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GENERAL AGREEMENT ON TARIFFS AND TRADE

Committee on Balance-of-Payments Restrictions

REPORT ON THE 1984 CONSULTATION WITH ISRAEL

1. The Committee consulted with Israel on 23 May 1984, in accordance with its terms of reference, under the Chairmanship of Mr. J.N. Feij (Netherlands). 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	(BOP/244)
Secretariat Background Paper	(BOP/W/78)
Import Surcharge - notifications by Israel	(L/5361, L/5480)
Import Deposit - notifications by Israel	(L/5506, L/5600, L/5610)
IMF Recent Economic Developments, dated 4 May 1984	

Opening Statement by the Representative of Israel

3. In his opening statement, the representative of Israel outlined the main economic developments, the sources of Israel's problems, the policies being applied and the initial results of those policies. He identified the three main problems in Israel's economy as its balance-of-payments situation, inflation rate and economic stagnation. The balance-of-payments situation was the central problem: since the last consultation in December 1982, the negative internal and external trends which had started in 1981 had continued in 1982 and 1983 with a negative impact on the balance of payments. The current account deficit, which had increased by US$1 billion from US$3.8 billion to US$4.8 billion from 1980 to 1982, rose to over US$5 billion in 1983; on the trade account, imports of goods and services increased from US$13.6 billion to US$15 billion from 1980 to 1983. While total exports of goods and services remained at a level of about US$9.9 billion during the same period, exports of goods fell by some 6 per cent in dollar terms in 1982 and by 2 per cent in 1983. Israel's debt situation was another important aspect of its balance-of-payments problems: at end-1983, Israel's foreign debt amounted to US$22.6 billion, with debt service of US$3.6 billion, out of which US$1 billion went to repayment of capital and about US$2.6 billion for interest payments.

4. Israel's inflation rate, reaching 190 per cent in 1983 and 260 per cent for the period April 1983 to April 1984, was cited as an interrelated serious problem. The earlier stabilization of inflation at the level of about 130 per cent in the previous three years was attributed to policies

aiming to reduce inflationary pressures via a supply-side approach to reduce or limit price increases. These included a slowdown in the rate of currency depreciation, increased subsidization of consumer goods, cuts in some indirect taxes, and low rates of increases in controlled prices of some government services. The reversal of these policies had given rise to what Israel believed would be a one-time jump to a higher level of inflation. These policies have the effect of absorbing liquidity and purchasing power of the public: thus together with other policies, they should bring a gradual reduction of inflationary pressure.

5. The third problem identified by the Israeli representative was stagnant economic activity, evidenced by the growth rate of only 1 per cent in GNP in the last two years (against a 4 per cent per annum growth prior to 1983 and a long-term growth trend of 8 to 9 per cent per annum). In this connection, he pointed out that due to the time-lag between the implementation and achievement of results of the policies, it was still too early to see the effects of the reduced economic activity on inflation, although their effect on the balance of payments may already be perceptible.

6. The representative of Israel identified a number of factors, both external and internal which had contributed to the stagnation in its exports and rise in imports. Regarding exports, the primary external factor was the decline of European currencies against the United States dollar and the consequent appreciation of the shekel against European currencies. A second external factor was the decline of demand in Israel's major export markets. Other factors included: increased local demand for commodities which would otherwise be exported, while currency movements led to a decline in exports and increase in imports; changes in trade flows between Israel, the European Community and the United States (with the decrease in imports from and increase in exports to the United States not yet compensating for the decrease in exports to and increase in imports from the Community). Regarding imports, inflationary expectations and relatively inexpensive import prices due to the shekel's appreciation led to increased purchases of consumer and investment goods.

7. The representative of Israel noted that his authorities had been able to mobilise enough foreign exchange to cover the current deficit and redemption of foreign debt. The maturity structure of Israel's debt included: 73 per cent long-term loans; 16 per cent medium-term loans and 14 per cent short-term loans. 58 per cent of the debt was owed at favourable terms, with 14 per cent owed to suppliers and 28 per cent to banks.

8. The primary objectives of Israel's current economic policy included the achievement of an improved balance-of-payments situation, a gradual reduction in inflation and renewed but controlled economic growth brought about through increased exports, selective encouragement of investment in know-how intensive industries geared towards high productivity and exports, while restricting public and private consumption. He emphasized that the steps Israel had taken regarding imports were very limited and marginal in

the context of its overall economic policy framework. The following policies were being pursued to help accomplish the aims outlined:

(a) restriction of demand, including public and private consumption;

(b) cuts in the government budget, including cuts in subsidies;

(c) increased indirect taxes, including, inter alia, increases in VAT from 12 per cent to 15 per cent, a substitute VAT on travel abroad, a 2 per cent tax on all sales on the stock exchange, 10 per cent purchase tax on luxury and semi-luxury goods, increased levies on education and health services, and the renewal of the import levy and import deposit schemes;

(d) restrictive monetary policy, including high liquidity requirements and increased real interest rates (up to 15-20 per cent above the inflation rate);

(e) promotion of savings, including changes in the inflation-linked savings programmes to compensate for inflation-induced losses in savings;

(f) incomes policy, including a new system of wages indexing involving a decline of real wages;

(g) an exchange rate policy aiming at a realistic level of the Israeli shekel against the currencies of major trading partners.

9. The representative of Israel cited a number of developments in early 1984 as indicating that the above-mentioned policies were beginning to take hold: steep decline in local demand with an indication of a concomitant increase in savings, decline in new building starts, decline in imports of investment goods and increase in exports compared with the same period in 1983. However, there had not yet been any progress in reducing inflation, as explained earlier.

10. In summing up, the Israeli representative said that Israel continued to adhere to a liberal trade philosophy and that the measures now in effect were of a temporary nature. He said the restrictions could not be reduced last year due to adverse developments. He emphasized the relatively limited impact of the trade measures and pointed out that it had been necessary to undertake measures that were symbolically linked directly to trade while at the same time having the effect of further increasing the shekel value of dollar-linked accounts. He said that his government probably would have no choice but to renew the import deposit scheme for six months. The scheme could be phased out should balance-of-payments trends be consistently favourable and reinforced by positive trends in reducing inflation.

Statement by the Representative of the International Monetary Fund

11. At the invitation of the Committee, the representative of the International Monetary Fund made a statement, the text of which is attached as Annex I.

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

12. A number of members observed the growth of the budget deficit in recent years. Noting that improvement in the balance of payments and reduction of budget deficits were inter-linked, members asked what targets had been established for the deficits in 1984 and beyond. One member, noting that the deficit on the trade account of the balance of payments was now declining, asked for information on the state of the current account balance in the first quarter of 1984, and whether it was expected that Israel's objectives for the current account would be achieved, assuming that present trends continued. If the deficit were not reduced as projected, he asked whether, and on what terms, adequate finance would be made available. He requested more details on the reductions made in domestic subsidies, and asked what adjustments were to be made to cost-of-living allowances in the context of gradually reducing inflation.

13. Some members requested information on the final outcome of the balance of payments for 1983, as currently estimated by the Israeli authorities, and on the projected deficit for the year 1984 as a whole. They noted that the Israeli shekel had appreciated substantially against European currencies while it had now regained its earlier relationship with the United States dollar, and asked what were the aims of future exchange rate policy particularly in the light of current inflation trends.

14. In reply, the representative of Israel spoke of the limits to possible reductions in budgetary deficits. It did not seem feasible to reduce government expenditure by more than 3 to 5 per cent in any one year. On the other hand, the high levels of both direct and indirect taxation - up to 200 per cent import duties and 66 per cent income tax at relatively low levels of income - would militate against obtaining substantial increases in revenue from this source. A proposed tax reform was unlikely to come into effect before the end of 1984. The target set out in the budget reflected the practical possibilities.

15. He could not be sure that the measures taken would be sufficient to achieve the long range targets established by the government. The authorities were committed to taking complementary steps if necessary to achieve them. While the balance-of-payments target for 1984, of a reduction in the civilian current account deficit by US$1 billion, was probably attainable, the longer range target was for a slower reduction of the deficit, to reach a level of US$2 billion (half the 1983 level) by 1987. Concerning subsidies, the aim was to reduce real subsidies to a level not greater than 25 per cent of the price of subsidized consumer goods, as against current levels of 50 to 100 per cent and over. While this would lead to budgetary savings, there would inevitably be inflationary effects: he noted that in the period October 1983 - May 1984 the prices of a number of staple foods had increased by factors of between 3.5 and 5 times, while the general cost-of-living allowance had increased by only 167 per cent in the same period. Changes had been made to the way in which cost-of-living adjustments to wages should be paid: while these were aimed at reducing the lags in payment of such adjustments, the proportion of income to be compensated would normally be some 80 per cent;

in the event of very high inflation rates 90 per cent compensation could be given. In relation to the financing of the current account deficit, he stated that small shortfalls from the realistic target for 1984 could be met from capital markets.

16. Regarding the trade balance, the representative of Israel noted that in the period January-April 1984, total imports of goods stood at US$2.6 billion as against US$2.7 billion in the corresponding period of 1983: excluding imports of raw diamonds, the figure was US$2.3 billion as against US$2.4 billion, a reduction of 4.9 per cent. Total exports had increased from US$1.6 billion to US$1.8 billion in the same period; agricultural and industrial exports, excluding diamonds, had increased from US$1.3 billion to US$1.4 billion. The overall civilian current account deficit, excluding diamonds, had fallen from US$1 billion to US$800 million over the same periods. Full trade date for 1983 and targets for 1984 will be supplied to the secretariat.

17. The relationship between the Israeli shekel and European currencies could only be corrected gradually. Too large and frequent currency depreciations would have adverse effects on inflationary expectations; the current exchange rate policy aimed to ensure that the level of the currency remained broadly in line with expected differences in rates of inflation as between Israel and its major markets. This would be achieved through a process of "crawling" depreciation, rather than major devaluations.

Systems, method and effects of restrictive import measures

18. References were made to the multiplicity of measures used by Israel for balance of payments purposes. It was noted that the import deposit scheme would probably be extended for a further six-month period. While recognizing the rôle of the scheme in reducing the level of liquidity in the economy, members encouraged Israel to eliminate the deposit, as well as the import levy, as soon as possible. In this connection, the representative of Israel noted the importance of timing in introducing or removing particular measures. For a number of reasons the time was not now appropriate to remove the import deposit scheme, but it was intended as a temporary measure and would be kept under review as conditions improved. One member asked whether the 1 per cent tax on sales of foreign exchange was for fiscal or balance of payments purposes.

19. A number of questions were posed concerning Israel's system of import licensing. It was not clear from the notification supplied by Israel in BOP/244, which gave four reasons for licensing, which products were subject to licensing for balance of payments reasons and which were applied under other GATT provisions such as Article XX, or for such purposes as protection of infant industry or agricultural production. It was pointed out that different measures could be justified under different Articles of the General Agreement. One member asked what plans the government had for reducing the number of products covered by licensing requirements, and whether it would be possible to give a schedule for the removal of products from the list. A number of members suggested that the Israeli delegation,

in consultation with the secretariat, should make clear the justifications invoked for licensing on different products, where possible using notifications made to other GATT fora as indicators.

20. The Israeli representative stated that, in fact, all products placed under licensing were done so for balance of payments reasons. In recent years no licensing requirements had been introduced for infant industry purposes; such protection was provided through the tariff. Criteria for licensing for each of the products listed were available in documents; many were published, such as those relating to standards. Thus, although all products on the list were subject to licensing, only 5 per cent of applications for licences were refused, which also indicates that the system is not being applied in a restrictive manner.

21. Questions were asked by some members regarding the operation of Israel's exchange rate insurance scheme for exports, and on a statement by Israel that any phasing out of the import deposit system would necessitate a replacement of the tax element included therein by some other means. In reply to the latter, the representative of Israel stated that the "tax element" in the deposit scheme came from the fact that, as the deposit was repaid without interest or inflation adjustment after one year, a depositor would lose the equivalent of the inflation during the period plus any additional real interest. The tax element could, at present inflation rates, be calculated at around 70 per cent. It was not intended to replace the scheme, as and when it ended, by any other import-restraining measure, but rather, by accelerated currency depreciation which would have the desired effect on imports. In relation to the exchange rate insurance scheme, it was noted that no compensation payments were made for adjustments of the exchange rate as long as they only kept pace with the rate of inflation.

Conclusions

22. The Committee recognized that Israel faced serious and persistent balance of payments difficulties, and that policies pursued in the recent past had not led to an improvement of the situation. The policies now being followed comprised a wide range of measures, priority being currently given to alleviating balance of payments problems. There were initial signs that these policies were showing positive effects.

23. The Committee noted that, in relation to its balance of payments situation, Israel had not had excessive recourse to trade restrictive measures. However, several trade policy instruments were being used simultaneously, as mentioned in paragraphs 18-20 above. In this connection, the Committee asked the secretariat to seek clarification about the status of the licensing measures notified by Israel.

24. The Committee recommended that, pursuant to paragraphs 1(b) and 1(c) of the 1979 Declaration on Trade Measures for Balance-of-Payments Purposes, Israel avoid the cumulation of different trade measures taken for similar ends, and indicate, as soon as practicable in line with improvements in the balance-of-payments situation, a time schedule for the phasing out of the restrictions.

ANNEX I

Statement by the Representative of the International Monetary Fund

The pace of growth of the Israeli economy slowed markedly in the last two years, to about 1 percent per year in 1982-83, compared to a growth of over 3 percent in 1980-81. During much of 1983, the imbalances in the Israeli economy deepened, with the external resource gap widening further and inflation rising. From the autumn of 1982, economic policy had focused on reducing the inflation rate by decelerating the growth of key nominal magnitudes, including the exchange rate and controlled prices. This policy did not succeed in significantly reducing inflation—over the year to September 1983, consumer prices increased by 128 percent, compared with 131 percent in the preceding 12-month period—partly because of institutional rigidities and deeply ingrained inflationary expectations, but also because of a deepening in the economy's real imbalances.

In the face of a rapidly deteriorating external position, and a mounting demand for foreign currency, the shekel was depreciated moderately in real terms in August 1983 and more substantially in October 1983. The second depreciation was accompanied by a basic change in exchange rate policy to ensure maintenance of the real effective rate; at the same time, budget subsidies were cut back substantially and steps were taken to begin reducing other expenditures. This heralded a change in the immediate focus of policy from reducing inflation to strengthening the balance of payments—which the Government has indicated that it intends to carry forward in 1984, when it is aiming to secure a reduction of about US$1 billion in the external goods and services deficit, primarily through a substantial reduction in the budget deficit.

As in the two previous years, aggregate demand—which increased by 5 percent—grew substantially faster than output during 1983. This reflected strong rises in both private consumption (7 percent) and public consumption (8 percent); fixed investment was also buoyant. The shift in pricing policy in October 1983 led to a release of repressed inflation—in the six months from September 1983, consumer prices rose by more than 120 percent and, by March 1984, stood more than 240 percent higher than a year earlier. Since real wages are adjusted incompletely and with a lag through indexation, real earnings fell by 15 percent in the fourth quarter, after having risen substantially earlier in the year. This sharp fall in real wages, combined with an erosion of the real value of the public's financial asset holdings in the fourth quarter of 1983 due to a collapse in the stock market, led to a turndown of domestic expenditure and output and a rise in unemployment.

The budgetary situation weakened markedly during 1983/84. The policy of tackling inflation in the first half of the fiscal year was responsible for higher price subsidies and increased outlays under an exchange rate insurance scheme; domestic defense costs and public sector wages also rose in real terms. Despite a number of measures to strengthen the budget from August 1983--including cuts in various programs--the deficit continued to widen in the second half of the fiscal year, due in part to a decline in both tax and nontax revenues. For the fiscal year as a whole, the budget deficit widened by the equivalent of 8 percentage points of GNP, to 26 percent of GNP. About one half of this deficit was financed by credit from the Bank of Israel. This monetary financing contributed importantly to a 9 percent real increase in the public's liquid financial assets during 1983. The public's holdings of total financial assets, by contrast, fell by 30 percent in real terms during 1983, reflecting the sharp fall in values on the Israeli stock market.

Israel's external goods and services deficit rose from US$4.7 billion in 1982 to US$5.0 billion in 1983, with a decline in defense imports (mostly financed by aid) more than offset by a further sharp rise in nondefense imports. As receipts from private and official transfers also fell slightly, the overall deficit on the current account rose by US$0.5 billion in 1983 to reach US$2.6 billion, or nearly 11 percent of GNP (compared to 9 1/2 percent in 1982 and 6 1/2 percent in 1981). The devaluations of August and October 1983, and subsequent exchange rate policy, have returned the real value of the shekel to around the level of September 1982; there are signs of improvement in the trade deficit in the second half of 1983 and early 1984. Gross external debt minus the foreign assets of commercial banks is estimated to have increased by US$1.4 billion, or 6 percent, in 1983 to US$22.3 billion (92 percent of GNP). The short-term component of debt declined marginally in 1983 to 14 percent of total debt; 70 percent of total debt was long-term, mainly at concessionary interest rates. Debt service remained unchanged at 22 percent of current receipts in 1983.

Although in 1977 most restrictions on payments and transfers for current international transactions and multiple currency practices were eliminated, new restrictions have been introduced, and some old restrictions reintroduced, as the external position has deteriorated more recently. The 3 percent import levy introduced in June 1982 and originally intended to lapse on April 1, 1983, was extended first to April 1, 1984 and then through March 31, 1985, though the rate of levy was reduced to 2 percent effective from April 6, 1983, when a levy on the purchase of foreign exchange by the public equivalent to 1 percent of the value of all transactions was introduced. On June 1, 1983, a noninterest bearing 15 percent deposit for one year on a range of imports was introduced, equivalent to a tax approaching 10 percent at average interest rates during the second half of 1983; this deposit scheme was renewed for a further six months on December 1, 1983. As from April 1, 1983, a travel tax on Israeli citizens traveling abroad

was reintroduced. Exporters continued to benefit from the exchange rate insurance scheme introduced in July 1981: net payments under the scheme were estimated at US$435 million in 1983 (8 percent of exports). The 2 percent surcharge on proceeds from the sale of domestically traded securities by residents and nonresidents, as well as on the proceeds from foreign-traded securities by residents introduced in June 1982, remains in force. In the face of continued sizable purchases of foreign currency by Israeli residents, foreign currency controls were tightened in both November 1983 and January 1984.

Given the imbalances in the Israeli economy, the current policy strategy aims appropriately at improving the balance of payments substantially through a sizable reduction in the budget deficit. The Fund hopes that the authorities, by further strengthening the adjustment effort, will be able to return to a more liberal exchange and trade system in the near future.