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# GENERAL AGREEMENT ON TARIFFS AND TRADE

Committee on Balance-of-Payments Restrictions

## REPORT ON THE 1987 CONSULTATION WITH ISRAEL

1. The Committee consulted with Israel 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 on 28 October 1987 under the chairmanship of Ambassador P.-L. Girard (Switzerland). The International Monetary Fund was invited to participate in the consultation pursuant to Article XV of the General Agreement.

2. The Committee had the following documents before it:

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| Report on the last consultation with Israel held on 3 December 1985 | BOP/R/155 |
| Basic document supplied by the Israeli authorities | BOP/275 |
| Background paper by the Secretariat | BOP/W/112 and Add.1 |
| International Monetary Fund, "Recent Economic Developments" dated 15 May 1987 | |
| Notifications concerning the import deposit scheme | L/5855 and Add.1, Add.1/Suppl.1, Add.1/Suppl.1/Rev.1, Add.2 and Add.3 |
| Notification concerning the import surcharge | L/5361 |

Opening statement by the representative of Israel

3. The representative of Israel described the economic difficulties with which the government had been confronted in the first half of the 1980s. Inflation had accelerated alarmingly and the balance of payments had come under severe strain. Measures designed to correct the rapid expansion of real domestic demand had produced only limited and short-lived results. By 1984-85, substantial capital flight was taking place because of loss of confidence in the stability of domestic prices and the exchange rate and this was placing pressure on the balance of payments and the level of monetary reserves.

4. In July 1985, the government had put in place a comprehensive programme of economic policies to address the deteriorating situation and

restore public confidence in the economy. The programme was supported by special financial assistance from the United States. It was distinguished from previous adjustment measures in its comprehensive medium-term approach and in the intersectoral support it received from the private sector. The basic strategy employed was to curb the expansion of domestic demand, reduce the share of government in economic activity, and create opportunities to renew economic growth through structural economic changes that favoured savings and investment and export activity. The objectives of the programme were to reduce inflation, stabilize real wages and renew the growth potential of the economy, with a longer-term aim of restoring a sustainable balance-of-payments situation.

5. The programme had a number of major elements. Deficit financing of the budget was cut substantially by reducing expenditures, particularly public subsidies, and by increasing revenues through temporarily raising existing tax rates, levying new taxes and increasing the efficiency of tax collection. Monetary policy was tightened, with the introduction of strict credit ceilings and an increase in real interest rates to as high as 100 per cent in 1985, declining to around 35 per cent by the end of 1986. Restrictive wage agreements were concluded which suspended the automatic linkage that had existed between wages and prices and allowed only partial and delayed compensation for cost-of-living increases. Prices of goods and services were initially frozen as a confidence-building measure in order to undercut inflationary expectations, and prices have since been decontrolled gradually. In conjunction with these policies aimed at restoring confidence in the currency and export profitability, the shekel was devalued in July 1985 and pegged at a fixed rate to the U.S. dollar and later to a basket of the currencies of Israel's major trading partners. This rate was maintained until January 1987 when the shekel was devalued again, by 11 per cent against the currency basket and by 9 per cent against the U.S. dollar. Finally, the programme included two reforms. One, of the capital markets, aimed to reduce the share of government in the market and to place the private sector on an equal footing as a borrower with the government. The other reform was of income tax on companies and individuals, reducing the previously high rates considerably so as to encourage investments and the renewal of growth.

6. The representative of Israel noted that the programme of economic adjustment policies had been implemented on a sustained basis. It had brought about satisfactory results in several areas, but certain targets had not yet been attained and some new problems had arisen that needed to be tackled.

7. Inflation had been reduced substantially, from an average monthly rate of 15 per cent in the first half of 1985 to 1.2 per cent since the last quarter of that year. The pace of consumer price increase slowed down to 20 per cent in 1986 and to 11 per cent in the first nine months of 1987. However, the current inflation rate was still above the level considered acceptable by the authorities, and continued efforts to reduce it by

maintaining firm control over the growth of domestic demand were being pursued by the government in order to prevent inflation from threatening to undermine exchange rate stability.

8. The balance of payments had reacted favourably to the adjustment policies, although the deficit in the civilian trade and services account increased in 1986 and 1987. Net short-term capital outflows had been reversed with the restoration of public confidence in economic policy and short-term capital inflows had resumed on a significant scale, in part in response to the high real interest rates prevailing while the exchange rate remained fixed. As a result, and on the basis also of special financial assistance from the United States, net monetary reserves of the Bank of Israel had increased sharply from US$1.9 billion in June 1985 to about US$4.5 billion in September 1987. External debt continued to grow, although at a lower pace. Debt service obligations remained high at around US$4 billion.

9. The current account of the balance of payments had recorded considerable improvement. However, this was the result of higher inflows of foreign grants, and developments on the trade account for civilian goods and services had continued to give cause for serious concern. Although export performance had been relatively good, with the volume of exports increasing by around 10 per cent a year over the past three years, imports, particularly of consumer goods, had not responded as expected to the demand management policies. After falling by 2 per cent in 1985, the volume of imports of goods had increased by 17 per cent in 1986 and was forecast to increase by 20 per cent in 1987. As a result, the trade account deficit had increased in both 1986 and 1987, and overall balance-of-payments developments needed to be interpreted with this mind, especially as the higher level of reserves resulted mainly from the one-time special US aid inflow and from short-term speculative capital movements.

10. Economic growth, which had slowed down considerably since the beginning of the 1980s, was renewed in the second half of 1986 and strengthened in 1987. GDP growth was forecast to reach 4½ per cent in 1987, and 5½ per cent in the business sector, its best performance for several years. However, a worrying feature for the future growth of the economy was that there had been sharp declines in the domestic savings rate, as the private sector had resisted pressure to cut consumption, and in investment in fixed assets which reflected in part high prevailing real interest rates. An increase of 8 per cent in fixed investment was being forecast for 1987.

11. The representative of Israel noted that liberalization of the economy and of trade in particular had been pursued at the same time that the government's adjustment programme was being implemented. The number of imports subject to special import deposits had been cut and the deposit rate had been reduced and would be phased out completely in January 1988. However, it was not considered prudent for the time being to abolish the temporary import levy that had been introduced in 1982 in view of the

continuing strength of import demand and the deficit in the trade and services account while the exchange rate remained stable. To do so could send the wrong signal to the private sector at this stage of the adjustment process.

12. Finally, the representative of Israel stated that the Government of Israel is committed to continue the implementation of the stabilization policy, demand management being its major tool. The Government of Israel reiterates its adherence to the principles of liberalization of the trade and exchange systems, as well as in other fields. Further progress in the stabilization of the domestic economy, the renewal of the reduction of the deficit in the trade and services account and continued inflow of capital from abroad in sufficient magnitudes, will make possible the further removal of remaining import measures, which have already been reduced to a very limited scope.

Statement by the representative of the International Monetary Fund

13. At the invitation of the Committee, the representative of the International Monetary Fund made a statement, the full text of which is reproduced in the Annex.

Balance-of-Payments position and prospects - alternative measures to restore equilibrium

14. Members of the Committee commended the Government of Israel on the sustained implementation of its economic adjustment programme. The reduction of the inflation rate and the improvement in the balance of payments were welcome evidence of the success of the government's stabilization policies, although it was recognized that further progress needed to be made in these areas and a continuation of the government's strict stance on demand management was encouraged. Members also welcomed the government's tax and capital market reforms and its privatization programme as contributing to the structural strengthening of the economy and reducing the role of government.

15. Members shared the government's concern about certain problem areas, in particular the decline in the savings rate which could have adverse implications for fixed investment and for long-term growth if it continued. They enquired whether the government had specific measures in mind to correct these problems. One member enquired about the government's assumptions and priorities in formulating the budget for Fiscal Year 1988-89. Another member asked for information on the composition of the currency basket to which the exchange rate was pegged, and enquired whether it reflected accurately the weights of Israel's major trading partners.

16. Some members questioned the extent to which Israel's balance-of-payments situation, which had improved considerably over the past few years, fully justified the continued application of trade restrictions, and in particular import licensing, for balance-of-payments purposes. They expressed concerns about the long-standing nature of some of these measures, and doubts about the contribution they could make to balance-of-payments adjustment. In this connection it was recalled from the 1979 Declaration on Trade Measures Taken for Balance-of-Payments Purposes that trade restrictions in general, and quantitative restrictions in particular, were considered to be an inefficient means to maintain or restore balance-of-payments equilibrium. Quantitative restrictions could, on the contrary, make more difficult the structural economic adjustment that was needed to place the balance of payments on a firmer, medium-term foundation. Israel was to be commended on its efforts to date in the area of structural adjustment, and it should be encouraged to continue to rely on fiscal and monetary policies for balance-of-payments adjustment purposes and to continue to liberalize its trade restrictions. In this regard, the conclusions of the representative of the International Monetary Fund received support from Committee members, and the Israeli Government was urged to announce a timetable for the early removal of the remaining trade measures it maintained for balance-of-payments purposes.

17. The representative of Israel noted that preparations for the budget for Fiscal Year 1988-89 had already begun. New targets for additional government expenditure cuts had been set and the fiscal stance would remain restrictive. Revenue projections were now more favourable than had earlier been forecast, as a result of increased economic activity.

18. The government's privatization programme should be viewed mainly in the light of its efforts to reduce the role of government in the economy rather than as complementing in any significant way the programme of macroeconomic adjustment measures. Reversing the decline in the saving rate was a high priority for the government. It was hoped that some improvement would take place in this area shortly as further progress was made in restoring domestic confidence in price and exchange rate stability and advance procurement behaviour on the part of consumers to hedge against future price increases died down.

19. With regard to the balance-of-payments situation, the representative of Israel reiterated that the trade account for civilian goods and services remained weak. He agreed that trade restrictions were not an efficient means of dealing with balance-of-payments problems in the long-run and recognized the potential harm they could cause to the structure of the economy. He reassured the Committee that the measures were temporary, but stated that the government considered the import levy and the import licensing system were still required for the time being. The timing was not yet right to remove them in view of the continued strength of import demand and the economic and political uncertainties that Israel faced. The licensing system was needed as a precaution against these uncertainties, and at present it was being operated liberally.

Systems, methods and effects of restrictive import measures

20. Members welcomed Israel's confirmation that the import deposit scheme would be phased out in January 1988.

21. Several members of the Committee questioned the need for Israel to maintain the import levy in current circumstances. They encouraged the government to remove the measure as soon as possible, and considered it would be useful to have an indication of the time-frame within which it would be removed. One member noted that the levy was currently scheduled to remain in place until March 1988, and hoped that its removal would not be delayed too long.

22. Some members expressed the view that there was room for improvement in the coverage and administration of import licensing. Two members asked for details on how restrictively the licensing system was operated at present, and in particular whether the imports covered were subject to quantitative restrictions, what criteria were used to select imports for licensing and to issue licences, and what plans the government had to move all imports over to be covered by the Free Import Order of 1978.

23. One member asked for information on the calculation and method of administration of the tama (coefficient used for the calculation of purchase tax on imported goods), on the government's policy towards countertrade offsetting, and on the base-price system that had been in operation recently for certain textile and paper product imports.

24. The representative of Israel stated that while the government had no special timetable for phasing out the import levy, it did not consider the levy to be an important element of its adjustment programme. The licensing system was currently operated on a flexible and liberal basis. The coverage of imports had been chosen to allow the government to cope with its balance-of-payments difficulties when necessary, and not everything in the list was subject to restriction at any one time. The government would move items onto the free import list as the balance-of-payments situation improved, but the timing was not yet right. He did not know of problems that had been caused for Israel's trading partners through the quantitative restriction of imports, although he did understand that there may have been some difficulties with the administration of the licensing system.

25. He also stated that improvements in the transparency of the tama had been made over the course of the last year, with the regular publication of the mark-up used to adjust the basic value for the calculation of purchase tax. With respect to countertrade offsets, the government did recommend to foreign suppliers of vehicles, which were a particularly large import item for Israel, to purchase Israeli-made goods such as spare parts whenever possible, but there was no enforcement of these recommendations. Israel had not introduced any new system of minimum or base prices. The so-called base price system applied to such products as textile roofing products and chemical copying paper was in fact the establishment of normal values for

the purpose of temporary imposition of refundable deposits in connection with anti-dumping procedures.

26. Some members of the Committee stated that they had not received full clarification on the extent of the use of quantitative restrictions under Israel's import licensing system.

Conclusions

27. The Committee took note of the improvement in Israel's balance-of-payments position since the last consultation. It commended the government on the sustained implementation of its economic adjustment policies and on its efforts towards the liberalization of trade, which had produced good results. It recognized that a certain number of problems remained, in particular the need to reduce inflation further, to bring import growth under firmer control through continued demand management measures, and the need to reverse the decline in the savings rate.

28. The Committee welcomed the confirmation which had been given that the import deposit scheme would be abolished in January 1988. It took note of the statements that had been made with regard to the government's intention to abolish the import levy when it considered the timing to be right, expressed concern that no timetable had yet been announced for its removal, and urged that this be done at the earliest opportunity and that the government keep in mind in this respect the provisions of paragraph 1(c) of the 1979 Declaration on Trade Measures Taken for Balance-of-Payments Purposes that "whenever practicable, contracting parties shall publicly announce a time schedule for the removal of the measures".

29. The Committee questioned the extent to which the import licensing system in general, and quantitative restrictions in particular, were of value in maintaining or restoring balance-of-payments equilibrium. It expressed views about the adverse effects of the prolonged maintenance of restrictions on the structural adjustment of the Israeli economy. While noting the statement of the representative of Israel that the licensing system was currently operated on a flexible and liberal basis, it saw a need for greater transparency in the administration of the import licensing system and in the nature of the trade restrictions that were being employed.

30. The Committee welcomed Israel's commitment to continue its programme of macroeconomic measures in order to restore a sustainable balance-of-payments situation, demand management being its major tool, and its statement that further progress in this area would permit the removal of the remaining import measures. It urged the Government of Israel to pursue its intentions in these areas resolutely.