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GENERAL AGREEMENT ON TARIFFS AND TRADE

Committee on Balance-of-Payments Restrictions

REPORT ON THE EXAMINATION OF THE ISRAELI TEMPORARY IMPORT DEPOSIT SCHEME AND IMPORT SURCHARGE

1. On 21 June 1974 the Council was informed by the delegation of Israel that the Government of Israel had reintroduced a temporary import deposit scheme as of 24 May 1974 (see document L/4042 and Add.1). The Council agreed to refer the examination of the scheme to the Committee on Balance-of-Payments Restrictions. The Committee consulted with Israel on this measure on 15 October 1974. It also examined an increase in Israel's import surcharge from 25 per cent to 35 per cent of the value of the goods imported, which became effective on 2 July 1974, (see document L/4060 and Add.1). The last regular consultation with Israel had taken place in March of the same year; in view of this, the Committee agreed that a comprehensive examination of all aspects of Israel's balance-of-payments situation was not called for, but that it should concentrate on the specific issues raised by the reintroduction of the import deposit scheme and the increase in the rate of the surcharge, in the light of recent developments in Israel's payments position.

2. The Committee had before it a basic document supplied by the Israeli authorities (BOP/149), a background paper supplied by the International Monetary Fund dated 28 June 1974, a supplementary paper dated 25 July 1974 and the text of a decision taken by the Executive Board of the International Monetary Fund on 9 August 1974.

Consultation with the International Monetary Fund

3. Pursuant to the provisions of Article XV of the General Agreement, the International Monetary Fund was invited to express its views on the Israeli measures. At the invitation of the Committee the Fund's representative made the following statement:

> "Following the previous GATT consultation in March 1974, Israel reintroduced, on May 24, 1974, a temporary import deposit requirement; an earlier system had been abolished on December 27, 1973. On July 2, the temporary import surcharge was increased from 25 per cent to 35 per cent. At the same time, however, a reduction in customs tariffs was

carried out to offset partially the protection arising from the higher import surcharge. Under the long-term program to reduce and rationalize tariffs, further general reductions are to be effected in January 1975 and January 1976, at which time this program is expected to be completed.

The balance of payments forecast for 1974 made at the beginning of the year has not been revised in detail. While individual components may change, it is not expected at this stage that the overall balance will be significantly different from the original forecast of an overall deficit of SDR 0.7 billion. In the first eight months of the year, international reserves declined from SDR 1.5 billion to SDR 1 billion, and in recent months the average rate of decrease has approached SDR 100 million a month. The balance of payments has remained under pressure because of the large increase in the cost of defense and oil imports, increases in other import prices, and a contained high level of private consumption. In addition to the balance of payments difficulties, prices have continued to rise rapidly and in mid-1974, consumer prices were about 35 per cent higher than a year earlier. In these circumstances, the authorities introduced, in July, a series of monetary and fiscal measures to stabilize the economy, including a severe restriction on credit expansion from July to November, increased interest rates, higher taxes and compulsory loans, a once-for-all levy on real property, and cuts in budget expenditures, particularly those for construction, where strains were especially evident. It is estimated that net revenue from taxes and compulsory loans will be about I£2.4 billion more than in the original budget and the increase in expenditure will be limited to about I£0.9 billion, whereas prior to the expenditure cuts additional expenditures, mainly due to higher prices and wages, were expected to be about I£1.5 billion. It is now expected that the public sector will not inject liquidity into the domestic economy in fiscal 1974/75.

The import deposit requirement was introduced primarily to reduce domestic liquidity. The requirement initially applied to imports bearing duties of 10 per cent (excluding the surcharge), but in July, coverage was reduced to those imported items bearing duties of 25 per cent or more with the result that imports of raw materials, production goods, and investment goods are free of the deposit, which applied to about one third of imports. The authorities have stated that the resulting increase in import prices is to be absorbed by importers and not passed on to consumers. Following the reduction in coverage in July, the absorption of liquidity from the economy is expected to amount to I£750 million by the end of the current fiscal year, i.e., March 31, 1975. The Israel authorities are considering a program for phasing out the import deposit requirement during the coming year.

The increase in the import surcharge was introduced mainly as a fiscal measure to increase revenue. As such, it was one of a set of actions designed to contain the increase in budgetary expenditures associated with rising prices and wages, and to raise revenues. It is expected that the import surcharge will yield gross additional revenue of about I£1.3 billion during the remainder of the fiscal year. The surcharge is a temporary measure, and the authorities intend to begin phasing it out as soon as circumstances permit.

In August 1974, the Executive Board of the Fund concluded the 1974 Article XIV consultation with Israel with a decision reading in part, "...The Fund believes that it is essential to restrain domestic demand and ease the strain on the balance of payments to a degree that will permit the gradual elimination of external restrictions and allow a simplification of the complex trade and payments system."

In the light of this decision and taking into account the continuing balance of payments difficulties, the Fund believes that the maintenance, on a temporary basis, of the import deposit requirement and the import surcharge, in conjunction with the strong fiscal and monetary measures already mentioned, does not go beyond the extent necessary to contain the deterioration in the balance of payments."

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 described the continued deterioration of Israel's external financial position, the policies that the Government had adopted to counter these developments, and the international economic conditions on which an improvement of Israel's balance of payments were largely dependent. During the first eight months of 1974, imports had increased by 32 per cent compared with the same period in 1973, while exports had grown by only 17 per cent. The trade gap had widened by 59 per cent and amounted to over US$[illegible].5 billion. External indebtedness had increased from US$5.1 billion to US$5.6 billion. Among the main reasons for the deterioration in the balance-of-payments situation were the higher costs of raw materials and food, the domestic inflationary pressures which had contributed to an increase in imports of consumer goods, and the slackening of economic activity in the Western world which had resulted in a reduced demand for some of Israel's major exports and also a decline of receipts from tourism and unrequited transfers. The Government had adopted a vast stabilization programme comprising a variety of internal monetary and fiscal measures complemented by the surcharge and the import deposit scheme. However, Israel's balance-of-payments prospects did not only depend on the results of this

programme, but also on an up-swing of the economic activity in the Western world, improved access to Israel's export markets, and the relations between Israel and its neighbours.

Examination of the import deposit scheme and surcharge

5. Members of the Committee expressed their sympathy for Israel's current financial difficulties, and their hope that the measures adopted by the Government of Israel would be gradually removed as soon as the situation improved. This would be in line with Israel's stated policy to achieve an improvement in its external financial position through the promotion and diversification of exports and the attraction of foreign investments, rather than through the restriction of imports. The representative of Israel was asked to describe his Government's efforts to promote foreign investment and exports. He replied that large-scale investments were being supported by his Government in the fertilizer and petrochemical industries. Israel had rich deposits of potash and phosphate to develop, and its oil refineries were producing twice as much as the internal market absorbed. During 1974 alone, investments amounting to US$600 million were planned in these industries. However, in view of the uncertain world economic situation it was difficult to attract large amounts of foreign private capital, even into these promising sectors. The Government was therefore turning to public sources of funds - in particular to the World Bank and the EEC institutions. On the other hand, this was exacerbating the already burdensome debt problem. In addition to the above, Israel has sought the assistance of the International Monetary Fund (IMF) in its efforts to overcome its balance-of-payments problems.

6. The success of Israel's export policies was not only dependent on Israel's own efforts but also, to a large extent, on the import policies of its trading partners. Some of Israel's main exports, in particular chemicals, fertilizers, food products and textiles, were presently facing high import barriers. A wider application of the Generalized System of Preferences (GSP) to Israel, a successful round of multilateral trade negotiations in GATT and the completion of a fully-pledged free-trade area agreement with the European Communities would greatly facilitate Israel's export promotion and diversification efforts and at the same time stimulate the inflow of foreign investments in export oriented sectors.

7. The representative of Israel was asked to explain why his Government had on the one hand lowered the import tariffs, and on the other increased the surcharge. The simultaneous adoption of these two measures appeared to be contradictory since one tended to cancel the effects of the other. The representative of Israel replied that it was the long-term policy of his Government to lower and harmonize import tariffs. The surcharge was merely a short-run expedient to be removed as soon as Israel's stabilization programme became effective and other more fundamental measures could be introduced. What would then remain were only the lowered import

tariffs. In the meantime the tariff reductions, although in part offset by the surcharge, contributed to correct through harmonization certain disparities in the Israeli tariff.

8. One member of the Committee wondered why Israel considered it necessary to supplement the surcharge with a deposit scheme; both these measures aimed at restraining imports by making them more costly and their simultaneous application appeared to complicate import procedures unnecessarily. The representative of Israel replied that the external effects of the surcharge and the deposit were similar as both tended to make imports more expensive, the former directly through additional levies and the latter by increasing the costs of financing imports. However, the internal effects of the two measures were different. The surcharge lead to a continuous flow of additional government revenue, which could be used for fiscal purposes. By contrast, the deposits to be made by importers would be frozen in the central bank and then returned to the importers who could use them for new imports. The deposit scheme was thus primarily a monetary measure designed to absorb excess liquidity. In view of the different fiscal and monetary effects of the two measures, the Government of Israel considered their simultaneous application both necessary and justified. The representative of Israel stressed that the combined effect of the two measures was within the bounds of what was necessary to contain the deterioration in Israel's balance-of-payments position. This had been confirmed by the IMF.

9. In reply to another question, the representative of Israel said that the deposits to be made by the importer could not be financed by the exporter. It was true that permitting the financing of deposits by exporters would stimulate the inflow of short-term capital; however, the scheme's main purpose was to absorb liquidity and this effect would be cancelled if foreign financing of the deposits were permitted. The deposit scheme would reduce domestic liquidity by roughly I£750 million.

10. In response to questions by members of the Committee, the representative of Israel explained that the rate of tax refunds on exports had been increased because the rate of indirect domestic taxes and of import taxes had risen.

11. In reply to another question the representative of Israel explained that the Government was primarily importing food and feed grains which had become significantly more expensive; imports by the Government had increased in value, and in percentage of total imports, but not in volume.

Conclusions

12. The Committee recognized that Israel had serious balance-of-payments problems, and a heavy debt burden, that its payments problems were primarily related to factors that already existed before the current widespread balance-of-payments difficulties had arisen. The Committee noted that strong pressures existed in many countries to adopt trade restrictions in the present period of exceptional and widespread balance-of-payments difficulties. It was therefore expecially important for all contracting parties to refrain from adopting policies that could lead to an escalation of trade restrictions. In these circumstances, strengthening of international co-operation was called for. The Committee did recognize that Israel's ability to redress its balance of payments by expanding exports was affected by economic developments in other countries. The Committee noted the finding of the Fund. It welcomed in particular the fact that Israel had adopted a programme of strong fiscal and monetary measures designed to permit the gradual removal of the surcharge and the deposit scheme. Finally, the Committee noted that the measures were temporary and expressed the hope that Israel would eliminate them as soon as circumstances permitted.

13. The Committee welcomed the decision of the Israel Government to continue its policy of import tariff liberalization and to end two of its existing bilateral trade agreements, despite the present payments difficulties.

ANNEX

Opening Statement by the Representative of Israel

When we assembled here last March none of us anticipated that we would have to meet again so soon to review new economic measures which my Government was forced to take this summer to counteract the deteriorating situation of our balance of payments.

Since I do not wish to repeat the analysis of the economic situation which I elaborated last spring, and which holds true today only so much more so, I should like to comment briefly on the developments that have taken place since then. This we have described in detail in Section 7 of the Basic Document, which we submitted to you last week and which I have no doubt will be further touched upon by the representative of the International Monetary Fund.

Notwithstanding all the actions we took last winter, imports rose during the first eight months beyond our wildest dreams or rather nightmares. During this time imports increased over the same period in 1973, by 32 per cent from US$1,930 to US$2,670 billion. Total exports increased by only 17 per cent from US$1,960 to US$1,130 billion. Thus, the trade deficit during the eight months grew by 59 per cent in comparison with the same period in 1973 and amounted to more than US$1.5 billion. Our indebtedness increased from US$5.1 billion to US$5.6 billion while the inflation continued by an annual rate of over 30 per cent. The reasons for this unprecedented deterioration in our balance of trade are easily identified. The higher cost of raw materials and food, and an increase of imports of consumer goods (as a result of people freely spending their earnings in a still over-heated inflationary economy); at the same time an international slow down, the decreased demand for our main exports (diamonds, textiles and other consumer goods), barely offset by the rise of exports of chemical products, the decline in tourism and the slow down in receipts from unrequited incomes. Meanwhile, in spite of increasing indebtedness, our reserves reached a critical low point.

Under these circumstances, the following monetary measures were taken:

1. Bank credits were frozen for three months.

2. Severe penalties were imposed on bank lending above the liquidity ratio.

3. The interest rate for Government directed credits was raised by 2 per cent.

At the same time a series of fiscal and administrative measures were initiated. These measures included:

1. The raising of the surcharge on imports from 25 per cent of the c.i.f. prices to 35 per cent.

2. The introduction of a property tax on real estate.

3. The increase on the already high luxury tax on cars by 5 per cent.

4. A new compulsory loan of 3 per cent which will absorb half a billion Israeli pounds.

5. The freeze on building activities until April 1975, while the building of appartments of 110 m^2 and larger were completely prohibited.

6. The budgets of all Ministries were considerably cut.

7. A 20 per cent import deposit was reintroduced, freezing thereby I£ 750 million.

Meanwhile, the scheme has already been modified to include only commodities paying a duty of over 25 per cent. This will be in force for another twelve months.

At the same time, the policy of liberalization was continued and protective tariffs were further reduced on an average of 5 per cent.

Having summarized these grim internal measures, I should like to mention a few heartening developments in our international trade relations. First of particular interest to this forum: since our last meeting we have been in touch with the Brazilian and Bulgarian authorities suggesting that our bilateral trade agreements with these two countries be allowed to lapse this year. Next: important discussions with the United States Government on possible new trade opportunities have recently been initiated. Meanwhile negotiations with the EEC for the completion of a fully-fledged free-trade area agreement have been resumed and we hope will soon be concluded. Finally, we were gratified to be included in the second important phase of the Generalized System of Preferences duty reductions of Switzerland and to receive GSP concessions from Canada. These are some glimpses of brightness in an otherwise sombre picture.

Where do we go to from here?

Since the late summer, the new measures which were introduced are beginning to show some results.

Apparently the inflationary pressure is lessening. Building activity has obviously gone down, consumption is dropping. Still, the gap in the balance of payments this year will be enormous - US$3.3 billion.

I explained to the Committee last spring why neither our exports (with the exception of chemicals and fertilizers), nor our receipts from tourism can bring us salvation: they are mainly dependent on the prosperity of the Western world - which, since it has to pay so much for oil and for certain raw materials is in difficulties which reflect on the imports, expressed in terms of quantities and prices, of such main consumer goods as: diamonds, food, textiles and ready-to-wear. The situation with regard to tourism is similar - which I understand has even fallen off in beautiful Switzerland. Instead of benefiting from increased exports to the Western world these stagnate in real terms. At the same time, the prices of our imports from these countries have been continuously rising. Thus the worsening of our terms of trade with the Western world during 1973-1974 has lead to a US$1.7 billion increase in the deficit.

Under these circumstances, only one of the two following miracles can transform everything again to prosperity and economic growth:

<u>Miracle No. 1</u>: The immediate upswing of the Western economies which will find a way to jointly overcome their crisis!

<u>Miracle No. 2</u>: Real peace with our neighbours and joint development of the underdeveloped rich area around us.

Although we belive in miracles, we must be prepared that none of these two wonderful solutions will occur in the immediate future, and if this is so, we must soberly brace ourselves to face a period of much hardship. The challenge will be one to our ingenuity:

- to increase production and efficiency, to continue to develop the most essential productive capacities of the country and to find a way to do all this without giving way to protectionist forces.

Moreover, we must retain and strengthen the policies of liberal industrialization and free international trade.

In all this we trust that our trading partners will give us a helping hand.