Director of the European Department said that it was the staff's understanding that the free-trade arrangement between Israel and the United States covered tariffs and excluded nontariff barriers.

The staff representative from the Exchange and Trade Relations Department commented that the Executive Board had decided that it would approve multiple currency practices that were thought to be temporary and were being applied while a member was implementing an adjustment program designed to eliminate its balance of payments problems. The staff did not recommend approval of multiple currency practices when the practices were not felt to be temporary or the adjustment program seemed inadequate. In addition, nonapproval of a multiple currency practice could have a beneficial effect of moral suasion in providing support to officials arguing within a government to eliminate such practices or limit their extension. That effect had been apparent in Israel, where the authorities had already noted with some concern that the description of the exchange system in the present staff report differed from that in previous reports.

The staff representative from the Legal Department remarked that the question of nonapproval of a multiple currency practice was an important one and had been discussed by the Executive Board on several occasions. The unapproved maintenance of a restriction or a multiple exchange practice that was subject to approval was clearly a breach of an obligation under the Articles of Agreement. Article VIII specifically stated that those practices should not be introduced or maintained without the Fund's approval. An ongoing breach could bring into play Rule H-1, which dealt with communications with a member, and Rule K-1, which dealt with reports by the Managing Director to the Executive Board concerning the nonobservance by a member of an obligation under the Articles. However, no such reports had actually been made to the Executive Board, probably because the approval or nonapproval of exchange restrictions was an act of the Executive Board itself.

Other provisions of the Articles could come into play when a member maintained exchange restrictions, the staff representative observed. Article XII, Sections 7 and 8 dealt with the possibility of further examination of such a question through informal communications with a member or even in published reports; of course, use of that approach would emphasize a member's unapproved exchange restrictions to a greater extent than the Executive Board had decided to do in the past.

Moreover, a link could be posited between an unapproved restriction on the one hand, and the policies on the use of Fund resources on the other, the staff representative continued. The question of such a link had been examined in recent years, particularly in the context of reviews under the compensatory financing facility, and there was ground for developing more general policies concerning unapproved restrictions and the use of Fund resources should the Executive Board decide to do so.

Article VIII, Section 2(b) gave an international effect to the approval or nonapproval of a member's exchange restriction by providing that in certain circumstances exchange contracts would be uninforceable in the territories of a member, the staff representative from the Legal Department concluded. It was not clear how that provision would apply to a multiple currency practice; that application would depend upon the reaction in the national courts of members to the multiple currency practice in the context of a particular dispute. However, the courts of members dealing with a dispute involving an exchange restriction would be obliged to take Article VIII, Section 2(b) into account.

Mr. Polak noted that the Executive Directors who had spoken had expressed common views on the economic situation in Israel reflecting their wide experience with efforts to deal with balance of payments problems and very high rates of inflation. Speakers had stressed the origin of the inflation in Israel, namely, the budget deficit and the management of the public sector debt. Attention had also been paid to the Government's significant share of the social product owing to its large role in the economy. In the circumstances, particularly the persistently large fiscal deficit, monetary policy had played a relatively subsidiary role. Even the recent legislation limiting the extent to which the Bank of Israel could finance the government deficit should be seen mainly as a means of forcing a reduction in the deficit on the Government rather than as a means of encouraging another form of financing further large deficits. Establishing nominal money supply growth targets affecting the small part of the money supply that was denominated in shekels and that was under the limited control of the Bank of Israel would be of little use until the problem of persistently large fiscal deficits was solved.

In summarizing the differences of view between the staff and the authorities, he doubted whether it was useful simply to say that the staff favored a shock treatment while the authorities favored a gradualist approach, Mr. Polak said. There was unanimous agreement that the authorities should adopt stronger and bolder policies than they had implemented thus far. Inadequate policies that failed to bring inflation under control might in the end adversely affect the variables that were particularly important to the authorities--such as employment--to a greater extent than the stronger policies favored by the staff and Executive Directors. The desired measures should be comprehensive: they should affect a broad range of economic variables and achieve structural changes. They should not be ad hoc or piecemeal. It was difficult to estimate the likely effect of the recently adopted measures. However, the fact that they were to cover only a three-month period and the comments on them by the Minister of Finance clearly indicated that they would not solve the problems facing the economy; they would merely buy some time to design structural measures.

The differences of view between the staff and the authorities concerning the indexation of financial assets were smaller than they appeared from the discussion in the staff report and his own opening comments, Mr. Polak considered. It was important to remember that deindexation of financial assets was a different issue from deindexation of wages and other variables. He was pleased that the staff agreed with the authorities that deindexation of long-term liquid assets would not be appropriate at the present stage. While attempting to reduce the rate of inflation, the authorities would have to maintain indexation of long-term assets to ensure that safe and reliable assets remained available. Executive Directors apparently also shared that view, although they seemed to feel that that matter was of secondary importance compared with the main conclusion, namely, that a strong and comprehensive program designed to correct the fiscal imbalance was clearly required.

The Acting Chairman made the following summing up:

Directors welcomed the improvement in the civilian trade account achieved in 1984, and noted that the worsening of inflation in 1984 partly reflected the impact of responses to policies in earlier years. They observed, however, that the continuing failure to deal with the underlying imbalances in the economy, reflected especially in large and expanding fiscal deficits, had contributed importantly to the major economic problems that had emerged and the increasing damage that inflation was inflicting on the Israeli economy and its financial system. In this situation, Directors--as in previous consultation discussions--emphasized the central role of a comprehensive stabilization program if the economic problems now facing Israel were to be adequately addressed.

Against this background, Directors noted the steps taken by the new Government shortly after taking office, which were intended to reduce the pace of inflation and avert a foreign exchange crisis. However, Directors took the view that such policies could only be viewed as temporary steps that provided a short breathing space while more fundamental measures were being put in place.

Directors noted that the Israeli authorities had opted for a gradualist approach to stabilization with emphasis on social consensus. While indicating their support for the general direction of current policies, which involved cuts in government expenditures, high interest rates, and maintenance of external competitiveness, Directors had serious doubts about the realism of the gradualist approach, given the dimensions of the economic problem. In the view of Directors, substantial, comprehensive, and immediate measures were needed in line with the magnitude and urgency of the adjustment task, and to avoid detrimental social consequences in the future.

Directors emphasized the critical role of fiscal policy in the stabilization effort. The Government's substantial recourse to central bank credit, as well as the difficulties in rolling over domestic debt, added a special urgency to securing a major improvement in the public finances. Directors welcomed the targeted cuts in domestic expenditures of about $1 billion included in the 1985/86 budget, but felt that the target was not sufficiently ambitious and that major additional cuts were necessary if the fiscal position were to be suitably strengthened. Several Directors expressed concern over the signs of slippage from the targeted cuts in domestic spending and stressed the importance of achieving agreed reductions, particularly given the heavy burden of taxation. The targeted reduction in the Government's financing requirement in 1985 to the equivalent of 9 percent of GNP would still leave the deficit at a relatively high level, and it looked increasingly uncertain whether that target would be achieved. Directors urged the authorities to continue and intensify their efforts to improve budgetary management and control and felt that the proposed legislation designed to limit and eventually eliminate central bank financing of the budget deficit would help to encourage fiscal restraint.

As regards monetary policy, Directors strongly supported the policy of maintaining high real interest rates, which should help contain the demand for credit, assist in rolling over the large volume of maturing domestic debt, and curtail capital outflow. A sharp reduction in central bank financing of the budget deficit was clearly critical to permit greater control of the monetary aggregates.

With regard to the question of total or partial deindexation of CPI-linked or dollar-linked assets, while some Directors thought that inflation would first have to come down from the recent very high rates before deindexation could be implemented, most speakers considered that the elimination of such linkages from short-term financial assets was essential for a more effective monetary policy.

Directors noted that real wages had increased strongly in recent years--particularly in the public sector--and substantially exceeded the rise in labor productivity. Directors felt that real wage restraint should form an important part of a stabilization program in Israel, and were concerned about the unambitious projections for cuts in real wages over the coming year.

Directors also urged that steps be taken to improve incentives and reduce regulation of the economy to permit a return to a more dynamic economic performance.

Directors welcomed the authorities' stated policy of maintaining Israel's external competitiveness, which was all the more necessary given the ambitious balance of payments targets and the weakening of the trade account over the early months of the year. Directors noted the exchange restrictions and multiple exchange rate practices recently introduced and regretted the extensive system of import restrictions and export subsidies.

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

The Executive Board then adopted the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Israel, in the light of the 1985

Article IV consultation with Israel conducted under Decision No. 5392-(77/63), adopted April 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/85/129. The Fund encourages Israel to eliminate these restrictive practices and return to a liberal exchange and trade system.

Decision No. 7986-(85/80), adopted
May 24, 1985

3. LIBERIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINTS UNDER RULES K-1 AND S-1, AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

The Executive Directors considered a staff paper on the Managing Director's report and complaints under Rule K-1 and Rule S-1 and notice of Liberia's failure to settle Trust Fund obligations (EBS/85/133, 5/22/85).

Mr. Thomas Hanson, Governor of the National Bank of Liberia, and Mr. Lindsey Haines, Deputy Minister of Finance of Liberia, were also present.

Mr. Hanson noted that the Fund had been actively involved in Liberia's stabilization efforts since 1980. The Government had demonstrated its commitment to the adjustment process by implementing measures agreed upon with the Fund and supported by a series of stand-by arrangements. There had been a dramatic increase in taxes, salaries had been reduced by 16-25 percent in 1982/83, and steps had recently been taken to reduce the size of the civil service. Those measures had been aimed at strengthening the Government's financial position. In addition, efforts were being made to improve the performance of the public corporations. In 1983/84 the overall government deficit had declined to the equivalent of 6 percent of GDP, compared with 12 percent in earlier years.

The program for 1984/85 was designed to build upon those achievements, Mr. Hanson continued. There had been some slippage in implementing measures crucial to attaining the revenue and expenditure targets. As a result, Liberia had been unable to observe the performance criteria under the stand-by arrangement approved in December 1984, and other external financing from bilateral and multilateral sources had not been forthcoming. The Government also had been unable to service its external debt, including repurchases in respect of purchases of Fund resources.

The Government took the external arrears--particularly the overdue obligations to the Fund--seriously, Mr. Hanson continued. Liberia's inability to make repurchases on schedule should not be seen as a deliberate attempt to avoid honoring the country's commitments. The inability to make the repurchases had been due essentially to the insufficient supply of foreign exchange and the poor performance of Liberia's major exports. Income tax revenues from iron ore production were virtually zero. Liberia's total reserves in February 1985 had amounted to SDR 2 million, compared with external arrears of $58 million at the end of March 1985. Recent estimates indicated that total arrears through June 30, 1985 were equivalent to about 38 percent of the domestic revenues projected for fiscal year 1985.

The Fund mission that had recently visited Liberia had held several meetings with the Economic and Financial Management Committee and together they had considered various policy options aimed at placing the economy on a sound footing, Mr. Hanson noted. Since then, a number of revenue and expenditure measures had been introduced. For example, the excise tax on gasoline had been increased from $1.25 to $1.50, and a 10 percent surcharge on imports had been levied with effect on May 1, 1985.

The Government had also taken steps to improve its debt servicing capability, Mr. Hanson went on. It had established a Special Foreign Debt Service Account to service exclusively all priority debt service payments, including payments to the Fund, the World Bank, the Asian Development Bank, and the London and Paris Clubs. The account, which had been opened with the Federal Reserve Bank of New York, would be credited by the National Bank of Liberia with 60 percent of all offshore revenues accruing to the Government. Sources of funding for the account included maritime revenues, offshore tax revenues, royalties, and stumpage fees, which together were projected at about $51 million in 1985/86. In addition, the Government had established a mechanism at the National Bank of Liberia to ensure the efficient monitoring and management of external debt obligations. To enhance fiscal discipline, a new Memorandum of Understanding had been agreed between the Government and local commercial banks. The memorandum stipulated inter alia that overdrafts by the Government were to be prohibited. The budget for 1985/86 was being reviewed by the Budget Committee with a view to containing expenditure and minimizing the financing gap.

The Government looked forward to maintaining the close relations with the Fund that had been developed over many years, Mr. Hanson commented. A considerable effort had been made to achieve economic stability, and the Government and the Fund should cooperate in seeking a workable solution to the problem of the overdue obligations to the Fund. The Government recognized that the arrears were a serious problem. However, given the difficult economic situation in Liberia, the Fund should approach the problem flexibly and postpone the adoption of a decision on the question of Liberia's overdue financial obligations to the Fund. Suspending Liberia's right to use Fund resources at the present stage would not contribute to solving the problem of the overdue financial obligations; it would further aggravate the difficult economic situation in Liberia. The fact that he had come to Washington underscored the importance that his Government attached to the present discussion.

Mr. Mtei remarked that the authorities clearly were willing to pay the Fund on time but were genuinely unable to do so. Indeed, the authorities had given priority to reducing the country's overdue obligations to the Fund, even at the expense of payment of salaries to civil servants. Moreover, the size of the civil service had been reduced. The authorities were obviously undertaking considerable social and political risks in their efforts to eliminate Liberia's arrears to the Fund. The Fund should show its understanding of the particular circumstances of Liberia and approach the extraordinary situation there in a flexible manner. The situation was extraordinary because the foreign exchange proceeds of exports did not accrue wholly to the monetary authorities. Liberia used the U.S. dollar as its domestic currency and had to rely upon export taxes to accumulate foreign exchange. The Fund should treat Liberia differently from other members with overdue financial obligations.

Mr. Dallara commented that the present discussion gave Executive Directors an opportunity to convey to the Government their feeling that the problem of the country's overdue financial obligations to the Fund was serious. During previous discussions on members' overdue obligations, Executive Directors had stressed the considerable impact of those arrears on the Fund's credibility and financial integrity. By jeopardizing the Fund's credibility, overdue payments impeded the Fund's ability to meet its obligations to the international financial community in general and to members in particular. The uniform treatment of members was one of the Fund's most basic principles, and it was based on the idea that every member was obliged to meet its financial commitments to the Fund in a timely manner.

Liberia's overdue obligations had been accumulating over a long period and were equivalent to more than 30 percent of the country's quota in the Fund, Mr. Dallara noted. Only one small repurchase had been made in 1985. Liberia had made extensive use of Fund resources in the past--total outstanding Fund credit was approximately 300 percent of quota--and substantial repurchases would fall due over the coming years. Despite the information that Mr. Hanson had provided in his opening statement, the Executive Board did not have a clear indication from the authorities that they were prepared to take the full range of steps needed to ensure prompt repayment to the Fund.

Furthermore, in December 1984 the Executive Board had approved a stand-by arrangement for Liberia under which the authorities had been committed to maintain their adjustment effort, Mr. Dallara went on. At that time, a number of Executive Directors had indicated that Liberia's prolonged use of Fund resources was a cause for concern. His chair had also expressed its concern about the pace of adjustment under the authorities' adjustment program. For example, the target for the reduction in the fiscal deficit as a percent of GDP was less ambitious under the program approved in December 1984 than under the previously approved program. Arrears to the Fund had developed soon after the approval of the stand-by arrangement in December 1984; shortly thereafter, it had become apparent that the fiscal position was likely to be much less favorable than the authorities had expected. Indeed, in the fiscal year ending in June 1985, the fiscal deficit was expected to reach 11 1/2 percent of GDP--6 percentage points above the program target. The recent increase in the gasoline tax and import surcharge would yield revenues equivalent to just 3 1/2 percent of GDP; they were clearly insufficient to close the domestic and external financing gaps.

The authorities' serious deviation from their commitments to the Fund had adversely affected their credibility in the eyes of his authorities and of the Executive Board, Mr. Dallara said. Liberia's overdue financial obligations to the Fund could adversely affect its standing with the international financial community. In the absence of normal relations with the Fund, the authorities had little hope of maintaining regular relations with other international creditors and donors. Liberia's arrears to other international institutions, bilateral donors, private creditors, and suppliers were growing, and the country could find itself cut off from all those sources of foreign credit. By one means or another, Liberia would have to undertake economic adjustment in the coming period. The authorities could do so by permitting shortages and arrears to increase, but that would certainly disrupt the economy. Alternatively, they could adopt and implement a comprehensive adjustment program that would restore the country's creditworthiness while ensuring that the required economic changes would be made in the most efficient manner possible.

Bilateral creditors could not be expected to provide additional financial support for an adjustment effort that they believed would not succeed, Mr. Dallara continued. The Liberian authorities must appreciate the gravity of the present economic situation and the medium-term economic outlook. Steps must be taken immediately to tackle the problems facing the economy. The international financial community could be expected to provide additional support only after it was convinced that the authorities seriously intended to improve the economic situation in Liberia; the evidence would have to include prompt elimination of arrears to the Fund.

He fully agreed with Mr. Hanson that the authorities had implemented some courageous measures under previous Fund-supported programs, Mr. Dallara said. Indeed, given the difficult decisions that the authorities had made in recent years and the Fund's willingness to provide continued support for Liberia, the country's performance in recent months and the authorities' lack of commitment to a comprehensive adjustment program were particularly disappointing and discouraging; the progress achieved as a result of the authorities' courageous steps and the Fund's financial support had been placed at risk. Some of the steps recently taken had gone in the right direction, but they were clearly insufficient to handle the serious problems facing the economy.

As Mr. Hanson had noted, the problem of an insufficient supply of foreign exchange had been growing in recent months, Mr. Dallara commented. However, it ought to be clear that the lack of foreign exchange--particularly as a result of declining donor contributions--was the direct result of the authorities' inadequate performance and that a restoration of adequate foreign exchange flows was invariably dependent upon the formulation and implementation of an adequate adjustment program that would bring the economy back onto the path of adjustment.

The proposed decision was acceptable, Mr. Dallara stated. The Executive Board had already established three-month review periods for other members in arrears to the Fund. However, the authorities should clearly understand that the adoption of the proposed decision should not be taken to mean that the authorities had been given three months to repay the Fund or to implement significant adjustment measures. There was every indication that further postponement of the implementation of a comprehensive adjustment program would merely aggravate the problems facing the economy and increase the need for adjustment and the hardship that it would entail for the Liberian people. The Fund should continue to respond to any request by the authorities for technical assistance in the formulation and implementation of required adjustment measures. A further comment on the measures that the authorities intended to implement in the immediate future in order to reduce Liberia's arrears to the Fund and to maintain a viable adjustment effort would be helpful. Given the obligations to the Fund that were due at present and that would become due in coming months and years, he doubted whether the funds that were to be placed in a new special account would be sufficient to meet Liberia's obligations to the Fund and other creditors. The establishment of the new account had been a step in the right direction, but sufficient funds would have to be deposited into the account and paid to the Fund, thereby eliminating the arrears, before the institution would be in a position to consider supporting any further use of its resources by Liberia.

Mr. Goos said that Mr. Hanson's opening statement had somewhat reduced his serious concern about the authorities' attitude toward the Fund. After all, the authorities had made no payment to the Fund since the previous discussion on Liberia. Moreover, Liberia had failed to adopt an adjustment program, which was crucial to restoring a balanced external financial position.

His position was similar to that of Mr. Dallara, Mr. Goos continued. Given the established procedures for dealing with cases of overdue obligations and the precedents in handling such cases, he had no difficulty in accepting the proposed decision. Its adoption would not in effect sever the Fund's relationship with Liberia. He hoped that before the next discussion on Liberia the authorities would demonstrate their commitment to repaying the Fund by reducing the country's overdue obligations to the greatest extent possible.

Mr. Clark said that the recently adopted measures and the steps that the authorities intended to take were welcome. However, the staff apparently felt that they were insufficient to solve the external financing problem.

The fact that Liberia had become overdue in its financial obligations to the Fund within a few days of the Executive Board's approval of a new stand-by arrangement in December 1984 was surprising and unsatisfactory, Mr. Clark went on. The initial purchase under the stand-by arrangement of about SDR 8.5 million was several times larger than the amounts that soon thereafter became overdue to the Fund. That such an acute cashflow difficulty had occurred shortly after the Executive Board discussion on Liberia and had not been identified in advance was disturbing and reinforced his conclusion that a member's financing arrangements should be clearly seen to be adequate before the Board approved a stand-by arrangement.

The Executive Board followed what was becoming an increasingly rigid timetable in its reviews of a member's financial obligations to the Fund, Mr. Clark remarked. In general, reviews should be agreed only when there were clear signs that in the meantime the authorities would take action to deal with the problem. Although the Executive Board was considering the Managing Director's complaint against Liberia for the first time at the present meeting, the arrears that had led to the complaint had arisen five months previously. Accordingly, the Liberian authorities had had five months to formulate their policies. It was disappointing that they had not done so. Finally, the proposed decision was acceptable.

Mr. Leonard said that Mr. Hanson had provided considerable assurance that the Liberian authorities clearly understood that the overdue financial obligations constituted a serious problem. However, there was no reason why the Executive Board should depart from the established procedures for dealing in an evenhanded manner with members in arrears to the Fund. The circumstances in Liberia were obviously difficult, and the authorities were making efforts to deal with them. The proposed decision would protect the interests of the Fund while giving the authorities an opportunity to meet their obligations to the Fund and to undertake an adequate adjustment program before the Executive Board took any further action regarding the country's arrears. The staff proposal would also enable Liberia to take advantage of the technical assistance that the Fund stood ready to provide. The draft decision should be approved.

Mr. Flamant stated that the draft decision was acceptable.

Mr. Doe considered that overdue financial obligations to the Fund should be eliminated promptly. The economic and financial situation in Liberia was difficult, and the authorities had taken steps to create the conditions that would enable them to settle their overdue obligations; the creation of an account to receive funds to be applied toward settling those obligations was especially noteworthy. The authorities should formulate and implement a strong, comprehensive economic and financial program commensurate with the magnitude of the imbalances in the economy. The Executive Board should be flexible in dealing with Liberia's overdue financial obligations.

Mr. Govindarajan remarked that maintaining the Fund's financial integrity was of paramount importance. At the same time, there should be evenhanded treatment of members in arrears to the Fund. Since the approval of the stand-by arrangement for Liberia in December 1984, the authorities had taken a number of steps that had shown their determination to repay the Fund. Nevertheless, even if they were to implement a full set of appropriate adjustment measures, they probably could not fully repay the Fund by the date mentioned in the final paragraph of the proposed decision. Was the text of that paragraph meant to suggest that the authorities would be expected to make full repayment within three months of the adoption of the decision? Given the measures described by Mr. Hanson in his opening statement, the Executive Board might wish to consider a period longer than three months. A relatively flexible approach to Liberia also seemed called for in the light of the special account that the authorities had opened to receive substantial sums that were to be used in payment to the Fund; indeed, the amount that the authorities intended to deposit was more than double the amount of Liberia's overdue obligations to the Fund.

Mr. Polak commented that it was troubling to note that the approval of the stand-by arrangement in December 1984 and the first drawing under that arrangement had occurred at virtually the same time that arrears to the Fund and other creditors had arisen. In the light of the information in the staff paper and in Mr. Hanson's opening statement, the Executive Board had no choice but to give Liberia another three months in which to become current with the Fund. The proposed decision was therefore acceptable.

Mr. Finaish said that Liberia's failure to settle its overdue obligations was disappointing. Liberia had continued to accumulate arrears vis-à-vis other multilateral and bilateral creditors. The case of Liberia was particularly unfortunate because the country had begun to accumulate arrears to the Fund only a few days after the Executive Board had approved a stand-by arrangement under which the authorities had been able to make an immediate purchase of SDR 8.5 million. That development raised serious questions about the priority given by the authorities to meeting their obligations to the Fund and about their management of the country's finances.

Liberia's disappointing performance was not totally surprising, Mr. Finaish continued. Liberia's track record--its performance under previous stand-by arrangements--had led his chair to express its doubts about the stand-by arrangement that had eventually been approved in December 1984, and particularly about the staff's conclusion that the implementation of the program proposed at that time had marked a significant turning point in the evolution of the economy and in Liberia's relations with the Fund. Subsequent developments had shown that those doubts had been fully warranted.

It was also unfortunate that Liberia, unlike a number of other members with overdue obligations to the Fund, had chosen not to make even partial repayments to the Fund before Board consideration of the Managing Director's complaint, Mr. Finaish said. Such repayments could have been interpreted as a sign that the authorities intended to deal with their arrears to the Fund. It was true that Liberia, like other members with overdue obligations to the Fund, faced serious economic problems, but Liberia's ability to settle its overdue obligations was apparently no more constrained than that of other members that had eliminated their arrears to the Fund. As Liberia's overdue obligations constituted only about 8 percent of the government budget, and in the light of the country's monetary and exchange systems, he wondered whether the authorities were giving first priority to eliminating those arrears. The recent adjustment measures announced by the authorities and described in Mr. Hanson's opening statement had gone in the right direction but clearly fallen short of what was required. Accordingly, the proposed decision should be approved. He hoped that the authorities would implement the necessary steps to become current with the Fund.

Mr. Ainley stated that the importance that Mr. Hanson attached to continued cooperation between the Fund and Liberia was welcome. The economy faced a number of difficult problems, and he was pleased that the authorities were attempting to solve them. However, the steps that the authorities were taking might not be sufficient to close the financing gaps and to eliminate Liberia's outstanding arrears to the Fund in the foreseeable future. Those arrears were substantial, and some of them had been outstanding for five months. Moreover, the volume of arrears had not been reduced since the previous discussion on Liberia. For those reasons, and in accordance with the principle of uniform treatment of members, the Executive Board had no choice but to approve the proposed decision.

The staff representative from the African Department considered that the measures that the authorities had formulated thus far probably would not enable them to undertake a comprehensive adjustment program and repay the Fund fully over the coming several months. The staff had concluded that, to achieve those objectives, the authorities at the highest level would have to implement extraordinary measures, particularly with respect to government expenditure. Moreover, they would have to provide clear evidence of their commitment to some adjustment measures before the international community would continue its support to Liberia. Because Liberia had been unable to eliminate its overdue financial obligations to the Fund over the previous several months, the country had forgone SDR 17 million that would have been available under the stand-by arrangement, a $16 million World Bank structural adjustment credit, and $22 million that the United States had planned to make available.

Mr. Hanson remarked that the problems facing the economy would have to be solved by Liberia itself. The Government intended to use Fund technical assistance in considering a comprehensive package of adjustment measures. The Ministry of Finance had already requested technical assistance in monitoring revenue performance. The emergence of arrears to the Fund soon after the approval of the stand-by arrangement in 1984 was unfortunate, and the authorities were making every possible effort to become current in their obligations to the Fund. The Government would continue to work with the staff to solve the problem of the overdue financial obligations, and it had already opened an account at the Federal Reserve Bank of New York, a clear signal of its intention to deal with the problem. In addition, the authorities were engaged in discussions with friendly governments on possible means of reducing the arrears to the Fund. At the same time, the Government continued to attach the greatest importance to the adjustment program approved in December 1984, and serious measures had been adopted in recent months. He hoped that the Executive Board would give the Government sufficient time to work out a program satisfactory to both sides. The authorities must be certain that such a program could realistically be implemented; failure to implement it fully would damage Liberia's credibility. For the moment, Liberia was simply unable to eliminate its arrears to the Fund.

The staff representative from the Treasurer's Department suggested that the text of paragraphs 4(a) and 4(b) of the proposed decision would be clearer and fully consistent with comparable parts of relevant previous decisions if the words "is fulfilling" were replaced by "has become current on."

Mr. Mtei noted that the final paragraph of the proposed decision would provide that the decision should be reviewed "within a period of three months." In fact, other members with overdue financial obligations had been given three full months, rather than a shorter period. The proposed text should be changed to show that Liberia would be given the same treatment, namely, three months, rather than any shorter period.

The staff representative from the Treasurer's Department remarked that, in dealing with previous cases of overdue financial obligations, the Executive Board had stipulated that the next review should be held within three months of the date of a decision. If Liberia were given a full three months from the date of the proposed decision, the review date would fall during the Executive Board recess. The first date for an Executive Board Meeting after the recess on the basis of the present schedule was August 26, 1985. In order to ensure evenhanded treatment of members in arrears, the Executive Board might wish to agree that the proposed decision should be reviewed no later than August 26, 1985. Accordingly, the Executive Board could conceivably hold the review before three months had elapsed. At the same time, the period until the next review could conceivably be three full months.

The Executive Board approved the decision, with the changes in the text proposed by the staff representative from the Treasurer's Department.

The decision was:

1. The Managing Director has reported under Rule K-1 and Rule S-1 of the Fund's Rules and Regulations to the Executive Board the facts on the basis of which it appeared to him at the dates of these reports that Liberia was not fulfilling its obligations under the Articles of Agreement and submitted complaints and notice on April 4, 1985 (EBS/85/87) in accordance with those Rules. The complaint under Rule K-1, as amended on April 23, 1985, was that as of April 19, 1985 Liberia was not fulfilling its obligations relating to repurchases and the payment of charges in the General Department in the total amount of SDR 18,340,697. The complaint under Rule S-1, as amended, was that as of April 19, 1985 Liberia was not fulfilling its obligations to pay charges in the SDR Department in the total amount of SDR 426,465. Furthermore, the Managing Director added to his complaints a notice of the facts on the basis of which it appeared to him that as of April 19, 1985 Liberia was not fulfilling its obligations under Decision No. 5069-(76/72) with regard to the Trust Fund to repay disbursements in the total amount of SDR 1,889,276. These facts, and the complaints and notice of the Managing Director, were communicated to the authorities of Liberia on April 24, 1985.

2. Taking into account the further obligations of Liberia that have become overdue since April 19, 1985, Liberia's overdue obligations to the Fund have increased to SDR 20,236,904 in the General Department, to SDR 871,693 in the SDR Department, and to SDR 2,080,676 under the Trust Fund.

3. Having considered the reports of the Managing Director, the complaints and the notice, and the views of Liberia, the Fund finds that Liberia has failed to fulfill its obligations under the Articles of Agreement and the Trust Fund as stated in paragraphs 1 and 2 above.

4. The Fund regrets the nonobservance by Liberia of its obligations and urges Liberia to resume their observance forthwith. The Fund decides

(a) pursuant to Rule K-2 of the Fund's Rules and Regulations that Liberia shall not make use of the general resources of the Fund until such time as Liberia has become current on its obligations under the Articles of Agreement relating to repurchases and the payment of charges in the General Department,

(b) pursuant to Article XXIII, Section 2(b) of the Articles of Agreement to suspend the right of Liberia to use SDRs that it acquires after the suspension until such time as Liberia has become current on its obligations to which that provision applies, and

(c) if Liberia were otherwise eligible to make use of the general resources of the Fund, to take into account the existence of any overdue obligations to the Trust Fund in considering any request by Liberia for the use of the general resources.

5. The Fund shall review this decision no later than August 26, 1985.

Decision No. 7987-(85/80) G/S/TR, adopted
May 24, 1985

APPROVED: March 4, 1986

LEO VAN HOUTVEN
Secretary