

**GENERAL AGREEMENT ON
TARIFFS AND TRADE**

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Committee on Balance-of-Payments Restrictions

REPORT ON THE 1987 CONSULTATION WITH ISRAEL

Addendum

ANNEX

Statement by the representative of
the International Monetary Fund

Israel

In his very comprehensive opening statement the representative of Israel covered economic developments and problems in economic policy implementation prior to the introduction of the comprehensive stabilization plan in 1985. My statement mainly covers the elements of the stabilization plan, the effects of the plan and subsequent economic developments. The comprehensive stabilization plan addressed both inflation and balance of payments problems and encompassed use of traditional stabilization instruments of fiscal and monetary restraint and price and income policy measures. The exchange rate was employed as an important "nominal anchor." Following a 16 percent devaluation on July 1, 1985, the new sheqel, which previously had been floating, was pegged to the U.S. dollar and was to be allowed to fluctuate only within a 2 percent band unless an erosion of competitiveness due to excessive wage increases necessitated a further devaluation. In August 1986, the peg was changed to a basket of currencies with a heavy weight for the U.S. dollar. Confidence in the stabilization program was underpinned by a US\$1.5 billion special grant provided by the United States, disbursed in two equal tranches in 1985 and 1986.

A significant improvement in budgetary performance was registered in 1985/86 and in 1986/87. The deficit before grants fell by 8.5 percentage points of GNP in 1985/86 and by a further 4 percentage points, to 16 percent of GNP, in 1986/87, which was virtually all

financed by foreign grants. The improved budgetary performance reflected higher government revenue stemming from the effect of decelerating inflation on tax collections, a curtailment of corporate tax reliefs, and other revenue measures adopted in the stabilization plan as well as cuts in expenditure, notably on subsidies and defense spending abroad. The approved budget for 1987/88 foresees a further cut in the deficit before grants by about 1.5 per-cent of GNP. Expenditures are targeted to be reduced by the equivalent of almost 4 percent of GNP, but revenues are also forecast to decline as a result of a lowering of customs tariffs, the phasing out of the import deposit requirement, and reductions in personal income and profit tax rates. The latter cuts were introduced as a first step toward a broader income tax reform which is a major element in recent structural policy initiatives aimed at improving the supply response of the economy. With the expiration of the special assistance from the United States, the financing requirement is projected to rise somewhat in 1987/88. We understand that there have been some changes in economic assumptions subsequent to the presentation of the budget and also some changes in expenditure plans. We do not have specific details on these changes.

The tight monetary restraint applied at the inception of the stabilization program has since been relaxed. In part, this was a deliberate reaction to the favorable budgetary performance but was also a response to the opposition to the severe squeeze imposed earlier on

companies qualifying only for credit in local currency. Nominal interest rates on sheqel overdraft credit were lowered, resulting in a reduction in real monthly rates from 6.5-7 percent in the second half of 1985 to about 1.5 percent in the last quarter of 1986. Although the renewed rapid growth of bank credits partly reflected financial reintermediation as a consequence of disinflation, in October 1986 the Bank of Israel raised interest rates moderately to signal the need to contain the overshooting of credit expansion. However, rates have been lowered during 1987 as consumer price increases were smaller than anticipated. Rapid monetary expansion continued through the early part of 1987, fueled by a strong growth of bank credit and the resumption of stepped up foreign currency conversions by the private sector. In the recent period, several steps have been taken to broaden the narrow base of monetary policy, including a move toward open market operations, and to reform the capital market.

The stabilization program achieved a notable success in dramatically reducing the rate of inflation. Consumer price increases slowed from an annual rate of some 450 percent in the year ending July 1985 to 20 percent during 1986 and 15 percent during the first seven months of 1987, although price controls have been implemented flexibly and their scope has been progressively narrowed. The costs of this achievement in terms of lower economic activity and unemployment were relatively small. In the early phase of the program all domestic demand components contracted and real GDP declined at an annual rate of

6 percent in the second half of 1985. However, fueled by stockbuilding and private consumption, real domestic expenditure grew by an estimated 4.5 percent in 1986. A 14 percent surge in real consumer demand reflected a fall in the private saving rate and rapid real wage increases largely attributable to wage drift in the business sector. These demand pressures were largely channeled to foreign markets, and the response of production was initially moderate with real GDP growing by only some 2 percent in 1986 as a whole. Economic activity picked up rapidly, however, in the first half of 1987. The unemployment rate has fluctuated sharply: it peaked at 7.6 percent of the labor force in the second quarter of 1986 but, one year later, it had dropped to 5.6 percent, the lowest level since early 1985.

Turning to the balance of payments, the civilian external deficit on goods and services fell sharply in 1985 as a result of gains in export market shares helped by the real effective depreciation of the sheqel, reduced domestic demand, and improved terms of trade. A rise in defense imports was exceeded by the effect of a shift of U.S. official aid from loans to grants, and transfer receipts were further boosted by the first tranche of U.S. special assistance. As a result, the external current account balance moved into surplus, of US\$1.1 billion, for the first time since 1954. The surplus increased to US\$1.4 billion, equivalent to 5 percent of GNP, in 1986, reflecting the disbursement of the second tranche of special U.S. aid, a surge in private transfer receipts, and a drop in defence imports. The civilian goods and services deficit widened, however, as imports recovered

sharply due to the buoyancy of domestic demand and exports were hampered by a squeeze on profitability: in real effective terms the new sheqel appreciated by 6 percent between July 1985 and December 1986. This appreciation was reversed in mid-January 1987, when there was a devaluation of 9 percent against the currency basket.

For 1987, the authorities targeted an improvement in the civilian trade balance but, in light of the expiration of U.S. special aid and a planned recovery of defense imports, the current account was projected to move to a deficit of some US\$700 million. However, despite a favorable export performance, recent data suggest a more significant erosion as domestic demand and imports have been more buoyant than anticipated. With the restoration of confidence and relatively high domestic interest rates, the previous substantial outflow of private capital was halted and so far in 1987 there has been a marked net inflow. Official reserves recovered from US\$2.5 billion in mid-1985 to a comfortable US\$5.2 billion at end-July 1987, equivalent to three months of imports of goods and services. External debt, net of the foreign assets of commercial banks, increased moderately due to the appreciation of its non-dollar component to US\$24.8 billion (93 percent of GNP) at the end of 1986. About two thirds of the debt is held by the Government, and the bulk of the latter is owed to governments and holders of State of Israel bonds; Israel remains a net creditor to the international banking system. The debt service ratio declined to less than 35 percent of exports of goods and services in 1986.

Israeli merchandise exports have benefited from a free trade agreement with the EEC which has been in force since 1977 and an agreement with the United States which has been in force since September 1985. Under these agreements, Israel is required to reduce customs duties on imports from the countries concerned. In this context, customs duties on imports into Israel were significantly lowered at the beginning of 1987. Following the accession of Portugal and Spain to the European Community, in December 1986 Israel also reached an agreement with the EC on a gradual reduction of customs duties on Israeli exports of agricultural and certain food products over a 7-10 year period.

In conjunction with the economic stabilization plan, the authorities undertook several steps to liberalize the trade and payments system. Export subsidies were cut by a replacement of directed export credits in sheqalim, by credits denominated entirely in U.S.dollars and a scaling down of subsidies through the exchange rate insurance scheme from US\$325.5 million in the fiscal year 1984/85 to US\$256.5 million in 1985/86; a further reduction is estimated to have taken place in 1986/87. The noninterest-bearing import deposit requirement was eliminated except for luxury goods for which it was significantly reduced. In August 1986, the authorities restored the allowance for support and gift payments abroad. The import deposit requirement was further cut to 3 percent by October 1, 1987 and it is to be eliminated by the beginning of 1988. In March 1987, the surcharge of 20 percent on airline and sea tickets purchased in Israel and the 15 percent surcharge on prepaid tourist expenditures abroad

were rescinded. Furthermore, in April 1987, the authorities raised the foreign currency allowances for tourist and business travel and for support and gift payments abroad. The exchange and trade restrictions pertaining to current international transactions which still remain in force include a 2 percent import levy, a 1 percent levy on the purchase of foreign exchange, the requirement of specific authorization for Israeli employers to make wage payments in foreign currency to Israeli citizens working abroad, limitations on the right of tourists to reconvert local currency into foreign currency, the multiple currency practice features of the exchange rate insurance scheme, and a 15 percent tax on imports of services.

Mr. Chairman, let me conclude by saying that the Fund welcomes the measures described above which constitute important steps toward liberalizing the exchange and trade system. In June 1987, the Fund gave a temporary approval for the remaining exchange restrictions subject to Fund jurisdiction in the light of Israel's strengthened economic policies and performance and the commitment of the authorities to further liberalization. With appropriate demand management and other supporting policies, the balance of payments and reserve position should permit further liberalization of the exchange and trade system.