

**GENERAL AGREEMENT ON
TARIFFS AND TRADE**

Committee on Balance-of-Payments Restrictions

REPORT ON THE 1985 CONSULTATION WITH ISRAEL

1. The Committee consulted with Israel on 3 December 1985, in accordance with its terms of reference and the Declaration of the CONTRACTING PARTIES on Trade Measures Taken for Balance-of-Payments Purposes (BISD 26S/205). The consultation was held under the Chairmanship of Ambassador P.-L. Girard (Switzerland). The International Monetary Fund was invited to participate in the consultation in accordance with Article XV of the General Agreement.

2. The Committee had the following documents before it:

Basic document by Israel	BOP/257
Secretariat background paper	BOP/W/92
IMF report "Israel - Recent Economic Developments", dated 8 May 1985	
Notifications concerning import prohibitions and import deposit schemes	L/5697 and Add.1 L/5769 and Corr.1 L/5784 L/5855

Opening Statement by the representative of Israel

3. The representative of Israel outlined the economic factors which had led to Israel's serious problems of inflation and balance of payments, the major policy measures which had been taken to rectify them, and the initial results which had been achieved to date. He noted that some trade measures had already been dismantled; that the initial results of recent policies were encouraging; and that further liberalization could be expected if such trends continued.

4. He said that Israel's balance-of-payments problems, and the related problem of inflation, could be traced to the combined effects of excess domestic demand and developments in the international economy. Strong demand had been created by the historically rapid development of the Israeli economy aimed at absorbing mass immigration, developing industry and infrastructure, and increasing the standard of living of a rapidly growing population, together with the direct and indirect effects of high security expenditures. Rapid increases in prices of oil and other basic imports during the later 1970s had added to pressure both on the trade balance and on domestic prices. Efforts to subdue inflation through the maintenance of a high exchange rate and subsidization of staple goods had proved unsuccessful, and had led to expectations of external instability, a flight from the shekel and capital outflows. The systematic indexation of wages to the cost of living had made it more difficult to break the inflationary spiral. Israel's deficit on goods and services had increased to some US\$5 billion in 1983; overall foreign debt had grown to an estimated US\$23.5 billion at end-1985 or US\$5,500 per capita, almost the highest level in any country. Debt servicing

had increased to some 35 per cent of exports in 1984 and, despite an increase in short term borrowing (which had adversely affected Israel's debt profile), reserves had declined by around one-third since 1982.

5. The representative of Israel stated that since the last consultation, three policy packages had been undertaken. In October 1984 a first "package deal" was introduced, to be followed by a second in February 1985. A far-reaching comprehensive policy programme had been introduced in July 1985. All these policies had been introduced with the agreement and support of trade unions and employers' organizations. Price controls had been introduced in July 1985 under emergency powers, being subsequently replaced by regular legislation. The balance-of-payments problem was addressed in the first place by far-reaching domestic adjustment policies, by additional economic aid and also by temporary trade measures.

6. The comprehensive programme introduced in July 1985 comprised budgetary policies aimed at decreasing expenditure and increasing revenue, strict monetary policy, and a temporary freeze on prices and wages. Given the small margin of manoeuvre for reductions in government spending, any cut in expenditure was bound to cause severe hardships in the provision of social services such as health, education and welfare as well as in the security budget. Hence, in order to reach budgetary targets, taxes had to be increased or their collection advanced; surtaxes had been introduced on companies and the self employed and a value-added levy had been introduced on imports of services. The expected total increase in tax revenue was about 10 per cent in real terms in January-September 1985 over the corresponding period in 1984. The combination of spending cuts and tax increases had brought the total liquidity injection into the economy back on to the target of US\$ 1.3 billion planned for 1985. Monetary policy maintained interest rates substantially above inflation, and restricted the volume of credit and the overall growth of the money supply. Israel's traditional savings ratio of over 30 per cent was re-established from the 22 per cent rate registered in 1983.

7. Subsidies on many basic consumer goods including milk, bread, eggs, public transport and oil had been considerably reduced or abolished, and the share of subsidy payments in the total budget had fallen from 9 per cent in 1981 to 2½ per cent in 1985. The automatic linkage of wages to the cost of living was temporarily discontinued. The considerable price increase in July 1985 caused partly by reductions in subsidies had been only half compensated by wage increases, and no cost-of-living allowances had been granted in the following three months. In the course of the year, real wages declined by 26 per cent; on an annual average basis, the decline was 17 per cent, or 12 per cent reduction in disposable income net of tax. Administrative controls on prices were expected to be gradually dismantled, in 1986.

8. The exchange rate of the shekel had been substantially devalued against the dollar in July 1985. The current rate of Shek.1500=US\$1 was expected to be sustainable in view of the decline in domestic demand. Trade policy measures taken during the period had been, in the Israeli representative's view, less stringent than could have been justified by the size of the economic problems and of the debt burden confronting Israel. He recalled that the overall import deposit introduced in 1983 was abolished in July 1985. The prohibition of imports of luxury items introduced in October 1984 was cancelled in February 1985, two months ahead of time. A degressive

special deposit on luxuries was introduced in February 1985, reducing by 3 percentage points monthly to reach 18 per cent in November. For reasons of overall policy, the regular monthly reduction of this special deposit had, however, been halted in December 1985 at the rate of 18 per cent. The import levy, introduced in 1982 at 3 per cent, had been maintained at its level of 2 per cent.

9. The representative of Israel said that the initial effects of the policy measures taken were seen in a rapid decline in domestic demand and public and private consumption and investment. The increase in exports was not sufficient to compensate for these declines, leading to a very low increase in gross domestic product and a considerable growth of unemployment. The overall civilian deficit in goods and services had fallen by US\$720 million in 1984 to reach US\$3.4 billion, and was estimated to decline by a further US\$1 billion in 1985. This resulted from declines in imports of US\$130 million and US\$650 million in 1984 and 1985 and increases in exports of US\$590 million and US\$360 million respectively. Reserves had been stabilized as from June 1985 and capital outflow arrested. Inflation was declining and a target of stabilization at around 2 per cent monthly had been set. Despite its serious and persistent balance-of-payments difficulties, Israel would continue to consider the removal of trade-restrictive measures in line with the progress of the economic recovery and its balance-of-payments improvement.

Statement by the representative of the International Monetary Fund

10. At the invitation of the Committee, the representative of the International Monetary Fund made a statement, the text of which is annexed.

Balance-of-payments position and prospects: alternative measures to restore equilibrium

11. One member, noting the efforts made to reduce the budget deficit and that additional measures were to be taken in future to continue the trend, asked how far such measures would involve the reduction of subsidies affecting exports. In relation to monetary and pricing policies, he asked what measures were available to the Central Bank to control inflation and how far price controls, which were currently subduing underlying inflationary pressures, were likely to be eliminated. Another member asked whether the inflation target of 2 per cent per month was likely to be maintained through 1986.

12. In reply, the representative of Israel noted that export subsidization was being eliminated in accordance with Israel's accession to the Agreement on the Interpretation of Articles VI, XVI and XXIII (Subsidies Code). Although certain controlled prices were still in force, there was no official supervision of such prices. In terms of monetary policy, the Bank of Israel had a number of powerful monetary control instruments. It was authorized to prescribe the liquidity ratios of commercial banks; interest rates had been maintained substantially above the inflation rate; and administrative controls were also set by the Bank on foreign exchange credit. Moreover, under the Bank of Israel Law, strict ceilings for lending to the Government had been established by Parliament. The 2 per cent monthly inflation target for 1986 appeared achievable in broad terms.

13. In reply to a question about the size of the government financing requirement for 1986, the representative of Israel said that domestic public consumption was projected to fall by 3 to 3½ per cent in 1985 and 1986. From 1987 it would probably grow very slightly. In broad terms, economic growth should be stimulated from 1986 onwards, initially through the encouragement of investment in fixed assets. GDP growth should rise gradually, in a controlled manner, from 2 per cent to around 5.5 per cent by 1989. Even under these circumstances, unemployment would remain a cause for concern.

14. In answer to a question on the balance-of-payments target for 1986, the representative of Israel said that exports of goods and services were projected to increase by some 7½ per cent as against 3½ per cent in 1985. The decline in imports of 4 to 5 per cent in 1985 could not be expected to continue; hence the trade deficit would decline less rapidly than in 1984-85. Asked about the effects on competitiveness in foreign markets of the shekel/dollar link, in the light of domestic inflation rates in excess of those abroad, he noted that the downward trend of the United States dollar since mid-1985 had helped Israel's export competitiveness vis-à-vis European markets. In reply to a question by one member, the representative of Israel gave a number of clarifications on the impact of the economic programme on government procurement.

Systems, methods and effects of restrictive import measures

15. One member asked whether the suspension of the monthly reductions in the special import deposit implied any change in the proposed February 1986 elimination date, and whether the 2 per cent import levy would be continued after March 1986. In reply, the representative of Israel said that the future of both measures was subject to review.

16. Another member asked what percentage of imports were covered by the special import deposit. In reply, the representative of Israel said that less than 6 per cent of total imports were likely to have been covered in 1985. In response to another question, the representative of Israel confirmed that both import licensing and import levies had been notified to the Committee as balance-of-payments measures.

Conclusions

17. The Committee took note of the improvement in Israel's current account balance during 1984 and 1985 to date. It welcomed the renewed efforts made by the Israeli authorities to re-establish internal and external financial balance and to reduce inflation and recognized the importance of the comprehensive economic programme adopted in mid-1985 for achieving these objectives.

18. The Committee also noted the various import measures adopted by Israel since the previous consultation. It welcomed the elimination of the general 15 per cent import deposit and the replacement of import prohibitions on luxury goods by a degressive special import deposit scheme, while observing with some concern that the process of reduction in the rate of this deposit had been interrupted. The Committee noted that the future of this measure, as well as that of the 2 per cent import levy in force since 1982, would be subject to review in the light of developments in the balance of payments and the stabilization of the domestic economy. The Committee, noting that a number of import measures were still applied concurrently, encouraged Israel, in line with what had been achieved to date, to pursue its efforts to eliminate remaining import measures taken for balance-of-payments reasons.

ANNEXStatement by the Representative
of the International Monetary Fund

Economic activity has remained depressed in Israel, with growth averaging slightly above 1 percent per year in 1982-84, compared with 3 percent in 1980-81. Available indicators suggest that this weakness has continued into 1985. Reflecting the weakness in economic activity, the unemployment rate rose to 6 1/2 percent (on a seasonally adjusted basis) in the second quarter of 1985, the highest level in recent years. A shift in policy toward the end of 1983, aimed at compressing domestic demand and improving external competitiveness, resulted in a strengthening of the current account position of the balance of payments in 1984, after steadily rising deficits in earlier years. However, inflation soared to an average monthly rate of 23 percent in September-October 1984, and substantial capital outflows led to a weakening of the overall balance of payments position and a considerable loss in foreign reserves.

In these circumstances, the Israeli authorities reached agreement with the employers' and employees' federations in early November 1984 on a three-month price freeze--or first package deal--which resulted in a marked cutback in the inflation rate around the turn of the year. However, fiscal policy was not tightened over this period, and indeed part of the slowdown in inflation was secured by raising subsidies on basic goods and services. Despite two subsequent package deals, the rate of inflation reaccelerated and reached a monthly average exceeding 12 percent over the five months from February to June 1985.

Fiscal policy in 1985/86 (beginning April 1) is aimed principally at improving the external position and reducing the rate of inflation by cutting the public sector's claims on the resources of the economy and reducing the cash injection from the budget. The financing requirement for the 1985/86 budget (after taking foreign grants into account) was targeted at 9 percent of GNP, compared with 20 percent in 1984/85. Various measures were taken to boost fiscal revenues, while expenditures were to be cut significantly, principally through sharply reduced price subsidies, cuts and rationalization in various welfare programs and other public services, and a significant reduction in the number of public sector employees. Monetary policy--which has continued to be constrained by the large fiscal deficits, the widespread indexation of financial assets, and the high level of domestic debt--has been focused on curbing the growth of credit to the private sector and discouraging the provision of credit outside the banking system. The authorities have continued to maintain a policy of high real interest rates.

The civilian trade deficit in 1984 almost halved to US\$1.2 billion (5 1/2 percent of GNP), due to an increase of 12 percent in exports and a decline of 5 percent in imports. Exports benefited from the recovery of foreign demand, an improvement in competitiveness, and the coming on stream of new productive capacity geared to export markets, while imports were reduced by the slack in domestic demand and by intensified exchange and trade restrictions. The improvement in the civilian trade account and enlarged government transfers (principally U.S. aid) helped reduce the current account deficit to 7 percent of GNP, from 9 1/2 percent of GNP in 1983. Nonetheless, because of substantial capital outflows, an overall balance of payments deficit was registered, and gross official reserves fell by US\$0.6 billion in 1984 to an end-year level of US\$3.1 billion. Available indicators suggest that the decline in the civilian trade deficit continued in the first three quarters of 1985, although at a slower pace, with imports falling marginally further and exports continuing to expand. Official reserves, however, continued to fall, reaching US\$2.5 billion by June 1985, before picking up in September to US\$2.9 billion (equivalent to a little over two months of imports of goods and services) following disbursement of U.S. emergency aid.

Gross external debt minus the foreign assets of commercial banks is estimated to have increased by 2 1/2 percent in 1984 to US\$23.4 billion (equivalent to 104 percent of GNP). The short-term component of debt increased marginally in 1984 to 15 percent of the total; 70 percent of total debt was long-term, mainly at concessional interest rates. Service on debt (net of foreign assets of commercial banks) increased from 22 percent of exports of goods and services in 1983 to 24 percent in 1984.

In July 1985, the Israeli authorities introduced a plan for economic stabilization aimed at securing a substantial cut in the inflation rate while strengthening the external position. The steps included an immediate devaluation of the shekel by 16 percent (in addition to the regular depreciations that had reflected inflation rate differentials relative to the main trading partners), a marked cut in price subsidies, and appreciable increases in controlled prices. Following these adjustments, a price freeze was imposed for three months and was subsequently extended in principle through March 1986. The plan also provides for a reduction in the number of public sector employees, introduction of a property tax, and implementation of a new tax law boosting revenue from companies and the self-employed. The various fiscal measures are designed to reverse the deterioration in the budget in the first quarter of 1985/86 and ensure reduction of the Government's financing requirement to the original target. Monetary policy has also been tightened, mainly by increasing banks' liquidity requirements on unlinked short-term assets. In a step to cut back on the indexation of liquid assets, new deposits in PATAM (i.e., foreign currency-denominated) accounts of less than 12 months' maturity must be lodged in foreign currency, and no longer in shekels. Further, as part of a step toward unifying effective exchange rates (and concurrent with a cut in the

import deposit requirement), directed credit for exports would henceforth be denominated entirely in U.S. dollars and would no longer be permitted in shekels. Against a background of rising real wages over 1981-83 well in excess of productivity gains, the plan provided for an immediate marked real wage erosion, followed by partial compensation spread over a number of months. With the introduction of the plan, the rate of inflation--which rose sharply to 27 percent in July in response to these various measures--subsequently declined to 4 percent in August and 3 percent in September; also, there has recently been a significant decline in real wages.

Although in 1977 most restrictions on payments and transfers for current international transactions and multiple currency practices were eliminated, the authorities have recently attempted to check capital outflows and protect reserves by introducing various trade and exchange restrictions. Apart from renewal of the 2 percent import levy, the 1 percent levy on the purchase of foreign exchange by the public and the 15 percent non-interest-bearing import deposit requirement, a series of new measures were taken in 1984 and early in 1985. In July 1984, the provision of foreign exchange for prepayment of imports was suspended, and in October a six-month ban was imposed on the importation of some 50 commodities considered luxury items; this latter was replaced in February 1985 by a 60 percent import deposit requirement to be reduced by 3 percent a month until February 1986. Further measures have included a 15 percent tax on imported services, a temporary increase in the foreign travel tax, a reduced foreign travel allowance, a ban on the voluntary prepayment of foreign obligations, and suspension of the allowance for gifts and support payments abroad (except for students). However, in conjunction with the devaluation of July 1985, and as a step toward unifying effective exchange rates, the import deposit requirement was eliminated except for luxury goods, where it was significantly reduced; furthermore, export subsidies were cut. The exchange rate insurance scheme introduced in July 1981 continues in force; the losses resulting from operation of the scheme--which are fully met from the Government budget--were somewhat lower at US\$250 million in 1984.

A free-trade agreement with the United States became effective in September 1985, providing for a gradual phasing out of duties over the next ten years on all trade between the two countries except on a limited category of sensitive goods. It also provides for the elimination by 1991 of financial incentives by Israel for industrial and agricultural exports.

The Fund believes that implementation of a comprehensive stabilization program is essential to deal with the underlying causes of Israel's economic imbalances. While the plan for economic stabilization introduced in July 1985 continues to focus appropriately on strengthening the public finances, the financing requirement of the Government targeted for 1985/86 remains high. The Fund hopes that the authorities, by further strengthening the adjustment effort, will permit a return to a more liberal exchange and trade system.