GENERAL AGREEMENT ON

TARIFFS AND TRADE

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Committee on Balance-of-Payments Restrictions

1987 CONSULTATION WITH ISRAEL

Background Paper by the Secretariat

1. This paper has been prepared in accordance with Paragraph 7 of the Declaration on Trade Measures Taken for Balance-of-Payments Purposes adopted by the CONTRACTING PARTIES on 28 November 1979 (BISD 26S/205-209).

I. Israel's previous consultations with the Committee

2. Since Israel's provisional accession to GATT in 1959, seventeen consultations have been held, in 1960-65, 1968-71, 1974, 1976, 1978, 1980, 1982, 1984 and 1985. At its last consultation held on 3 December 1985 (BOP/R/155), the Committee took note of the recent improvement in Israel's current account balance and welcomed the adoption by the authorities in mid-1985 of a comprehensive economic programme designed to restore internal and external financial balance and to reduce inflation. The Committee welcomed the elimination of the general 15 per cent import deposit and the replacement of import prohibitions on luxury goods by a digressive 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 balance-of-payments developments 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 purposes.

II. Trade measures maintained for balance-of-payments purposes

(a) Import deposits

3. The reduction of all import deposit requirements by 15 percentage points in July 1985 resulted in the elimination of the general import deposit requirement and the reduction of the special import deposit requirement on commodities considered luxury goods from a rate of 45 per cent to 30 per cent *ad valorem*. The special import deposit requirement was

then reduced monthly in steps of 3 percentage points, and stood at 15 per cent ad valorem on 1 February 1986[1].

4. The rate was fixed at 15 per cent ad valorem for the period 1 February to 31 July 1986 and Israel notified the Secretariat that, at that time, 153 tariff headings drawn from the Israel National Tariff were subject to special import deposits.[2] The requirement was subsequently extended at the rate of 15 per cent ad valorem from 1 August 1986 to 31 January 1987, and at the same time Israel notified the Secretariat that the number of tariff headings covered had been reduced by 54.[3]

5. In January 1987 a further reduction of 3 percentage points was announced, and the authorities announced a schedule for further cuts of 3 percentage points every three months and affirmed that the requirement would be eliminated by the beginning of 1988.[4] The deposit rate was cut by 3 percentage points on 1 April, on 1 July and on 1 October 1987, bringing it to 3 per cent. Import deposits are refundable after a one-year period.

6. The Secretariat estimates that imports of goods subject to special import deposits amounted in 1986 to approximately US$446 million, the equivalent of 4.6 per cent of Israel's total imports in that year. This estimate may be somewhat on the high side of the actual figure, since it has not been possible to match exactly the list of tariff headings subject to special import deposits with the published trade data. The main import items (by value) subject to the special import deposits were: chocolate and other food with cocoa (imports valued at US$28 million in 1986); dishwashers and parts (US$10 million); television receivers (US$28 million); and passenger cars (US$325 million). At the same time, in 1986 no imports at all were recorded for 38 of the 99 tariff headings subject to special import deposits.

(b) Import levy

7. The temporary import levy that was introduced in September 1982 (L/5361) remains in force at the rate of 2 per cent ad valorem. It applies to all goods that are subject to VAT, and it is levied on the price of imports (c.i.f.).

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[1] Israel - Import Deposit, L/5855.

[2] Israel-Import Deposit, L/5855/Add.1 and Add.1/Suppl.1/Rev.1

[3] Israel - Import Deposit, L/5855/Add.2.

[4] Israel - Import Deposit, L/5855/Add.3.

Economic policy background: other measures to restore equilibrium

8. The liberalization of the import deposit scheme that has been described above was one component of the Economic Recovery Programme approved by the Government on 1 July 1985. This Programme has been in place throughout the period since Israel's last consultation with this Committee and macroeconomic policy has been formulated in line with the objectives of the Programme. A sharp reduction in the inflation rate has been the main objective of the Programme, and fiscal, monetary and exchange rate policy measures put in place to help achieve it have aimed simultaneously at bringing about an improvement in Israel's balance-of-payments position.

9. On the fiscal side, the Government succeeded in reducing the central government budget deficit sharply in F.Y. 1985/86[5] to 0.3 per cent of GNP (from 17 per cent of GNP in F.Y. 1984/85) by relying mainly on raising tax revenues and cutting subsidies. The deficit was held at 0.4 per cent of GNP in F.Y. 1986/87. The budget estimate for 1987/88 is that the deficit will amount to 3 per cent of GNP.

10. The introduction of the Economic Recovery Programme was accompanied by a drastic tightening of monetary policy, but the monetary stance was progressively relaxed in the last months of 1985 and the first half of 1986 in order to bring about a lowering of domestic interest rates. Faced with the subsequent expansion of domestic credit at a faster rate than was considered desirable, the authorities raised interest rates in October 1986 and again in February 1987. The Bank of Israel lowered its discount rate in April 1987 following lower-than-expected domestic price increases which stemmed from the devaluation of the new sheqel in January 1987 (see below) and hence the maintenance of higher-than-desired real interest rates in the economy. At the same time, the interest rate on the reserve deposits of banks was cut while certain minimum reserve requirements were tightened. The interest rate on the reserve deposits of banks was cut further in June 1987.

11. The exchange rate of the sheqel was pegged to the United States dollar as part of the Programme introduced in July 1985. In August 1986, the new sheqel was pegged to a basket of five currencies in order to avoid an excessive depreciation vis-à-vis European currencies and an effective depreciation of the new sheqel that would raise import prices. However, the new sheqel appreciated in real effective terms during 1986, and the Government consequently devalued the currency in January 1987 by 9.2 per cent in terms of the basket.

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[5] Fiscal year: 1 April - 31 March

12. The Economic Recovery Programme has included, along with the liberalization of trade measures maintained for balance-of-payments purposes, the liberalization of certain domestic price controls and of certain exchange restrictions. It is also being supported by a tax reform, a capital market reform, and a privatization programme.

III. Developments in the Israeli Economy

13. Since the late 1970's, two recurring problems in Israel's economy have remained the focus of macroeconomic policy. The authorities have consistently sought to elaborate and implement a comprehensive strategy which would tackle simultaneously (i) a persistent inflation problem (with usually far-reaching domestic social and economic consequences and no less immediate implications for the balanced growth of foreign trade and the improvement of export competitiveness), and (ii) continuously strong pressures on the current account of the balance of payments. Some of the key measures taken to cut the deficit on the current account have on occasion contributed more or less directly to an increase in pressure on the price level: the devaluation of the currency twice in the second-half of 1984 by substantial amounts and the reduction in price subsidies are reckoned to have had this effect. In a similar way, some key measures taken to lower inflation growth rates appear not to have fully facilitated efforts to reduce the current account deficit and to improve relative international competitiveness. With the suspension rather than elimination of wage indexation under the stabilization programme adopted in July 1985, much of the incidence of lower subsidies fell on enterprise costs which rose as did the real exchange rate.

Macroeconomic policy strategy and measures

14. The strategy of the July 1985 stabilization programme, which was supported, in part, by the United States providing $1.5 billion in emergency assistance, comprised the following main elements: a substantial cut in the budget deficit for the 1985/86 fiscal year; a sharply restrictive monetary policy designed, among other things, to secure an almost immediate reduction of 10 per cent in bank credit in real terms; after the 15.8 per cent devaluation of the currency on July 1 the new sheqel was pegged to the US dollar; increases of between 30 and 100 per cent in the prices of subsidized items and by an average of 17 per cent for other products and services followed by the freezing of prices at their new levels; the suspension of the cost of living arrangement; and a cut in the import deposit requirement.

15. In the two years following the introduction of these measures Israel's economy improved quite strongly both in its overall performance and in a number of critical areas. The inflation rate in 1986 was below 20 per cent, compared with 450 per cent in 1984. The current account of the balance of payments moved into surplus in 1985 and 1986, in part because of higher net transfers, amounting to some 5 per cent of the 1985-86 GNP,

compared with a deficit in 1983-84 of about 7 per cent of the 1983-84 GNP. The underlying trade situation had not improved as decisively. Although export volume rose by nearly 6 per cent in 1986, import volume went up more than twice as fast. Growth in official reserves has been particularly strong, nearly reaching in absolute terms the US emergency assistance of $1.5 billion in support of the stabilization programme. The authorities' direct contribution to restoring domestic fiscal balance has been no less impressive.

16. It is generally acknowledged that much of the movement towards internal and external equilibrium can reasonably be attributed to the government's adjustment programme. A clearly significant contribution may also have been made by certain developments in the international economic environment favourable to Israel, not all of which were likely to remain positive in their effects. These include substantially lower commodity and energy prices and the strong growth in net private transfers in 1986. The degree to which the more favourable inflationary outlook and more viable current account situation can be consolidated and improved on will depend to a substantial degree on the ability of the government to resist challenges to the realization of their main budgetary objectives for fiscal 1987-88, on the maintenance of the broader fiscal and monetary stance against revived inflationary pressures, including faster growing real wages and consumer credit and spending, and on further liberalization of the exchange and trade regimes.

Domestic demand and output

17. Continuing strong growth in domestic demand in volume terms virtually throughout 1986, by nearly 6.5 per cent, reflected sharp rises in consumption expenditures and in spending on inventories. Private consumption rose in real terms by a sizeable 12 per cent. Growth in GDP, in contrast, was just 1 per cent. Higher consumption expenditures, including a large increase in spending on durable goods, was sustained by a substantial 12 per cent overall rise in real wages, (there was no evidence of an increase in the household savings ratio), and was apparently undeterred by the broadly deflationary intent of the July 1985 stabilization programme. Stocks run down in 1985 were up sharply in 1986 to some 2.6 per cent of the 1985 GDP, reflecting industry's desire to improve inventories, and to avoid anticipated price increases from further currency devaluation.

18. As was noted above, growth in aggregate output during 1986 was much below growth in domestic demand, reflecting the impact of higher domestic consumption expenditures. The relatively high growth sectors were food, beverages and tobacco, by 13 per cent in 1986 following a 1 per cent drop in 1985; textiles, clothing and leather goods, up four times as fast as the 2 per cent rise in 1985; and a 7 per cent rise for other light industry products. Industrial production is estimated to have increased by 3.2 per cent in 1986. Slight declines of about 1 per cent were recorded in the output of metals and electronics and chemicals industries. Output of

services, including trade and finance and transport and communications, rose by around 3 per cent.

19. The failure of aggregate supply to match the growth in domestic demand can be attributed to the performance of a business sector faced with a squeeze on profit margins as nominal and real wages and corporate tax burdens rose markedly during 1986. The result was that a high proportion of the additional domestic demand had to be met by higher imports, with the volume of civilian imports rising by 18 per cent. The value of consumer goods imports rose considerably in the first three quarters of the year, by nearly 40 per cent, compared with the same period in 1985.

Foreign trade

20. In 1986 the volume of total exports rose by about 10 per cent. As export prices went up by about 2.5 per cent, Israel's share of world exports increased for the third consecutive year. Export volume growth is nearly halved if diamonds are excluded, and only modest gains are shown in relative market share. Much of the improved performance of total exports may be attributed to larger deliveries to the United States, particularly in 1984 and 1985, facilitated by the substantial depreciation of the sheqel relative to the US dollar and the initial net trade-creating effect of the bilateral free trade relationship between Israel and the United States. It is even possible that exports were aided by reductions in export subsidies resulting from cutbacks in direct budgetary support to exports and the withdrawal of certain lines of subsidized export credit, in the sense that there was added pressure on export-oriented firms to become more efficient.

21. Exports to West European destinations came under some pressure in 1985 as the sheqel appreciated in inflation-adjusted real terms against some European currencies and, for certain agricultural products, with the accession of Portugal and Spain to the EEC. As the US dollar fell further in 1986 its real depreciation against the sheqel contributed to slowing down growth in the share of Israeli exports to the US market. Changes in relative exchange rates during 1986 and the buoyancy of the Japanese market are believed to account for most of the growth in 1986 (by over 50 per cent in the value) of Israel's exports to Japan, a large proportion of which are accounted for by diamonds. Except for a slight rise in 1986 in the country's exports to developing countries (12.4 per cent of all exports), the share of exports to developing countries has declined each year since 1982 (when it was 15.9 per cent). Much of this decline may be explained by the growth in the share of diamonds in total exports, from 17.9 per cent in 1982 to 24 per cent in 1986, and to declines in the shares of ores and minerals, and food and textiles.

22. Merchandise imports for civilian use went up in volume by 12 per cent in 1986, as the volume of consumer goods imports shot up nearly 40 per cent in response to much higher levels of domestic demand and real wages, inadequate aggregate supply response and the expectation that short-term import prices would rise following relative exchange rate changes. Imports

of consumer durables, mainly from Western Europe, increased noticeably as consumers' inflationary expectations moved them to prefer real assets to the more exposed financial assets. The value of total imports rose twice as fast in 1986, by nearly 17 per cent, than in 1985, even though significantly lower prices for energy and of commodity imports operated to hold down the total import bill. Lower fuel import prices are estimated to have led to a saving of some $850 million in 1986. While the value of diamond imports went up by some 25 per cent, making it possible both to increase diamond exports and build up domestically held stocks, that of imports of capital goods remained relatively flat and a further fall was recorded in the value of imports of plant and equipment.

Balance of payments

23. The improvement in the current account balance which was recorded in 1984 has largely been maintained in recent years with inevitable variations from year to year. A series of annual deficits since 1954 had come to a halt in 1985, mainly following a sizeable inflow of emergency support funds from the United States in the context of the economic recovery programme. Despite a sharp rise in 1986 in the civilian deficit on goods and services account, larger inflows of aid funds and private transfers have combined with significantly lower defence imports and a slowing down in private short-term capital outflows to sustain broadly the improvement in the overall current account position. The fact that the civilian trade deficit appears to have widened even further in the first quarter of 1987 does give some cause for concern.

24. The downward trend in unit labour costs from the first quarter of 1983 was reversed two years later when unit labour costs rose strongly, notably in 1986 and into the first quarter of 1987. With export unit values remaining generally stable between 1982 and 1986, export profitability, measured roughly as export unit values relative to unit labour costs, has declined markedly since 1985. Rising real wages and unit labour costs and declining profitability of exports have meant that the growth of exports and the improvement in export competitiveness have had largely to be facilitated through a progressive devaluation of the sheqel.

25. The strategy of the authorities for restoring and maintaining an equilibrium in the economy's external account, simultaneously with domestic equilibrium, is generally acknowledged to be appropriate. It comprises measures to encourage official and private capital inflows, the judicious use of exchange rate adjustment, the elimination or reduction in de facto export subsidies and progressive liberalization in the exchange and trade regimes.

TABLE 1 - Israel: Selected Economic Data

(Annual Percentage Change)

	1982	1983	1984	1985	1986[1]
GDP at constant prices	0.5	2.3	1.7	2.8	1.1
Gross Domestic Expenditure[2] (constant prices)	7.0	6.8	-5.3	-3.3	6.4
Private Consumption	7.1	8.0	-7.2	-0.4	12.0
Gross Domestic Investment	13.8	10.3	-7.6	-13.4	6.8
Exports, f.o.b. (US dollars)	-5.8	-0.4	11.7	6.6	15.8
Imports, f.o.b. (US dollars)	-6.5	-0.5	-0.4	2.5	7.3
Terms of Trade	3.3	1.6	-1.7	1.3	5.0
Nominal Effective Exchange Rate[3]	-47.2	-61.6	-81.6	-67.4	-13.0
Real Effective Exchange Rate	12.2	-3.2	-1.2	-3.3	1.3
(Percent of GNP)[4]					
Current Account Balance	-8.8	-8.3	-6.0	5.1	4.7
External Debt Outstanding[5]	123.5	117.4	129.0	139.7	117.5
Gross Official Reserves, Year-End (in months of total imports)	3.1	3.0	2.4	3.0	3.6
Gross Debt Service (as percentage of exports of goods and services)	37.1	35.1	37.0	36.5	34.5

Notes:
1. Provisional
2. Excluding direct defence imports
3. Deflated by consumer price index
4. GNP figures in US dollars neglect the overvaluation of the shekel in 1982 and 1983; the percentages therefore arguably understate somewhat the percentage GNP figures.
5. Gross external liabilities.

TABLE 2 - Israel: Export Volume and Price Indicators, 1982-86
(Percentage change from previous year)

	1982	1983	1984	1985	1986[1]
Volume Indicators[2]					
Agriculture	6.2	-6.7	10.9	-8.0	12.3
Industry, excluding diamonds	0.7	-1.0	20.0	7.3	6.3
Diamonds (net)	-10.1	14.0	10.5	27.5	28.6
Total (net)	-0.7	1.2	17.7	9.4	10.8
Total, excluding diamonds	1.7	-1.6	19.2	5.2	6.1
Price Indicators[3]					
Agriculture	-13.3	-2.3	-5.4	-3.6	6.5
Industry, excluding diamonds	-4.1	-3.4	-0.4	0.3	1.5
Diamonds, net	-5.9	-2.8	-6.0	-4.1	2.6
Total (net)	-5.7	-3.2	-2.3	-1.0	2.6
Total, excluding diamonds	-5.7	-3.3	-1.1	-0.1	2.6

Notes: 1. Estimates.
2. Value data deflated by Fisher-type unit value indices.
3. In U.S. dollars.

TABLE 3 - Israel: Destination and Origin of Trade, 1982-86

(in percent of total)

	1982	1983	1984	1985	1986
Exports					
Industrial countries	65.4	71.2	70.0	73.7	73.4
EEC	34.6	35.9	33.7	31.4	30.5
United Kingdom	7.9	8.1	8.3	7.6	7.2
Germany	7.0	7.0	6.2	5.3	5.2
France	4.9	4.9	4.1	4.2	4.4
United States	21.3	26.0	28.2	34.2	32.9
Japan	3.7	3.7	3.3	3.4	4.5
Other industrialized countries	7.6	7.5	7.0	6.1	6.5
Developing countries	15.9	14.5	13.8	12.1	12.4
Other countries 1/	18.8	14.3	16.3	14.3	14.2
Imports					
Industrial countries	69.0	74.7	73.8	77.5	84.6
EEC	37.6	42.1	42.4	44.9	51.4
United Kingdom	7.6	7.8	8.3	9.1	10.2
Germany	11.0	12.1	11.2	10.8	12.6
France	4.5	4.7	3.8	3.6	4.0
United States	19.0	19.2	21.1	20.2	18.6
Japan	2.3	3.2	1.2	2.2	3.2
Other industrialized countries	10.5	10.6	9.5	10.5	11.9
Developing countries	7.3	6.8	7.3	5.8	6.7
Other countries 1/	23.7	18.5	18.9	16.7	8.8

Sources: Central Bureau of Statistics, Monthly Bulletin of Statistics; IMF, Direction of Trade Statistics.

1/ Includes countries and areas not specified.

TABLE 4 - Israel: Commodity Composition of Exports, 1/ 1982-86

	1982	1983	1984	1985	1986
		(In millions of U.S. dollars)			
Agriculture	522	504	529	469	560
Citrus	186	163	116	172	174
Fruit and vegetables	110	97	111	99	135
Others	257	244	301	197	251
Industry, excluding diamonds	3,510	3,357	4,009	4,315	4,656
Ores and minerals	204	231	246	256	249
Food 2/	343	316	372	383	333
Textile 3/	353	344	373	379	466
Other light industries	405	427	509	535	628
Chemicals	647	644	750	835	790
Metals, machinery, and electronics	1,559	1,395	1,760	1,928	2,190
Diamonds (net of returned exports)	893	990	1,028	1,257	1,658
Total 4/	4,991	4,890	5,622	6,084	6,914
		(In percent)			
Agriculture	11.1	10.3	9.4	7.7	8.1
Citrus	3.7	3.3	2.1	2.8	2.5
Fruit and vegetables	2.2	2.0	2.0	1.6	2.0
Others	5.1	5.0	5.4	3.2	3.6
Industry, excluding diamonds	70.3	68.7	71.3	70.9	67.3
Ores and minerals	4.1	4.7	4.4	4.2	3.6
Food 2/	6.9	6.5	6.6	6.3	4.8
Textile 3/	7.1	7.0	6.6	6.2	6.7
Other light industries	8.1	8.7	9.0	8.8	9.1
Chemicals	13.0	13.2	13.3	13.7	11.4
Metals, machinery, and electronics	31.2	28.5	31.3	31.7	31.7
Diamonds (net)	17.9	20.2	18.3	20.7	24.0
Total (net) 4/	100.0	100.0	100.0	100.0	100.0

Source: Central Bureau of Statistics, Foreign Tradee Statistics Quarterly; and Monthly Bulletin of Statistics

1/ Excluding returned exports and exports to administered areas
2/ Includes beverages and tobacco.
3/ Includes clothing and leather.
4/ Numbers do not sum because the total includes "other export", mainly scrap metal.

Table 5 - Commodity Composition of Imports[1], 1982-86

	1982	1983	1984	1985	1986
	(In million dollars)				
Consumer goods (for direct consumption)	832	953	657	621	1023
Food	271	257	241	229	292
Passenger Cars	186	245	130	102	203
Production Inputs (raw materials)[2]	5412	5203	5282	5180	5480
Iron and Steel	353	313	340	315	354
Fuels and Lubricants	1914	1607	1593	1510	924
Spare Parts and Accessories	501	568	538	573	714
Chemicals	356	378	413	401	525
Diamonds (net of returned imports)	494	649	723	982	1364
Investment Goods	1295	1779	1572	1414	1604
Machinery and Equipment	997	1302	1247	1227	1295
Transport Equipment	299	476	326	187	309
Total[3]	8047	8592	8249	8293	9477
	(in percent)				
Consumer Goods (for direct consumption)	10.3	11.1	8.0	7.6	10.8
Food	3.4	3.0	2.9	2.8	3.1
Passenger Cars	2.3	2.9	1.6	1.2	2.1
Production Inputs (raw materials)[2]	67.3	60.6	64.0	63.1	57.8
Iron and Steel	4.4	3.6	4.1	3.8	3.7
Fuels and Lubricants	23.8	18.7	19.3	18.4	9.7
Spare Parts and Accessories	6.2	6.6	6.5	7.0	7.5
Chemicals	4.4	4.4	5.0	4.9	5.5
Diamonds (net of returned imports)	6.1	7.6	8.8	12.0	14.4
Investment Goods	16.1	20.7	19.1	17.2	16.9
Machinery and Equipment	12.4	15.2	15.1	15.0	13.7
Transport Equipment	3.7	5.5	4.0	2.3	3.3
Total[3]	100.0	100.0	100.0	100.0	100.0

[1] Net of diamonds returned imports
[2] Excluding diamonds
[3] Total import figures include the net figure for trade in diamonds

CHART 1. ISRAEL: SELECTED EXTERNAL ACCOUNT AGGREGATES AS PERCENTAGES OF GNP, 1982-86

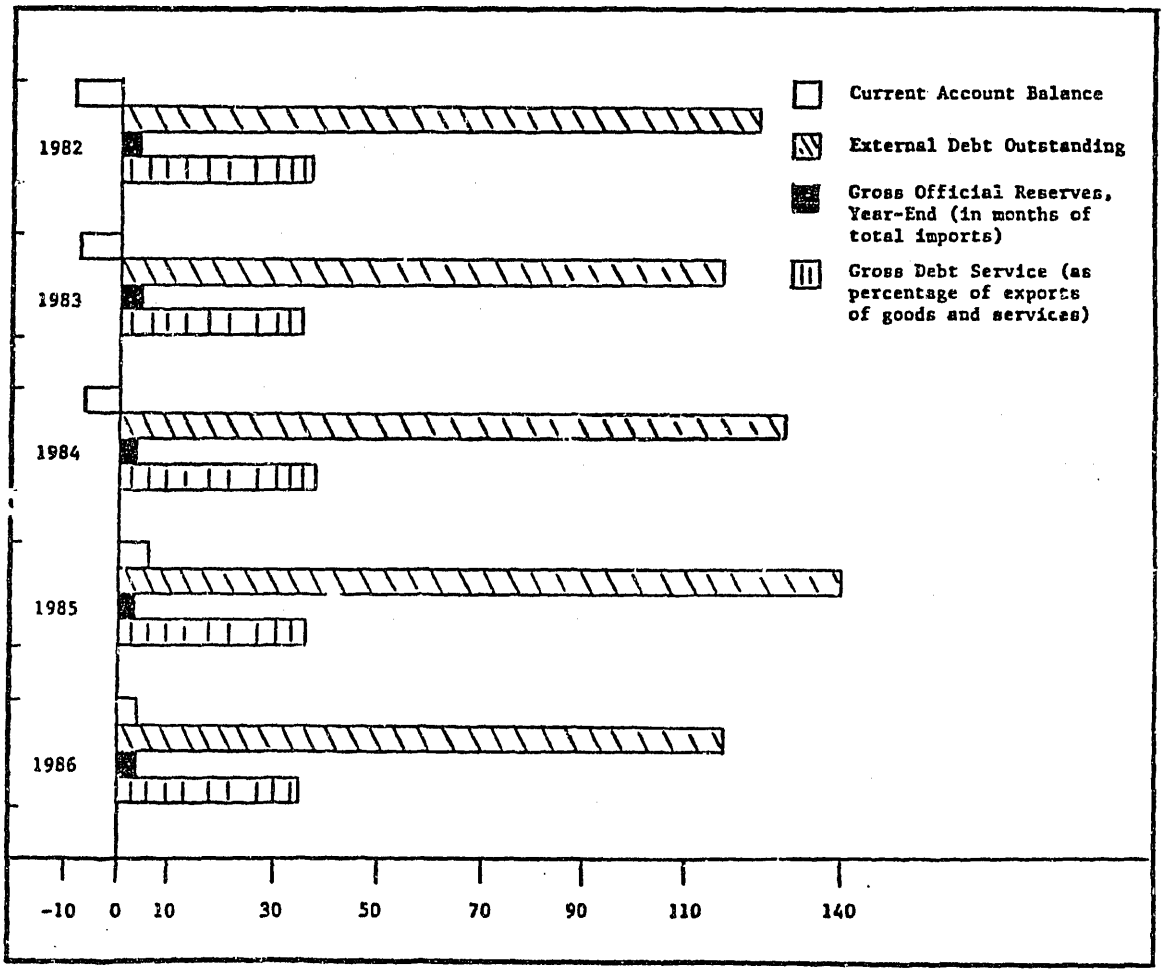

CHART 2. - ISRAEL: GROSS FIXED CAPITAL FORMATION AND GROSS SAVINGS AS PERCENTAGES OF GROSS DOMESTIC PRODUCT, 1980-86