

GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

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Committee on Balance-of-Payments
Restrictions

REPORT ON THE CONSULTATION WITH ISRAEL

1. In accordance with its terms of reference the Committee has conducted a consultation with Israel. The last regular consultation with Israel had taken place on 1 November 1976. The Committee had before it a basic document supplied by the Israeli authorities (BOP/187), and a supplementary background paper supplied by the International Monetary Fund dated 19 April 1978.
2. The Committee generally followed the plan for such consultation recommended by the CONTRACTING PARTIES (see BISD, 18th Supplement, pages 52-53). The consultation was held on 29 May 1978. This report summarizes the main points of the discussion.

Consultation with the International Monetary Fund

3. Pursuant to the provisions of Article XV of the General Agreement, the CONTRACTING PARTIES had invited the International Monetary Fund to consult with them in connexion with the consultation with Israel. Upon the invitation of the Committee, the representative of the Fund made a statement as follows:

"Israel has experienced very low rates of growth of GNP in real terms in the last three years as the economy has been faced with the task of adjusting to a sharp deterioration in the terms of trade due to increases in the price of oil and other imported commodities, as well as the burdens of increased defense expenditures. The rate of growth of GNP, having averaged 8.5 per cent per annum in the five years to 1974, fell to 2.1 per cent in 1975, 0.9 per cent in 1976, and only 0.5 per cent in 1977; these rates were significantly below that of increase in population, leading to declines in per capita income. The Israel authorities now expect the GNP growth rate to recover to 4 per cent in 1978 chiefly on account of an improved trade performance associated with the recent improvement in the terms of trade, rising demand for Israel products, and some strengthening of public and private consumption.

"The last three years have also witnessed high rates of inflation (on average the consumer price index increased by between 30-40 per cent a year) and a steady depreciation of the exchange rate of the Israel pound. The latter has contributed toward the maintenance of the competitive position of Israel exports. The Government has attempted to implement policies designed to reduce the external and internal

imbalance by containing excess demand and encouraging the reallocation of resources to the export sector. Fiscal and monetary policies were intended to be restrictive, but in practice the Government budget has shown very large deficits in recent years, the impact of which could not effectively be offset by monetary policy. This has led to very large increases in credit and broad money aggregates. Broad money rose by 33 per cent in 1975, 41 per cent in 1976, and 82 per cent in 1977; as approximately half of broad money is denominated in foreign exchange, these figures partly reflect the effects of the depreciation of the Israel pound.

"The balance of payments improved in 1976 and 1977 on account of both internal and external developments. In 1976, there was a sharp reduction in the balance of trade to SDR 2.4 billion from SDR 2.9 billion in 1975. While export promotion policies and a recovery in world economic activity led to a robust increase in export volume (of about 22 per cent) at slightly increased unit prices, the continued stagnation in the domestic economy led to restrained import growth which rose by about 2 per cent. Net service payments and private transfer receipts remained virtually unchanged, but there was a near doubling of official transfer receipts. Despite a decline in capital inflows, the overall balance of payments swung from a deficit of SDR 131 million in 1975 to a surplus of SDR 16 million in 1976, thereby slightly increasing the level of gross official reserves to SDR 1.2 billion or about two months' imports of goods and services which is low by historical standards.

"Preliminary data indicate that the balance of trade remained virtually the same in 1977. In contrast to the previous year, the strong export performance was largely due to price increases, partly resulting from a shift in the export mix toward industrial and noncitrus agricultural products. This was entirely offset by a faster growth in imports apparently due to the replenishment of inventories. The decline in the current account deficit from about SDR 1 billion to about SDR 0.5 billion was due almost entirely to a swing in net service payments from deficit to surplus, which more than compensated for a decline in total net transfer receipts; the latter was mainly a consequence of a postponement of some direct defense imports. In conjunction with an increase in net capital inflows, these developments led to a higher overall balance of payments surplus estimated at SDR 194 million. By the end of the year gross official international reserves had increased to SDR 1.3 billion, or the equivalent of about two months' imports of goods and services.

"Exchange rate action has been one of the main elements in Israel's policy of export promotion and has been a major factor responsible for the improvement in the balance of payments. From June 1975 to October 1977 Israel followed an exchange rate policy under which the Israel pound was depreciated by small amounts at frequent intervals (from July 1976 to the end of this period, the exchange rate was determined daily on the basis of an export-weighted basket of five currencies). In addition, since March 1976 the authorities periodically adjusted the rates of indirect tax rebate to exporters pari passu with the depreciation of the exchange rate. On October 28, 1977, Israel introduced a floating exchange rate régime and abolished the system of indirect tax rebates to exporters. Taking into account the recent increases in domestic costs relative to increases in costs abroad, the effect of these measures has been to maintain the overall profitability of exports, especially industrial exports.

"Other aspects of the exchange and trade system were also liberalized in October 1977: the 15 per cent temporary surcharges on imports and some invisible payments were abolished; the licensing requirement for imports of goods and invisibles was almost entirely eliminated; import duties which were 12 per cent or higher were reduced by a fifth; the tax on foreign travel was abolished; the limits on travel allowances were abolished for businessmen and raised for tourists; the import and export of Israel currency were liberalized; and the structure of resident and nonresident accounts was simplified.

"The Fund welcomes the comprehensive liberalization of Israel's exchange and trade system effected in October 1977, including the elimination of the import surcharges and indirect tax rebates to exporters, the abolition of the multiple currency practice arising from the surcharges previously applied to certain invisible payments, and the tax on foreign travel. The remaining restrictions on trade and payments are of minor significance in terms of balance of payments considerations."

Opening statement by the representative of Israel

4. The representative of Israel made an opening statement (the full text of which is reproduced in the Annex) in which he drew attention to two special aspects of Israel's economy which should be taken into account when making an overall evaluation of the balance-of-payments position of Israel. These were the imperatives of defence needs and immigration absorption which required exceptionally large expenditures. Obviously Israel needed to maintain ample foreign exchange reserves. He went on to describe the recent developments in the balance-of-payments situation and stressed the size of the external debt. He described the different measures taken on 28 October 1977 within the framework of Israel's new economic policy and stressed that from the foreign trade point of view the liberalization had

to be considered as an act of faith. Finally, he stated that the Government of Israel was fully committed to its policy of trade liberalization and that it would continue to review the remaining restrictions in order to reduce them to an absolute minimum.

Parts I and II

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

5. Members of the Committee thanked the representatives of Israel and of the International Monetary Fund for their comprehensive and up-to-date statements and documents. The Committee was unanimous in congratulating the Israeli authorities for the unprecedented trade liberalization introduced in October 1977 with the new economic policy. The list of measures taken was impressive. The exchange rate action was singled out as being the key factor of the reform and appreciation was expressed for the courage that had been necessary for the Israeli authorities to introduce such a drastic change of policy. The Committee hoped and expected this new policy to be successful. Recalling that Israel's balance of payments and development problems were common to many countries, it was felt that the Israeli approach provided a useful alternative to the trade restrictions resorted to to redress a difficult balance-of-payments situation. It was felt that the success of this policy should enable Israel in future to remove the remaining import restrictions.

6. Members of the Committee noted that the balance of payments had improved substantially since 1976 and now showed a slight surplus. The current account was still in deficit, the trade account in particular showing a very large deficit. It was noted that on the capital account, receipts from abroad were expected to amount to some US\$4.3 billion in 1978; this would allow the Israeli authorities to finance the current account deficit, to service the foreign debt and to build up reserves which were still relatively low at an equivalent of two months' imports.

7. Several questions were asked concerning the observable impact of the measures taken in October 1977. Although it was appreciated that only six months had gone by since these measures were introduced, members of the Committee were interested to hear what effects had been felt on internal demand, on the level of prices and wages, on imports and the impact they had had on the external position of Israel. The Israeli authorities were forecasting a growth rate of 4 per cent for 1978 and it was asked how the authorities expected to reconcile the rate of inflation, which had not subsided and was expected to possibly exceed 30 per cent in 1978, with such

a rate of growth. The representative of Israel said that the International Monetary Fund document included a forecast of the rate of inflation of 30 per cent for 1978; Israeli economists however, were divided on the matter; generally, it was thought that the rate would exceed 30 per cent. He explained that it would depend on the interaction between salary, wages and price increases. In October 1977, when the new economic policy was introduced, measures had been taken to control price increases especially after the 45 per cent depreciation of the Israeli pound; such measures included an increase of the value-added tax and credit restraints. These measures and price freezes were working themselves through the economy and through salaries, which themselves were linked to the cost of living through price indices. While the Government had undertaken to freeze prices of certain goods and services, there had been in exchange an unwritten undertaking by trade unions to limit wage demands to 15 per cent. It was not possible at this stage to say to what extent the interaction of these factors would result in a higher or lower rate of inflation. The end effect could be an increase in real wages, which had fallen in the past two years; this in turn could lead to a growth in demand. Any wage increases would immediately be reflected in government expenditure, which was not desirable as the Government had already cut its own budget by some I£ 7 billion after submitting it to the Knesset. However, if wage negotiations did lead to a larger expenditure this would have to be met by the Central Bank and would, in time, add to inflationary pressures.

8. Several questions were asked concerning the medium-term prospects for the balance of payments. It was noted that the IMF document included a forecast of a larger balance-of-payments surplus in 1978. In particular, questions were asked concerning capital imports and the level and structure of the foreign debt and whether the Israeli authorities considered that there were limits to foreign indebtedness beyond which they would not go. The representative of Israel pointed out that with regard to receipts from abroad, a large part would be made up of unilateral transfers - some \$2.3 billion. As for the acceptable limit of foreign indebtedness he explained that a certain amount of borrowing was essential: development needs and immigration absorption required a large amount of capital. This expenditure could not be covered through current income. Even if the overall balance-of-payments situation looked favourable, the details were not so favourable, in particular the size of the foreign debt. His authorities had no forecasts for the medium term; it was hoped that the choice of policies making better use of market forces would be conducive to achieving external balance. He stated that it was not his Government's intention to reduce the trade deficit through import restrictions; it was hoped that an increase in exports would eventually close the trade gap.

9. The representative of Israel was asked to comment on the results obtained by the Government's efforts to redirect investment towards export-producing industries. It was asked what particular sectors had had funds re-allocated to them and what results had been achieved. Questions were

also asked with regard to the development of the tourist industry. The representative of Israel said that the previous policy of promoting exports by refunds of indirect taxes had been terminated. It was an open question whether exporters were better or worse off for the change. In reply to a specific question whether Israel could afford to let its currency float downwards any further without adopting corrective measures, the representative of Israel replied that the actual rate of depreciation of the Israeli pound at present amounted to less than 2 per cent a month, which was the average monthly rate of devaluation under the previous policy which called for depreciation by small amounts at frequent intervals. The 45 per cent devaluation of the Israeli pound had been a big boost to tourism. Efforts were being undertaken to improve charter travel facilities to Israel from various points in Europe. So far the infrastructure of the tourist industry had been developed mainly in the high-class hotel category; further investments had to be made to develop popular tourism and it was generally thought that there was scope for growth in this area.

10. In reply to a question whether there were problems or trade restrictions applied by third countries to Israeli exports which affected the development of Israel's exports, the representative of Israel said that a number of countries - some for political reasons - applied restrictions or boycotted Israeli exports. These restrictions constituted a major non-tariff barrier to the development of Israel's exports. In addition, Israel's exports encountered a number of other restrictions, particularly in the agricultural products sector.

Parts III and IV

System and method of the restrictions and effects of the restrictions

11. Members of the Committee congratulated the Israeli authorities for the courage it had shown in introducing a new economic policy which had led to extensive trade liberalization. It was appreciated that the termination of exchange controls had contributed in no small way to making liberalization possible. It was also noted that the International Monetary Fund had welcomed the comprehensive liberalization of Israel's exchange and trade system and that it considered the remaining restrictions on trade and payment of a minor significance in terms of balance-of-payments considerations. Members of the Committee appreciated the degree of uncertainty which still faced the Israeli economy and in particular the level of reserves and of foreign indebtedness. In view of these uncertainties members of the Committee felt that it was desirable that Israel continue to consult regularly in the Committee on its remaining restrictions. It was also hoped that Israel would be able to make further efforts to shorten the list of imports still subject to licensing.

12. It was asked what specific restrictions remained and whether these were applied for balance-of-payments purposes. It was also asked what percentage of trade was covered by these restraints and whether there were any estimates of the effects on the trade account of the recent liberalization measures. The representative of Israel referred to Annex I of the Basic Document (BOP/187) in which were listed the imports subject to licensing. He added that these products made up some 20 per cent of total Israeli imports. The licensing system was not prohibitive nor very restrictive. His authorities felt that a degree of surveillance licensing was necessary in order to monitor the level of imports in this transitional stage of the economy. The list would be kept under constant review. In reply to a specific question concerning fiscal measures, the representative of Israel explained that the "Tama" was not a special duty but a method of calculating the incidence of the purchase tax on imports.

Conclusions

13. The Committee congratulated the Israeli authorities for the measures taken in October 1977 which had allowed an unprecedented degree of trade liberalization. It welcomed the improvements in Israel's external position and the favourable forecasts for the balance of payments in 1978. However, the Committee appreciated that the large trade deficit, the level of foreign reserves and the size of the foreign debt were factors of uncertainty for the future. In this context it welcomed the statement that it was the Israeli authorities' policy not to resort to further import restrictions to reduce its deficit on the trade account, but hoped to achieve balance through increased exports.

14. The Committee invited the Israeli authorities to keep under review the remaining import restrictions and to make further efforts to shorten the list of products subject to import licensing.

ANNEXOpening Statement by the Representative of Israel

In preparation of today's consultations, we have provided in our basic document (BOP/187) an outline of our balance-of-payments situation and of the import régime which is now applied in Israel. In doing so, we have made an effort to cover all the essential aspects of the situation, and have therefore included a note on economic development policies and prospects 1976-1978, which you will find in Annex IV to the document. Furthermore, we shall try to provide, to the extent possible, any additional information required by you which might not have been sufficiently covered by our document.

I have already stressed at our last consultation that when drawing up the basic document, one is of needs restrained to follow the descriptive framework prescribed both by the decisions and the traditions of this Committee. I therefore feel it necessary to draw your attention to some basic features of Israel's economy which are not specifically referred to in the basic document, although their direct relevance to our balance-of-payments problems can hardly be denied.

Israel, as a developing country, is of course only one of the many developing countries who consult with your Committee on their BOP problems and the effects on their foreign trade policies. The problems arising out of developing needs are therefore familiar to you and therefore I need not elaborate on them insofar as they are faced by Israel. There remain, however, two special aspects which must be taken into account when making an overall evaluation of our BOP position and of our efforts to cope with its results. I refer to the overriding imperative of our defence needs and the special needs of Israel relating to its continuing task of receiving new immigrants and of absorbing them in the fabric of our society. As far as our defence effort is concerned, it is obvious that the need to maintain an efficient and creditable defence posture requires exceptionally large expenditures, expenditures which reflect directly on our balance of trade, on our balance of payments and on our needs to maintain ample foreign exchange reserves. As far as immigration is concerned, I believe that members of the Committee are aware that Israel provides a haven for tens of thousands of new immigrants every year and tries to give them adequate housing, productive employment and necessary infrastructure: new schools, hospitals, community centres and more.

The results of these efforts: development, defence and immigrant absorption are clearly reflected in our basic document - a deficit on our balance of trade exceeding US\$1.7 billion in 1977, a total deficit on our

balance of trade, both visible and invisible, of more than US\$2.7 billion. These figures by themselves are enormous taking into consideration that Israel's population amounts to only 3.7 million and that our merchandise exports in 1977 amounted to some US\$2.8 billion. They are more eloquent than any detailed explanation which I could provide in this statement.

But even that is only a part of the picture. You will have noted that our trade and services deficit is financed to a large extent from institutional remittances, transfers from foreign governments and loans extended again by foreign governments or private sources. In other words, in order to assure our current economic needs, whether for consumption, investments, defence or otherwise, we have to rely on foreign assistance by governments and institutions and on borrowing. The fact that by the end of 1978 our external debt will reach the staggering figure of US\$11.2 billion is, I think, the most important and relevant indicator of the true nature of our balance-of-payments situation. After all, this figure is equivalent to the gross national product estimated to be generated in Israel this year. The fact that our foreign exchange reserves at the same time will amount to approximately US\$1.5 billion must also be seen in that perspective - yet even these reserves will cover only about two months of Israel's imports of goods and services. Taking into account the political situation existing in our part of the world, reserves of such a size can hardly be considered adequate.

It is against this background that one has to appreciate the scope of the economic reforms promulgated by the Government of Israel on 28 October 1977, within the framework of its new economic policy. As far as the changes in our foreign trade régime are concerned they are so far-reaching that I feel it appropriate to enumerate them in detail in my statement:

- (a) Foreign exchange control on almost all foreign trade transactions has been abolished;
- (b) The import régime has been further liberalized; the number of commodities still subject to licensing has been greatly reduced;
- (c) The import licensing system has been changed substantively; instead of a list of "Free Imports" there is a list of commodities subject to licensing;
- (d) The temporary import surcharge of 15 per cent has been abolished;
- (e) The scope of government imports is being reduced;
- (f) Ad valorem duties were reduced on an across-the-board basis by 20 per cent of the rates in force until then;
- (g) The system of refunds of indirect taxes on exports has been abolished.

In addition to these measures in the field of foreign trade, mention must be made of monetary and fiscal measures designed to create the overall conditions for a renewed economic take-off. A reference to them is included in Annex IV.

Taking into account the many difficulties which we are facing, some of which I have specifically referred, the new economic policy, particularly as far as foreign trade is concerned, must be considered an act of faith; on the one hand, an act of faith in the adaptability of our economy and its propensity to expand and, on the other hand, an act of faith in the stability and reliability of the international framework for trade within which we operate. I will not refer in detail to the uncertainties of the international economic horizon: trends towards protectionism, international monetary instability, energy prices, to name only a few. To this must be added problems of particular relevance to Israel: the necessity of a continual flow of development and other assistance, access to capital markets, assured sources of raw materials, non-discriminatory treatment in all markets, effects of the boycott, etc. I shall make particular reference to some of these aspects during the deliberations of your Committee.

At this stage I would only wish to underline that despite these factors, which I have just enumerated, the Government of Israel is fully committed to its policy of trade liberalization. At home, it will continue to review the remaining restrictions in order to reduce them to an absolute minimum. Within GATT, it will continue to play an active rôle in order to assure the success of the MTN.