GENERAL AGREEMENT

ON TARIFFS AND TRADE

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Committee on Balance-of-Payments Restrictions

REPORT ON THE 1993 CONSULTATION WITH ISRAEL

1. The Committee consulted with Israel on 1 and 2 July 1993, in accordance with its terms of reference and the Declaration on Trade Measures Taken for Balance-of-Payments Purposes (BISD 26S/205). The consultation was held under the Chairmanship of Mr. P. Witt (Germany). 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 supplied by Israel	BOP/315
Background paper by the Secretariat	BOP/W/152
International Monetary Fund, Recent Economic Developments, dated 21 April 1993.	

3. The opening statement by the representative of Israel is contained in Annex I.

4. The statement by the representative of the IMF is contained in Annex II.

(i) Balance-of-payments position and prospects; alternative measures to restore equilibrium

5. The Committee welcomed the positive response of Israel's economy to the structural reform programme aimed at improving competitiveness and absorbing the massive inflow of new immigrants, which had increased the population by over 10 per cent in the last three years. Since the last consultation, real GDP growth had averaged around 6 per cent a year, investment and employment had increased significantly, and inflation had been reduced to single digit levels. The Committee noted that the current account had weakened somewhat in 1992, and that international reserves had declined, to cover about two and a half months of imports; but the debt service ratio had improved considerably. With continuation of present policies and immigration trends, the current account deficit was not expected to rise much above the present level in the medium term, especially in the light of the recently agreed external loan guarantees by the United States.

6. Members of the Committee complimented Israel on the progress made in liberalizing its economic, trade and foreign exchange régime and encouraged it to pursue its structural reforms and ensure macroeconomic stability. The Committee encouraged Israel to continue implementing its tariff reduction programme according to the original schedule and eliminating remaining trade restrictions. Members asked for more information about Israel's labour policy, the implementation of the tariff reduction programme, the effect of real effective depreciation of the Israeli currency on trade flows

and the progress of privatization programmes. One member, in the context of Israel's large-scale investment programmes, asked about Israel's policy towards countertrade. Questions were also asked regarding the interest rates paid on deposits required to be kept by Israel's exporters in domestic banks.

(ii) System, methods and effects of restrictions

7. Committee members welcomed that since the last consultation Israel had abolished the additional temporary import surcharge, introduced in September 1991, and that the Government intended to eliminate the export exchange rate insurance scheme by early next year. Members supported the replacement of quotas with tariffs; however, concern was expressed over the lack of progress in liberalizing trade in agriculture, where duties, variable levies, quotas and import licensing continued to be applied. Members asked Israel to notify, on a tariff line basis, the agricultural items which were subject to import restrictions maintained for balance-of-payments purposes. One member regretted that products such as timber and some electronic goods were still subject to licensing.

8. Members expressed concern over the continued application of the "HARAMA" customs valuation system and the "TAMA" method of valuation for purchase tax; both instruments were considered as discriminating against imports and their application lacked transparency. Some members noted that the alternative purchase tax valuation recently introduced by Israel was not used by companies and, as a result, the "TAMA" method remained the norm. Some members question the consistency of the "TAMA" with Israel's obligations under Article VII of the GATT and urged Israel to join the GATT Customs Valuation Code.

9. The Committee noted that Israel would reduce the 2 per cent temporary import levy, maintained for balance-of-payments purposes on industrial products, to 1 per cent not later than 31 December 1994. It questioned, however, whether at that level the measure was effective in protecting the country's balance of payments and urged Israel to accelerate its phase-out.

10. In reply, the representative of Israel stated that Israel provided substantial help to new immigrants in the areas of housing, education and health services. The new labour force was being absorbed by the business sector, without direct intervention by the Government. The high inflow of immigrants was the main driving force behind increased investments and imports.

11. The tariff reduction programme announced in 1991 was being implemented according to the original schedule, with the exception of textile products, which would be subject to a tariff reduction period two years longer than originally scheduled. The privatization programme was also being implemented in accordance with the original schedule. The reaction of the economy to the real effective depreciation of the sheqel was gradual, in terms of changes in export and import flows. Israel did not support barter trade, but it encouraged industrial cooperation with larger suppliers. The country had no specific rules on interest rates to be paid on deposits by exporters.

12. The future of the balance of payments situation of Israel remained unpredictable, due to a number of reasons such as the impact of continued import liberalization or the size of immigration. Therefore, Israel was not in a position to commit itself to a precise date for disinvocation of the GATT balance-of-payments provisions. It was, however, the intention of the Israeli authorities to eliminate the import levy as soon as possible. In respect of trade in agricultural products, she stated that trade in wheat and coarse grain was subject to State-trading, to ensure adequate levels of security reserves. Imports

of these products, however, had been privatized. Meat was still under State-trading, but it was expected that this would be eliminated soon.

13. Import licensing on agricultural products was still maintained for balance-of-payments reasons. In this connection, she noted that trade in agricultural items was under negotiation in the Uruguay Round with Israel's participation. Israel was ready to provide, by September 1993, an updated list identifying balance-of-payments restrictions on agricultural products at tariff line level.

14. The "HARAMA" customs valuation system and the "TAMA" purchase tax valuation method were not maintained for balance-of-payments reasons. Israel was positively considering its accession to the Customs Valuation Code; an exact date, however, could not yet be given. The Israeli authorities did not share the view that the "HARAMA" system had import restrictive effects, and it was not meant to create discrimination. The "TAMA" method did not discriminate against imports. At present, already the majority of importers, depending on the volume of their total imports, had the right to choose, instead of "TAMA", the actual wholesale value for domestic purchase tax purposes. By 1995, more than 90 per cent of imports would be conducted under the optional régime. In addition, it was Israel's intention to decrease the number of items subject to purchase tax and lower the level of the tax. The alternative valuation method was not preferred by importers because the declared wholesale value, which included the importer's actual mark-up, was usually higher than the tax base established under the "TAMA" method. This was due to the use of the "normalized" mark-up, which was lower than the actual mark-up.

(iii) Conclusions

15. The Committee welcomed the positive response of the Israeli economy to the structural reform programme aimed at improving competitiveness and absorbing the massive inflow of immigrants since 1989. Since the last consultation in 1991, real GDP growth had averaged about 6 per cent per annum, inflation had fallen to single-digit levels and investment and employment had increased significantly. While immigration had slowed in 1992, unemployment continued to rise and the level of future immigration remained a source of uncertainty.

16. The Committee took note of the view expressed by the International Monetary Fund that, on the basis of current policies and trends in immigration, the current account situation should not give rise to financing difficulties, especially in the light of recently agreed external loan guarantees by the United States. The Fund considered it essential that Israel continue to aim at providing a stable macroeconomic environment, while at the same time intensifying its structural reform efforts.

17. The Committee complimented Israel on the progress made in economic and trade liberalization, and urged it to pursue its structural reforms vigorously while ensuring macroeconomic stability. The Committee noted the abolition of the additional temporary import surcharge introduced by Israel in September 1991 and the steps taken towards liberalizing the foreign exchange and banking systems.

18. The Committee urged Israel to continue implementing its tariff reduction programme vis-a-vis non-free trade area partners and to resist domestic pressures to extend the time schedule. Concern was expressed over the continued application and import-restrictive effects of the "HARAMA" customs valuation system, as well as the use of the "TAMA" method of valuation for purchase tax, which Committee members saw as discriminating against imports. The Committee encouraged Israel to accede to the Customs Valuation Code.

19. The Committee noted that the only remaining measure applying to industrial products for which Israel invoked GATT balance-of-payments provisions was the 2 per cent import levy, scheduled for reduction to 1 per cent not later than 31 December 1994. The Committee urged Israel to accelerate the phasing out of this measure, which it considered to have little significance for the present balance-of-payments situation.

20. On agricultural products, Israel was still invoking balance-of-payments provisions in respect of import licensing. The Committee, while noting the statement that agricultural items were under negotiation in the Uruguay Round, urged Israel to establish a timetable for the phasing out of these restrictions. Israel agreed to provide, by September 1993, an updated list identifying balance-of-payments restrictions on agricultural products at tariff line level. The Committee agreed to examine this question after receiving the notification from Israel.

ANNEX I

Opening Statement by the Representative of Israel

Trade Policy

During the previous balance-of-payments consultation we presented a comprehensive trade liberalization programme which we started on 1 September, 1991. The core of this programme was the abolition of quantitative restrictions, which had been imposed on industrial imports for balance of payments reasons, and the replacement of such restrictions by temporary higher tariffs to be reduced linearly to a level of 8 to 12 per cent over a period of 5 to 7 years.

The purpose of this liberalization programme was to achieve - by means of increased import competition - better allocation of resources, which would lead to enhanced structural adjustment and rationalization of production. The purpose of this programme was also to achieve substantially lower rates of inflation by allowing increased competition from m.f.n. countries which do not have a free trade area agreement with Israel.

I am pleased to inform the Committee that the import liberalization programme has been so far fully implemented according to schedule. Discretionary licensing for imports of industrial products was abolished on 1 September, 1991. For many industrial products licensing requirements were cancelled altogether. For the remaining products subject to licence for monitoring purposes, the licence is issued automatically and the list of such products had been reduced during the last one and a half years.

The linear reduction of those tariffs, which had been increased on 1 September, 1991, has taken place as scheduled on 1 September, 1992. It should be noted that in fact the scope of tariff reductions, which took place on 1 September, 1992, has been even widened to include all industrial products subject to a tariff higher than 12 per cent, even if such tariff had not been previously increased within the framework of the tariffication programme.

Moreover, for textiles and textile products, on which particularly high tariffs had been imposed ranging up to 110 per cent, an accelerated tariff reduction is scheduled to take place on 1 September, 1993, when the 100 per cent tariff ceiling will be lowered to 82 per cent. On the other had, taking into account the particular vulnerability of this industry and the need for a longer adjustment period, the Israeli Government had decided to lengthen by two years the time schedule for reaching the target rate of 8 to 12 per cent. The total time schedule for this sector will therefore be 9 years, i.e. until September 2000, instead of the planned 7 years.

During the 1991 consultation, concern was expressed by several members that the replacement of licensing by tariffs could have substantial trade restrictive effects in the transition period. While certain marginal restrictive effects might have occurred during the first year of implementation, overall import growth from m.f.n. countries in 1992 has been similar to or higher than the growth in imports from countries which have a free trade area agreement with Israel. Preliminary data for the first few months of 1993 seem to indicate a similar development in imports by geographic origin.

As stated at the beginning, the liberalization of the import régime is the core of a more comprehensive liberalization programme. The liberalization of the import régime has been accompanied and has been made possible by a further liberalization of foreign exchange restrictions, financial and capital market reforms, as well as privatization and more active enforcement of Israel's anti-trust law.

The main purpose of all these measures is to increase competition and minimize possible discrimination among economic operations. In order to achieve this aim without creating serious imbalances, we must proceed gradually. In this context, we are continuing the gradual reduction of the import levy which will be reduced from 2 per cent to 1 per cent not later than 31 December 1994, as has already been notified. As of today, the date for the complete elimination of the levy has yet to be decided. We do hope that before the next consultation we shall be in a position to provide a date for the elimination of the levy.

Macroeconomic situation

In the past four years half a million immigrants arrived in Israel, most of them from the former USSR. As a result of the immigration wave, local demand grew rapidly in the years 1990-1991, lead by investments. Residential investments grew by 19 per cent in 1990 and 74 per cent in 1991. Non-dwelling investments grew by 24 per cent a year. Exports of goods and services were stable, influenced by the gulf war and the recession in international trade. As a result of the increased demand, civilian imports rose rapidly, by 8 per cent in 1990 and 15 per cent in 1991. GDP rose by 6 per cent per year and business sector production expanded by about 7.5 per cent a year.

The expansion of total consumption continued at a similar pace, approximately 9 per cent in 1992. The composition of consumption, however, was markedly different: a significant slowdown of dwelling investment and deceleration in growth of non-dwelling investments (from 24 per cent to 9 per cent). Exports however, rose by about 14.5 per cent. This acceleration reflected the recovery of tourism after the gulf war, and the expansion of other services and industrial exports.

In 1992, GDP rose by 6.6 per cent; the business sector production by 7.9 per cent. Industrial production rose by 9.2 per cent.

Balance of payments

The civilian import surplus increased from US$ 2.7 billion in 1989 to US$5.4 billion in 1992. Despite this massive increase, a similar change on the current account has been avoided thus far. Assistance and transfers to the government and to the private sector have grown substantially. Most of the upturn in transfers to the government originates in non-recurrent assistance connected to the gulf war. We have no full explanation for the increase of private sector transfers (US$850 million compared to 1990) and cannot estimate how stable it will be in the future. The net foreign debt has stood at approximately US$5 billion for the past three years; expressed in percentage of the GDP it has fallen steadily and reached about 23 per cent in 1992.

In the labour market, despite the rapid growth of the economy and the expansion of employment (about 4 per cent in the past three years), the unemployment rate rose from 8.9 per cent in 1989 to 11.2 per cent in 1992, due to a large increase in the number of job seekers, as a consequence of the substantial immigration. At the end of 1992, there were 165,000 immigrants in the labour force (of which 125,000 were employed).

The inflation rate dropped from 18 per cent in 1991 to 9.4 per cent in 1992. The main factors helped reduce inflation were: the moderation of nominal wage growth, and nominal housing prices.

The overall budget deficit decreased from 4.3 per cent of GDP in 1991 to 2.4 per cent of GDP in 1992.

The following economic reforms have continued since the last consultation: The gradual opening of local financial and capital markets to foreign markets; the privatization of corporations owned by the government; and the liberalization of foreign trade. In January 1993 there was a reduction in the value added tax from 18 per cent to 17 per cent and the duty on imported services and the tax on foreign travel were abolished.

The Israeli economy has coped with the immigrant absorption challenge without deterioration in the balance of payments thus far. However the process is not yet complete and long term stability in this regard has not been achieved. The balance of payments trend over the next few years is still shrouded in great uncertainty.

Annex II

Statement by the IMF Representative

Over the past three years, Israel's economy has been subjected to a supply-side shock in the form of massive inflows of new immigrants that have increased the domestic population by over 10 per cent. To date, the economy has responded rather well under a strategy that has emphasized improvement of the investment environment rather than direct intervention in the labour market. Since 1990, real GDP growth has averaged around 6 per cent a year, employment has risen at an annual rate of 4 per cent, and inflation has been reduced to single digits for the first time in over 20 years. These achievements are all the more noteworthy when viewed against the relatively unfavourable external environment prevailing over this period. Employment growth has, however, not matched the large increase in the labour force and the rate of unemployment has risen from almost 9 per cent in 1989 to around 11 1/4 per cent at present.

The authorities' basic strategy toward absorbing the immigrants, while abstaining from direct intervention in the labour market, has been to cater to their housing needs and to provide subsistence grants and training during the first year of residence. At the same time, the strategy has focused on the creation of an adequate infrastructure and a more favourable business environment such as to allow the gradual absorption of the immigrants into private sector employment. The underlying rationale was that although in the short run direct government intervention could provide jobs, in the longer run such an approach would be counterproductive as it would perpetuate resource misallocation by interfering with the efficient use of human capital.

Since 1990, the priority placed on immigrant absorption has affected budgetary policy importantly. On the expenditure side, incentives were offered to speed up dwelling construction and provide accommodation for immigrants; mortgages to immigrants were subsidized; extrabudgetary commitments were made to contractors to buy back unsold housing units; and a variety of wage subsidies were provided to firms that employed additional labour. Over the same period, there was a significant reduction in the proportion of public spending on defense, while a temporary 5 per cent income tax surcharge and an increase in the VAT were introduced. These measures were sufficient to prevent any significant deterioration in the public sector's accounts through 1991. And they allowed a contraction in the overall budget deficit from 4 1/4 per cent of GDP in 1991 to around 2 3/4 per cent of GDP in 1992, as a lesser number of immigrants than expected arrived in Israel.

After remaining stuck at around 18 per cent between 1989 and 1991, inflation, as measured by the consumer price index, decelerated to 9 per cent by end-1992. An important factor in this performance was the marked deceleration in wage inflation that has been associated with the immigration-induced increase in the labour supply over the past three years. Nominal wage inflation decelerated from 23 per cent in 1988 to 13 per cent by 1992, while in real terms, the average business sector wage is estimated to have declined by a cumulative 7 per cent since 1989.

In mid-1992, a Labour-led coalition government came into office on a platform that included a commitment to a significant reduction in unemployment. To that end, the recently presented 1993 budget reiterated the Government's commitment to a strategy aimed at increasing the level of overall investment, improving the conditions for business sector operations, and laying the basis for export-led growth. This strategy was to embrace a basic reorientation of public sector spending away from the housing sector and toward infrastructure investment, a broad-based program of structural reform, and

the maintenance of macroeconomic balance. In the latter context, and as part of a medium-term budgetary strategy to eliminate the domestic component of the budget deficit by 1995, the current budget was to aim at reducing that deficit from an estimated 5 per cent of GDP in 1992 to 3 1/4 per cent of GDP in 1993.

Any strategy to reduce unemployment on a sustainable basis should be framed in a manner that maintains macroeconomic balance and that reduces the supply side rigidities of the economy. In that respect, the broad strategy spelt out in the 1993 budget fundamentally goes in the right direction. However, the success of that strategy will ultimately depend on the vigorous pursuit of structural reform measures to make the economy more flexible and more attractive to foreign investment. Such reform should embrace efforts at privatization, labour market flexibility, and a further trade liberalization. In this regard, the recently announced decisions to reform the banking system are to be welcomed. These decisions aim at increasing competition in the economy, reducing potential conflicts of interest between the banks and other financial institutions, and divestment of government ownership in the banking system.

At end-1991, the authorities replaced the system of an exchange rate band around a fixed rate that had operated since 1989 by a "diagonal exchange rate band". The system was intended to strike a balance between consolidation of the gains of reducing inflation and avoiding the risk of speculative capital outflows associated with the anticipated discrete changes in the exchange rate. Under the new regime, the 5 per centage point band of the previous system was maintained, but the midpoint was to be devalued daily at a preannounced rate. After an initial 3 per cent devaluation, the authorities announced a 9 per cent downward crawl for 1992, which was believed to be in line with the 14 per cent inflation objective for the year. As the inflation outturn in 1992 was more favourable than targeted, at less than 10 per cent for the consumer price index, the final result was a significant real effective depreciation of the currency, which restored Israel's level of competitiveness to that prevailing in the mid-1980s.

In November 1992, the authorities devalued the midpoint of the exchange band by 3 per cent, which they indicated was to be seen against the background of the intention to remove the subsidy element of the present exchange guarantee system. At the same time, the authorities announced an 8 per cent pace of crawl for 1993, set to be consistent with the 10 per cent inflation target for the year. In the staff's view, particularly in light of Israel's present labour market situation, it would have been desirable to have set a more ambitious inflation target for 1993, while on balance of payments grounds there would not appear to be a strong case for any real devaluation of the currency.

On the basis of latest revised data, the external current account improved slightly between 1991 and 1992, moving from a US$ 1/4 billion deficit to about balance. A principal factor in the balance of payments performance in 1992 was a strong rebound of exports of goods and services, particularly tourism, from the Gulf War-related low levels of the previous year. Imports of goods and services, rising by 10 per cent in volume, continued the rapid expansion that has accompanied the recent wave of immigration. The staff envisages little change in the external current account balance in 1993 as economic growth slows down. On the basis of present policies and immigration trends, the external current account deficit over the medium-term is not expected to rise above its 1991 level of less than US$1 billion. This should not give rise to financing difficulties, especially in light of the recently agreed U.S. external loan guarantees mentioned below.

The free trade agreements with the United States, the European Community and EFTA have helped increase domestic competition through a partial opening of the domestic market. Approximately

85-90 per cent of Israel's imports originating in the EC and the United States fall under these agreements. The agreement with EFTA, that became operative at the beginning of 1993, accords treatment similar to that agreed with the EC. Since 1991, the authorities have been implementing a program that is to extend trade liberalization to third countries. In September 1991, quantitative restrictions on imports from third countries were replaced by protective tariffs, in a general range of between 20 and 75 per cent, but with higher protection accorded to sensitive products, such as textiles and wood. These tariffs are to be reduced to maximum rates of between 8-12 per cent over a five to seven year period; however, this period has since been lengthened to nine years for textiles. Licensing requirements, which still apply to imports of textiles, clothing, footwear, plywood and fertilizers are to be phased out by September 1994; in the meantime, licenses are to be issued automatically. The first stage of the planned tariff reductions was implemented in September 1992, broadly in line with the original schedule. However, there is pressure from the so-called sensitive industries to modify this schedule further.

In early 1993, Israel removed the 4 per cent foreign exchange tax on the import of tourist services and abolished the tax on foreign travel. However, the 2 per cent import duty surcharge, introduced in 1983, was maintained. The exchange rate insurance scheme for exporters, which had a subsidy element of around 3 percentage points of the export value at end-1992, also continued to be in place, although, effective April 1, 1993, the subsidy element was reduced to 2 per cent and is intended to be eliminated in 1994. Effective subsidies have been below these levels as they were applied to value added only.

Over the past two years, the reform of the foreign exchange control system, which began in 1987, continued. By 1992, practically all restrictions on the inward movement of capital had been eliminated, and during 1992 further substantive steps were taken toward liberalizing the capital account, especially regarding outward portfolio investment by individuals and outward direct investment by corporations. However, Israel continues to maintain a number of exchange restrictions, among which the exchange rate insurance scheme for exporters, which gives rise to a multiple currency practice. The Fund has not approved this restriction in the absence of a clear time schedule for its removal. The authorities, however, have declared their intention to remove soon those remaining exchange restrictions in order to allow Israel to accept the obligations under Article VIII of the Fund's Articles of Agreement.

The progressive deregulation of the capital account, together with that of the domestic financial markets, has brought about a marked change in the structure of capital flows, increasing the share of short-term capital, including errors and omissions. Toward end-1992, these developments, together with the policy to ease interest rates, had produced significant capital outflows. However, since then, the Bank of Israel has increased short-term interest rates, from around 10 to 12 1/2 per cent, which has triggered capital reflows and a strengthening of the currency. In addition, the U.S. Congress approved in late 1992 a US$10 billion five-year loan guarantee program to help the absorption of immigrants from the former Soviet Union. It should be noted that no more than one third of the annual US$2 billion borrowing under these guarantees is to finance the Government's budget, the bulk being intended to build up private sector productive capacity and official foreign exchange reserves. Reserves at end-1992 slightly exceeded US$5 billion, equivalent to 2 1/2 months imports of goods and services, while Israel's net external debt amounted to less than 25 per cent of GDP.

The Fund believes that, if future debt servicing problems are to be avoided, increases in foreign borrowing need to be accompanied by a concomitant increase in productive investment. The latter, in turn, depends upon the success of the structural reform efforts that are to increase efficiency and competition in the domestic market so as to allow sustained noninflationary growth, including the creation

of an adequate level of employment opportunities. In this respect, it is considered essential that the authorities continue to aim at providing a stable macroeconomic environment, while at the same time intensifying their efforts at structural reform. In this context, the authorities should firmly resist domestic pressures to deviate from the scheduled reduction in import tariffs and they should aim at making further strides toward the elimination of remaining trade restrictions.