

GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

BOP/R/73
28 March 1974

Limited Distribution

Committee on Balance-of-Payments Restrictions

REPORT ON THE CONSULTATION WITH ISRAEL AND EXAMINATION OF THE ISRAELI TEMPORARY IMPORT SURCHARGE

1. On 19 December 1973, the Council was informed by the delegation of Israel that the Government had increased the temporary import surcharge (see L/3976). The Council agreed that the matter should be referred to the Committee on Balance-of-Payments Restrictions for examination in relation to the relevant provisions of the General Agreement (C/M/92). The Committee has examined the matter in conjunction with the regular consultation with Israel on its balance-of-payments import restrictions, which took place on 19 March 1974.
2. The Committee had before it a basic document supplied by the Israeli authorities (BOP/145 and Add.1) and a background paper supplied by the International Monetary Fund dated 11 February 1974. It generally followed the plan for such consultations recommended by the CONTRACTING PARTIES (see BISD: 18th Supplement, pages 52-53).

Consultations with the International Monetary Fund

3. Pursuant to the provisions of Article XV of the General Agreement, the CONTRACTING PARTIES had invited the IMF to consult with them in connection with the Israeli measures. The representative of the Fund made the following statement:

"With one exception discussed below, the general performance of the Israel economy prior to the October 1973 hostilities was satisfactory. During 1972 and the first nine months of 1973 the real GDP grew strongly, although the rate of growth slowed down to some extent during 1973. For the third consecutive year Israel experienced an overall balance of payments surplus and in 1972 it amounted to SDR 597 million which was more than triple that of the previous year. During the same period, the surplus on basic balance increased to SDR 637 million from SDR 229 million in 1971 mainly as a result of a large decrease in the deficit on services account; the inflow of unilateral transfers increased by almost 30 per cent. The performance of the trade sector also improved as exports continued to increase while imports were marginally lower, resulting in a reduction of the trade deficit from SDR 830 million to SDR 714 million. During the first nine months of 1973 exports continued to rise rapidly but the trade gap widened as the continued expansion of the economy led to increasing imports. The international reserves of the Bank of Israel stood at SDR 1.1 billion at the end of 1972; they had increased to SDR 1.5 billion by the end of 1973.

The exception to the generally favorable developments was a sharp rise in prices. In addition to the buoyant domestic conditions, other factors contributed to this development including the import surcharge introduced in 1970, the devaluations of 1972 and 1973, large wage increases in 1972, and the higher world prices of imported commodities. The consumer price index increased by 13 per cent in 1972 and is estimated to have increased by about 26 per cent during 1973. To restrain the price increases, nonetary and fiscal policy was tightened at the end of 1972 and early 1973 and was further strengthened in the middle of that year when, in addition, a three-month price-freeze was imposed.

The October hostilities and their aftermath have led the authorities to introduce measures of economic austerity designed to divert the use of resources to public consumption, especially defense, and away from the private sector.

Preliminary estimates indicate that for the whole of 1973 the economy is estimated to have grown at about 4 per cent in real terms, considerably less than the annual rate prior to the hostilities. Although the full effects of the hostilities will not be reflected on the balance of payments until sometime in 1974, existing estimates for the whole of 1973 indicate a deterioration of the trade deficit from SDR 714 million in 1972 to an amount that is believed to have been well in excess of SDR 1 billion, with the balance on goods and services increasing from a deficit of SDR 980 million in 1972 to more than SDR 2 billion in 1973.

The measures instituted by the authorities since the October hostilities have been motivated by two major considerations, the maintenance of economic stability and the financing of the direct costs of the war, which are estimated at between \$4.5 billion to \$6 billion. The measures have included compulsory and voluntary war loans, an increase in purchase taxes, a reduction in subsidies on essential goods such as bread, flour, vegetable oils, and milk products and a 5 percentage point temporary increase in the import surcharge from 20 per cent to 25 per cent ad valorem on all but a small group of imports. This latter measure was designed to yield revenues of £ 600 million and to slowdown the rise in imports. In appraising the reasons for the maintenance of the surcharge, including the recent increase in its rate, two factors have important bearing. First, during the period under review, with the exception of the surcharge the Israel authorities have continued to implement their long-term plan of trade and payments liberalization. In December 1973 the import deposit scheme introduced in 1970 was eliminated, while in January 1974 the tariff duties on many products were decreased by between 2.5 per cent and 3 per cent. Second, in the period ahead the balance of payments, as well as the economy as a whole, will continue to be dominated by the aftermath of the October hostilities. Despite the restraining

measures mentioned above, inflation is likely to continue in 1974 due, inter alia, to the removal of subsidies and increases in purchase taxes as mentioned above, and the rising import prices. At the same time the high defense expenditures, especially abroad, will put serious pressures on the balance of payments. International reserves, which at SDR 1.5 billion were high at the end of 1973, may have to be drawn down considerably in the period ahead to finance the anticipated deficits in the balance of payments.

In view of the expected pressures on the balance of payments in 1974 and the fiscal importance of the surcharge, the general level of restrictions in Israel including the maintenance on a temporary basis of the import surcharge is not unwarranted."

Opening statement by the representative of Israel

4. In his opening statement, the text of which is annexed to this report, the representative of Israel reviewed the balance-of-payments performance of Israel over the past few years, the implication of the recent rise of commodity prices, the economic effects of the October war and various factors that were likely to determine future balance-of-payments developments. Despite the payments difficulties that arose in 1973, the Government had not imposed any additional quantitative restrictions on imports. The items that were still subject to administrative controls represented no more than 8 per cent of total imports, excluding food and fuel imports by Government agencies. The Government had pursued its policy of unilateral tariff reductions and had eliminated the import deposit scheme. When the deterioration of the balance of payments made corrective measures inevitable, the Government had decided against returning to a system of administrative import controls and in favour of measures that would operate through the market mechanism. The Government was convinced that its balance-of-payments policy should rely primarily on export expansion rather than import limitation. For this reason it attributed great importance to further lowering of import duties and to free and fair access to markets of developed countries - through the Multilateral Trade Negotiations - and to improvements in the Generalized System of Preferences.

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

5. In discussing Israel's balance-of-payments position, members of the Committee expressed their full understanding of Israel's present payments difficulties. It was noted that during 1971, 1972 and the first nine months of 1973 Israel experienced an overall balance-of-payments surplus but that the hostilities in October 1973 and their aftermath had led to renewed pressures on the balance of payments. Members of the Committee welcomed the determination of the Israeli Government to overcome the present difficulties by emphasizing expansion of exports rather than restriction of imports. Members of the Committee noted that the

consumer price index was estimated to have increased by about 26 per cent during 1973 as compared to 13 per cent in 1972 and expressed concern about the effects of inflationary pressures on Israel's future balance-of-payments performance. In this connexion one member of the Committee pointed out that the recent increase in the rate of the import surcharge would tend to exacerbate the inflationary problem by making imports more expensive; domestic monetary or fiscal measures to solve the balance-of-payments problem would have avoided such undesirable side effects on the domestic price level. Members of the Committee noted with concern that in 1973 Israel's outstanding foreign debt had reached SDR 4.2 billion or SDR 1,296 per capita.

6. The representative of Israel was invited to comment on the general balance-of-payments prospects for 1974, the export promotion and diversification policies of the Government and its related investment strategy, the measures the Government intended to take to restrain further price increases, as well as the steps it planned to take to cope with the foreign debt problem.

7. Concerning the balance-of-payments prospects for 1974, the representative of Israel informed the Committee that present forecasts showed that the current account deficit would rise by US\$805 million and reach US\$3.5 billion in 1974. The terms of trade were expected to worsen as import prices would increase by 26 per cent and export prices by 15 per cent. A trade deficit of US\$2 billion was forecast. This represented an increase of US\$625 million compared to 1972, resulting from an estimated US\$760 million increase in imports and a US\$135 million increase in exports. As for services, a deficit of US\$1.1 billion was predicted.

8. Regarding export promotion and diversification policies and the related investment strategy of his Government, the representative of Israel pointed out that a return to full production could be expected during the year; the transportation system had been restored and most of the manpower was again available for production. To diversify export earnings the Government had promoted investments in the electronics, metal and chemical industries. Part of the production of these industries had been used for defence purposes during the hostilities; it was now again available for exports. Mineral exports, in particular phosphate exports, were expected to benefit from rising prices, and investments in mineral extracting and processing industries were being increased. Agricultural output was limited by the availability of land and water. The Government had therefore promoted changes from low to high yield crops. A recent emphasis on cotton production had turned out to be particularly profitable. Special efforts were made to increase foreign exchange earnings of the transport and tourism industries. The rising foreign exchange earnings of these industries indicated that they were now increasingly competitive.

9. The Israeli representative emphasized, however, that future export performance did not only depend on domestic production capacity but also on Israel's access to markets and the economic conditions in the export markets. In this context Israel attached great importance to the Multilateral Trade Negotiations and to further improvements in the Generalized System of Preferences. The general slowdown of economic activity in many industrialized countries was likely to adversely affect Israel's exports, particularly of consumer goods. A certain shift of sales away from Israel's traditional export markets towards countries benefiting from the oil price increase would be necessary though this would involve new promotional efforts. The Government supported exporters' efforts in many ways, for example by promoting international trade fairs or exhibitions by individual exporters or by assisting through its trade missions. The Government had the twofold policy of giving producers confidence that their export efforts would continue to be supported while at the same time making them realize that any protection of the domestic market was temporary.

10. In response to questions on measures to restrain inflation, the Israeli representative pointed out that one had to distinguish between domestic and imported inflationary pressures. To fight the domestic cause of inflation the Government had taken numerous measures to reduce internal demand. Thus, it had substantially increased direct and indirect taxes, reduced subsidies on essential goods such as bread and milk, and introduced compulsory and voluntary war loans. All these measures helped to absorb private purchasing power. The Government's efforts to reduce demand, however, had to take into account the legitimate social demands of the existing population and the immigrants. As to imported inflation, the Government was facing a dilemma: while a reduction of import charges would certainly help reduce the price of imported goods these charges were necessary to protect Israel's external financial position.

11. On the debt problem, the Israel representatives commented that debt service payments absorbed about half of Israel's export receipts. The total outstanding foreign debt was expected to reach US\$6 billion by the end of 1974. Already now Israel had the highest per capita foreign debt of the world. However, the structure of the external debt was favourable and the Government was seeking to improve it further by trying to obtain long-term loans with long grace periods and low interest rates.

System and methods of the restrictions and effects of the restrictions

12. Members of the Committee commented favourably on the fact that the import deposit scheme, introduced in January 1970, had been abolished in December 1973 and that tariff duties on a broad range of products had been reduced by 2.5 to 8 per cent in January 1974. One member welcomed the decision of the Government of Israel to resort less and less to quantitative restrictions to protect its balance of payments. Another member pointed out, however, that the principal

restrictive technique applied by Israel, namely the import surcharge, required a waiver under the General Agreement. He added that, while the surcharge had originally been introduced as a temporary measure to be eliminated in March 1972, its temporary nature could now be questioned; he therefore suggested that the Government of Israel consider requesting a waiver. The Israeli representative replied that his Government considered the surcharge the best technique available both from a national and international point of view. When notifying the contracting parties of the recent increase in the rate of the surcharge, the Government of Israel had suggested that the measure be examined in the Balance-of-Payments Committee. This suggestion had been accepted by the contracting parties. In reply to the question whether Israel had any plans to phase out the import surcharge, the representative of Israel said that he was not in a position to give a definite answer, but that the uncertainties of the present situation made a phase-out unlikely.

13. In response to queries by several members of the Committee, the Israeli representative explained that the import surcharge did not apply to rough diamonds because over 99 per cent of the imports were re-exported after processing. An additional reason lay in the inherent difficulty of controlling trade in diamonds. Invited to comment on the system of tax rebates on exports, the Israeli representative said that the main purpose of these tax rebates was to reimburse indirect taxes on the exported products and the import charges levied on raw materials and components contained in exported products and to rebate the import surcharge. The present rate of the rebate was If 1.42 per US\$1 of export value.

14. In reply to a question by one member of the Committee, the representative of Israel explained that there were at present three bilateral payments agreements in force. Israel's policy had been to move away from the use of bilateral agreements; in recent years some twelve such agreements had been terminated. Those that remained covered only about US\$22 million or less than 1 per cent of Israel's total imports.

Conclusions

15. The Committee expressed appreciation for the efforts made by the Government of Israel to cope with the numerous problems it faced, both in the domestic market and in its balance of payments. It noted that while Israel's foreign reserves were relatively high at the end of 1973, there were strong indications that they would decline in 1974, in view of the expected balance-of-payments pressures. The Committee welcomed the emphasis placed by the Israeli authorities on the expansion of exports as a policy to achieve equilibrium in its balance of payments, rather than the restriction of imports.

16. The Committee noted that Israel's system of restrictions relied principally on the import surcharge, with quantitative restrictions playing a diminishing rôle. The surcharge, in its application, was found to conform to the criteria laid down in the relevant articles of the General Agreement on import restrictions for balance-of-payments purposes. It regretted, however, that the measure had proved less temporary than originally expected, and urged Israel to consider a phasing-out programme as soon as possible. Members of the Committee also expressed the hope that Israel would soon find it possible to terminate its remaining bilateral trade and payments agreements.

17. The Committee complimented the representatives of Israel for their able presentation of their country's economic situation, and expressed the hope that Israel would soon find it possible to fully implement its policy of trade liberalization and abolish remaining import restrictions.

ANNEX

Opening Statement by the Representative of Israel

Since we last met with this committee for consultation extreme and unexpected changes have shaken the world economy. Climaxing these developments which profoundly effected our own economy we had to face the most critical experience.

The increasing deficit in our balance of payments and other indications become manifest in the comprehensive documentation we presented to you as well as in the material which was submitted by the International Monetary Fund.

In my address in March 1971 I tried to describe the dangers that lie in the ever-growing gap in Israel's balance of payments and explained the implication of the conflict between two alternatives that lay before us to prevent a further deterioration of that situation. One possible choice was to return to the system of administrative import control with all the distortions that this would imply as to the allocation of economic resources. The other possibility was to operate through the market mechanism, such as the imposition of an import levy, a deposit on imports and to adopt other fiscal and monetary measures.

We have chosen the second alternative, and we believe that the steps we took have proven their effectiveness in as far as a further deterioration in the trade balance could be prevented. While in 1971 the deficit had risen to \$830 million, i.e. by 21 per cent, it decreased in 1972 to \$775 million - a decrease of 7 per cent in spite of rising prices. As to the total balance of payments the improvement was even more impressive and the deficit that had diminished in 1971 by 2.1 per cent was further reduced by 12 per cent in 1972. Such a decrease must be measured against the rise in the deficit of 29 per cent in 1968, of 35.6 per cent in 1969 and of 39.7 per cent in 1970.

In spite of the improvement in the state of the foreign currency balance and the slow-down in the increase of the national debt, there appeared the first signs of a development which became clearly manifest in 1973, namely the steep rise in import prices, inflationary pressures, industrial unrest and a conspicuous growth of private consumption.

Indeed in 1973, Israel's balance of payments showed signs of a critical deterioration. Price developments on the international market - in particular for essential primary commodities - did not fail to leave their mark on our economy. The increase in the index of import prices in 1973 amounted to 31 per cent compared to 6 per cent in 1972, and prices for essential import items rose at rates such as 45 per cent for wheat, 89 per cent for meat, 59 per cent for soya and 45 per cent for fuel. Although in quantitative terms imports in 1973 increased no more than 15 per cent, they rose in terms of c.i.f. by more than 50 per cent, or from a total of \$1,857 million in 1972 to \$2,785 million in 1973, an increase of nearly \$1 billion.

Our exports on the other hand did not benefit to the same extent from the general boom, neither with respect to prices nor quantities. Export prices, excluding diamonds, showed a rise of no more than 21 per cent. Even oranges - our main export item (excluding diamonds) - did not enjoy the soaring rise of prices of foodstuffs due to the large supplies from other competitors, while the nature of the rise in prices of polished diamonds was not stable.

Nevertheless, some of our export items mainly minerals such as phosphates, potash, copper cement enjoyed much higher prices. However, since production of these commodities cannot be increased at will the increased income of foreign currency will only be evident this year.

In real terms, exports rose by a mere 3 per cent, and if we count industrial exports only (not including diamonds), there was no rise at all.

In addition to the worsening of the terms of trade in the first nine months of 1973, the economic effects of the October war and of the state of emergency that followed it accentuated this development. The expenditure on defence in the current budget year (1973/4 ending this month) was more than two-and-a-half times the expected amount, the main part of which is payable in hard currency. As a result, our expenses for defence, which had shown a downward trend over the last two years, were back again to the former 40 per cent of the budget and 30 per cent of the GNP. The shortage of manpower and means of transport during the last three months of the year led to a slow-down in production and consequently to a deceleration in the growth of exports and a simultaneous acceleration in the growth of imports of certain products, thus exerting additional pressure on the balance of payments.

The developments that took place in 1973 as presented in detail in the document we submitted to the Committee, find their most striking expression in the data on the balance of payments.

The trade deficit rose by 84 per cent and the total deficit in the balance of payments by 115 per cent, exceeding \$2.5 billion. We find a similar picture in the same year with respect to the national debt.

We therefore assume that in the current year also imports of goods and services will rise at a greater rate than exports. Although tourism is back to normal, and sales of potash and phosphates and other commodities will push up receipts from exports considerably, we anticipate a further deterioration in the current account and our foreign currency debt. The increase in imports will not be financed by exports and by imports of capital at the former scale. Thus we will have to make an all-out effort to attract additional foreign capital and investments and we shall have to draw on our foreign currency reserves.

In view of the exceptional circumstances, there may be a change in the composition of the rising imports. The import of consumer goods and of building and constructional materials will probably decrease as a result of the freeze or even decrease in the standard of living. On the other hand, there will be a growth in imports of investment goods and of raw materials and semi-manufactured goods and of imports for the military industries.

In spite of the difficulties that developed in 1973, we continued in our declared import policy: no additional administrative restrictions were imposed on imports. The policy of liberalization was accelerated thus exposing our local industry to foreign competition. Three general reductions on import duties were introduced since January 1973 - including reductions on 1,300 industrial items - the last one with effect from January 1974, i.e. in the midst of the state of emergency, shortly after the war. We intend to go on with this policy until the target rate is reached in 1976. Protection for the various goods will then be fixed at a unified rate in a way that duties on imported goods competing with our local industry will generally not exceed 20-25 per cent. It should be noted too that, at the end of 1973, we abolished import deposits.

As to import restrictions, more than 50 per cent of total imports are now free, i.e. do not require import licences. The list of items that are still submitted to import restrictions constitutes no more than 8 per cent of total imports, to which we must add essential foodstuffs and fuel which are imported by or through the Government to secure their regular supply. On all other goods licences are granted automatically. On the other hand, we have had to implement a number of measures, such as the increase of the import levy from 20 to 25 per cent.

Whoever examines Israel's import policy should take into account that in view of the tremendous gap in the balance of payments and the foreign debt, the large sums needed for the absorption of immigrants, for development programmes and defence, we are trying to steer a cautious course lest our foreign currency spending gets beyond our means leading to increasing difficulties with all the grave consequences involved for our import, consumption, investments and production.

A review of our import policy has to consider the whole picture of Israel as an importing country. Israel is a growing market for goods from all sources. Imports have more than doubled since our last consultations, and we expect their constant expansion in the future, already now we import nearly \$1,000 per capita! I should like to emphasize that we do not view the improvement of the Israeli balance of payments to be a function of the limitation of imports. This obviously is not our policy. The potential for import substitution is becoming relatively less important, as the goods imported which may still be replaced by domestic production become fewer. Imports are necessary to ensure constant growth and expansion and a steady flow of investments. Such an exposure is needed to raise the standard of living and to enhance the efficiency, and thus the competitiveness, of our industry. We are convinced that the improvement of our balance of payments should rely on ensuring rapid expansion of exports and the increase of our export potential and not on restricting imports. This is the reason why we struggle for conditions of free and fair access and object to any discriminatory measures on our exports in the industrial countries which have a positive balance of trade with us and benefit from our liberal import policy.

In our negotiations with the EEC we endeavour to obtain those terms that are granted to other Mediterranean trading partners that are not Common Market members. Moreover, we strive to obtain preferences granted to developing countries from other developed countries that have so far denied us such preferences. In this sense we wish to emphasize that we attribute great importance to the forthcoming GATT negotiations and hope that they will contribute to further lowering of tariffs and elimination of non-tariff barriers to the benefit of all trading partners.

Having ourselves adopted a liberal import policy, we stand for reciprocity in the trade relations between nations, and we expect our supplier countries to grant us the most favourable conditions. Just as we do not impose restrictions on the import nor any discrimination against any of these countries.

The year 1974 will not see major development of our exports. Only now the economy is back to normal with most of the manpower back in industry and transportation again fully functioning.

However, we intend to take advantage of the opportunities offered in our various markets, to expand existing export branches and introduce new lines which have been developed in the last few years mainly in the industrial sector.

Finally, we hope that conditions at home in the world will make it possible for us to carry out this policy.