GENERAL AGREEMENT ON

TARIFFS AND TRADE

RESTRICTED

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Committee on Balance-of-Payments Restrictions

REPORT ON THE 1989 CONSULTATION WITH ISRAEL

1. The Committee consulted with Israel on 22 November 1989, in accordance with its terms of reference and the Declaration of the CONTRACTING PARTIES on Trade Measures Taken for Balance-of-Payments Purposes (BISD 26S/205). The consultation was held under the Chairmanship of Mr. J.-F. Boittin (France). 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:

BOP/295 Basic document submitted by Israel
BOP/W/129 Secretariat background paper

IMF, Recent Economic Developments dated 7 June 1989

Opening statement by the representative of Israel

3. In presenting the economic situation, the representative of Israel discussed economic developments since the last consultation, the reasons for these developments and the outlook. In this context, he emphasized basic structural problems and their implications for policy measures to be reviewed by the Committee.

4. 1988 and 1989 were years of economic slowdown for Israel. Real GDP grew by only 1.5 per cent in 1988, and was expected to increase by around 1 per cent - a decline in GDP per capita - in 1989. Industrial production was expected to fall by 2 per cent. Unemployment, which had been around 6 per cent before 1988, was estimated at 9.6 per cent in the second quarter of 1989.

5. Real exchange rate developments were a major reason for the economic slowdown. After the 1985 stabilization programme, which had reduced inflation to around 15-18 per cent, the sheqel had been pegged first to the U.S. dollar and then to a basket of currencies. Under these circumstances, the continuing gap in inflation rates between Israel and the rest of the world reduced the competitiveness of the export sector and stimulated an increase in imports, especially in 1988. The need to maintain high interest rates to support the exchange rate also had a depressing effect on overall level of economic activity. Secondly, revenues from tourism had fallen, adversely affected by political developments. At the same time, a decline in private consumption was partly caused by, and partly contributed to, the fall in economic activity in 1988/89; in 1989, private consumption was estimated to fall by 3 per cent. Demographic changes also contributed

to depress the labour market in a period of recession, with the workforce participation rate rising from 50 to 52 per cent between 1986 and 1939. Finally, the implementation of the 1985 economic adjustment programme itself had created many challenges for industries, including adjustment to changes in the levels and term structure of real interest rates. Israel was still in the middle of its adjustment process and a number of severe problems still persisted, particularly in the agriculture sector and for some industries.

6. A key factor in the fight against inflation was the reduction of budgetary deficits which, from around 15 per cent of GNP in the early 1980s, were eliminated by the mid-1980s, showing a modest surplus in 1986. The estimated outcome for 1989 was to be a deficit of some 5 per cent of GNP, mainly due to a sharp fall in tax collections; these were expected to improve as the economy recovers leading to a lower deficit in 1990.

7. Substantial reforms had been made to Israel's capital markets. During the period of high budgetary deficits, Government borrowing had crowded out private borrowers. The situation had now changed completely. The real rate of interest on Government bonds had been reduced from between 4 and 6 per cent to just over 2 per cent, and since 1986 there had been a continuous increase in private share and bond issues on the Tel Aviv stock market. A further indication of the liveliness of the market was the sharp competition in interest rates and lending periods existing among mortgage banks. As a further anti-inflationary step, indexation was no longer being applied on Treasury bills of up to one year.

8. The economic slowdown of 1988/89 had been directly reflected in the pattern of merchandise imports, which were 3 per cent lower in real terms in the third quarter of 1989 than in the same period of 1988. Imports of durable consumer goods fell by 22 per cent and capital goods by 17 per cent, while imports of raw materials grew by only some 2 per cent. While Israel's external accounts had thus improved in 1989 to date, the rate of improvement might be reduced as the economy picked up.

9. All these structural changes had their effects on the pattern of supply. As a small country, highly dependent on external factors, Israel's adjustment must proceed cautiously. The Government had taken a number of steps since December 1988, including the devaluation of the sheqel by some 13 per cent in two stages in December/January, a further devaluation of around 5 per cent in June 1989, and the conclusion of a new agreement with the trade unions. Measures taken to reduce barriers to trade in merchandise, services and capital movements included the abolition of a 3 per cent levy on foreign loans in September 1988, a reduction in the minimum period for foreign loans from 30 to 18 months in April 1989 (exporters are now allowed almost complete freedom in their borrowing from abroad), opening up of the bond market to foreign purchasers, reduction in the import levy on services from 15 to 7.5 per cent in April 1989 and exemption from the levy of all services except tourism as from September 1989, and an increase in the permitted advance payment on letters of credit from 15 to 35 per cent.

10. The outlook appeared somewhat more optimistic. Merchandise exports (excluding diamonds) had grown steadily over the last few months; the monthly average for the third quarter of 1989 was some 15 per cent higher than in the same period of 1988. The number of tourists to date had increased by 8 per cent. In the period May-August 1989 there had been a modest increase in industrial output, and the unemployment rate had fallen slightly in the third quarter. Surveys of business confidence and unofficial conversations showed similar trends. Tentatively, GDP was projected to grow at around 4 per cent in 1990, with a real increase of 6 per cent in exports and of 7 to 8 per cent in investment.

11. The representative of Israel also stressed that Israel's market for merchandise trade was largely open. The purpose of Israel's trade policy was not to erect barriers but to contribute to the rectification of structural problems. This was foreseen in Article XII:3(d) of the General Agreement which recognised that a contracting party may experience a high level of demand for imports in promoting full-employment or resource development policies. Israel also made every effort to comply with the "least disruptive" provisions of the 1979 Declaration. Some trade measures had already been reduced or eliminated. The announcement of a timetable for removal of other trade measures when practicable was linked to the development of the general economic situation. Israel was also careful to avoid damaging the interests of other trading partners, and no complaints had been received.

Statement by the representative of the International Monetary Fund

12. The statement made by the representative of the International Monetary Fund at the request of the Committee is annexed.

Balance-of-payments situation and prospects: alternative measures to restore equilibrium

13. Members of the Committee generally welcomed the steps which had been taken by Israel to reduce inflation and stabilize the economy. It appeared that, after a period of disappointing economic performance, there were grounds for cautious optimism that sound economic growth and development could be achieved in the medium term, provided that the general direction of policy could be continued. The changes in business confidence signalled by the Israeli delegation were positive signs. The current account deficit seemed not to be unmanageable, and reserves were at a relatively comfortable level. In this connection, the fact that the improvement in the current account in 1989 so far had come mainly from export growth was encouraging. The flexible exchange rate policy adopted had helped the export sector regain profitability and had stemmed earlier capital outflows. However, while inflation had been successfully reduced from the very high rates of previous years, it was still relatively high; there was also evidence that the budget deficit was widening again, after having been brought down from an excessively high level.

14. Members welcomed the steps taken towards progressive deregulation and liberalization of financial markets, as well as other reforms undertaken in

January 1989 including reduced subsidies, cuts in government expenditures and moderate wage adjustments.

15. Members encouraged Israel to continue with the process of progressive liberalization and restructuring within the economy. In this connection, one member noted that the high levels of defence expenditure and of foreign debt repayments, as well as the structure of labour relations, might still lead to problems. Members underlined the statement by the IMF that continued policies of budgetary and monetary restraint, effective incomes policies, and restructuring of the financial and enterprise sectors were essential elements of policies which should help the balance of payments and reserves position to gain sufficient underlying strength to permit, and to benefit from, further liberalization of the exchange and trade system.

16. Replying, the representative of Israel said that he was encouraged by members' reactions to the structural reforms taking place in Israel. His Government was firmly committed to the process of economic reform and restructuring; liberalization of trade and capital flows was seen as part of the process.

Systems, methods and effects of restrictions

17. Members expressed their satisfaction that the import deposit scheme had been abolished on schedule in 1988 and that tariffs had been reduced in recent years. Concern was expressed, however, that the 2 per cent import levy, which Israel had said would be removed at an appropriate time, was still in existence. In this connection, members asked for more precise information on the likely timetable for removal of the levy, and drew attention to the provisions of Paragraph 1(b) of the 1979 Declaration.

18. Members thanked the Israeli delegation for the information on imports subject to license provided in the basic document (BOP/295). It was noted that import licensing was still applied to a broad range of goods, and that the system itself contained broad discretionary elements. One member asked whether the list as now presented under the Harmonized System had been enlarged. In this connection, it was also pointed out that the prolonged use of licensing systems did not help to restore balance-of-payments equilibrium on a sound and lasting basis: members asked what plans might exist for the progressive phasing out of the import licensing list, and whether Israel could give more precision on the practicability of establishing a timetable for doing so, particularly in view of the improvement in its balance-of-payments situation. One member said that the implications of maintaining restrictions for balance-of-payments purposes and, at the same time, liberalizing bilateral trade within as free-trade agreement should be examined more closely.

19. Clarification was sought concerning the criteria for including goods in the import licensing list, and whether any of the items on the list were subject to quotas. In this connection, one member raised questions concerning the transparency of the procedures for import licensing; he requested clarification on the procedures involved with respect to the imposition of quotas, citing examples of certain products on which quotas

had apparently been introduced at very short notice. He also asked whether all agricultural products referred to on the list of products requring import licences were also subject to quantitative restrictions. Another expressed concern about reported abuses of the licensing system, including arbitrary introduction of non-automatic import licences. A third member asked whether the information provided by Israel on the operation of its import system could imply discrimination as between different sources of supply. In this connection, one member welcomed the positive developments which had taken place concerning the administrative arrangements for imports from certain sources.

20. One member asked whether all import licensing was justified on balance-of-payments grounds: if not, to what extent licences were in place for balance-of-payments reasons and to what extent for protective purposes. He also asked for clarification concerning a "freeze" of civilian imports referred to on page 3 of Israel's basic document.

21. Questions were asked about the calculation of the "normal" or landed value of imported goods and, in particular, about the rôles of the import levy and of the TAMA (importation rate uplift) used in purchase tax valuation. Clarification was also sought as to whether purchase tax was applied equally to imported and domestic goods.

22. In reply, the representative of Israel recalled that a number of liberalizing measures had been taken. Israel was committed to the abolition of the 2 per cent import levy, which applied to all imported goods subject to VAT, but could not at present give a timetable for this; such a step should be seen in the context of the general reform and liberalization process.

23. Concerning justification of import licensing measures, he said that the list was composed of items which could be restricted as and when the balance-of-payments situation required it, and was under constant review. It did not contain raw materials or inputs for Israeli industry. In this connection, he referred to the provisions of Article XVIII:10 concerning priority for importation of products which are more essential to economic development. He also recalled that Israel had, in November 1985, stated in a letter to the GATT Secretariat for the Committee that all the measures notified had been taken for balance-of-payments purposes under the relevant provisions of the General Agreement, although some of them might also have incidental effects in areas referred to in other GATT provisions.

24. In respect of sources of supply, Israel had stated in its background paper that although its trade policy was based on the principle of non-discrimination, goods from countries which "prohibit or limit, expressly or otherwise, the imports of commodities from Israel" were not freely importable but required individual licences.

25. The timetable for the phasing out of import licensing requirements was related to the general economic restructuring taking place, and could therefore not be established clearly at this time.

26. Replying to points raised by individual members, he said that more details should be sought on alleged "abuses" of the import licensing procedures. He wondered to what exactly the question referred and stated that he was not aware of any problems in this regard. He added that the few cases raised in the past were more related to other types of problems, and mutually agreed solutions had been found. In another case concerning drinking glasses, there had been a misunderstanding of the procedures to be followed by the association in question, which could not be related to the general question of transparency procedures. In relation to a case concerning imports of a number of products including tuna and alcoholic liquors, a list of agricultural products subject to particular measures had been notified to GATT under the appropriate procedures. There had been no administrative "freeze" on imports in 1988: the stagnation of imports was entirely due to the poor economic situation.

27. The TAMA was not a balance-of-payments measure. It was a coefficient which was applied to imports of products subject to purchase tax, for the purpose of levying the tax. Current legislation underway in the Knesset was aimed at changing the system to allow a more precise calculation of purchase tax based on the wholesale price for each item rather than on the average values of imports. Every effort was being made to pass this legislation expeditiously.

Conclusions

28. The Committee noted with satisfaction the structural reforms undertaken by Israel. It encouraged the authorities to continue the process of macroeconomic adjustment, in particular by pursuing appropriate budgetary, monetary and incomes policies.

29. The Committee encouraged Israel to continue the liberalization of its trade régime and exchange system, and welcomed the measures taken to eliminate the import deposit and reduce import duties.

30. The Committee noted that the use of import licensing remained widespread and that the import levy introduced for balance-of-payments reasons remained in force. In this context it recalled the provisions of paragraph 1 of the 1979 Declaration on Trade Measures Taken for Balance-of-Payments Purposes.

31. The Committee encouraged Israel to reduce the use of import measures taken for balance-of-payments purposes, in view of the improvement in the economic situation, and to announce a timetable for the progressive phasing out of the measures in force, as practicable. It expressed the hope that progress in this direction could be made by the time of its next consultation with Israel.

Annex

Statement by the IMF Representative to the 1989 Consultation of the GATT Balance of Payments Committee with Israel

The July 1985 stabilization program was followed by two years of rapid expansion of demand, production, and productivity together with a sharp deceleration of the inflation rate and a better balance of the fiscal accounts. The performance of the economy in 1988 and early 1989, however, has been disappointing. Thus, the strong recovery of business activity in 1987 was followed by a pause in 1988; the substantial increase in fixed investment was followed by a decline; and a peak export performance was followed by a decline in export volumes. Despite the weakening of domestic demand, and the maintenance of a stable exchange rate in the two-year period after January 1987, the rate of inflation failed to decline below the 15-20 percent range where it has remained since 1986.

The recessionary tendencies in 1988 and early 1989 are attributable in part to unfavorable weather conditions and disturbances in the administered territories. However, part of the decline in the rate of growth of GDP--to only about 1 1/2 percent in 1988--can also be traced to the surfacing of underlying structural problems as inflation abated and the policies of the Government. First, the earlier buoyancy of output, which reflected the positive responses of enterprises to a less inflationary environment, was replaced by the phasing out of uncompetitive production lines by financially overextended firms. In addition, the authorities' efforts to bring public sector expenditures into line with available resources, including retrenching of certain defense-related industries, put downward pressure on industrial activity. Second, the policy of stability of the nominal exchange rate, which had played a significant role in the scaling down of inflation expectations, began to have negative effects as well due to the extended delay in adjusting the exchange rate. While the credibility of the stable exchange rate policy was still being established, wage increases continued to exceed price increases, though by a diminishing margin. The redistribution of incomes, to which this wage overshoot gave rise, caused the private savings rate to fall. Although helping to maintain activity by raising consumption at first, the overshoot was bound in time to undermine the profitability of investment as it did the competitiveness of exports. The external value of the new sheqel (hereinafter referred to as the sheqel) was, however, kept broadly stable from January 1987 until the end of December 1988, when it gave way to market pressure. Over that time, however, the cumulated loss of competitiveness was sufficiently large to contribute to the slacking of activity.

Against the background of slowing economic activity, rising unemployment, and the external current account balance, that in volume terms had begun to rise again to reach 1 1/2 percent of GDP in 1988, the new Government that took office at the end of that year decided to make a resumption of growth its primary policy objective. Growth was to be

restored by preserving the stability in the balance of payments position and by advancing structural changes in the economy. The measures included a devaluation, first by 5 percent at the end of the year and when speculative pressures continued in the market by a further 8 percent on January 8, 1989. The devaluation was supported by a successful bargain with the trade unions to help ensure that wage adjustment would not undermine the relative price effects of the exchange rate adjustment or regenerate inflationary pressures. The draft budget for 1989/90 envisaged maintenance of the deficit at about the same level relative to GNP (4 percent) as in the preceding year. This required cuts in budget expenditures over and above those already effected in the preceding two years (equaling nearly 8 percentage points of GNP) which had offset almost equivalent reductions of budget revenues. The downward trend in revenues was expected to continue in 1989/90, particularly reflecting the effects of the cuts in customs duties in accordance with agreements with the European Community and the United States, continued declines in foreign grants relative to GDP and in corporate profits and the effect on income tax revenues of a further deceleration in the inflation rate. With the recession undermining revenues, indications are, however, that a larger deficit may emerge.

Success in containing the budget deficit is a major element in the overall success of regenerating investment activity, and, thereby, economic growth. The further scaling down of budgetary expenditures is the sine qua non for a continued easing of monetary policies, which in turn is necessary to achieve a further reduction of nominal and real interest rates from their current very high levels. These efforts, however, will need to be accompanied by further progress toward structural measures to correct the segmentation of and distortions in the capital and money markets. As the latter, in particular, have distorted the yield curve as well as constrained the scope for lowering interest rates, reform of the capital market and banking system is necessary if an easing of monetary policy is to have the desired positive effect. In fact, in the given circumstances, efforts in 1988 to support activity by easing monetary policy may have contributed instead to maintenance of a relatively high rate of inflation and to downward pressures on the exchange rate. The various steps already taken toward reform of the capital market have already contributed to an appreciable reduction in the real market interest rate.

A major premise of the 1985 stabilization policy was that nominal exchange rate stability would in time lead to wage moderation consistent with a sustained lower rate of inflation. With real wages increasing less rapidly in 1988 and actually declining in early 1989, there is evidence that this policy is bearing fruit. However, as long as domestic costs and prices continue to rise well ahead of trading partners', prolonged periods without adjustment of the exchange rate can result in an excessive erosion of competitiveness and profitability. This is believed to have contributed to the onset of the period of weak economic activity and investment in 1988. The delay in adjusting the exchange rate in 1988 reflected uncertainty on when an agreement could

be reached with the trade unions on restraining wage demands in support of the devaluation. The authorities are now determined not to wait as long as evidenced by their decision to introduce a further (smaller--4.9 percent) depreciation in June 1989. The recent moderation in wage adjustments was believed to reflect a growing recognition on the part of the labor movement that cost and price increases were no longer automatically being accommodated.

Turning to the external payments performance, the current account and basic balances strengthened sharply in the aftermath of the stabilization program, reflecting both special external assistance and an improvement of the civilian balance on goods and services. The current account balance, which was in surplus in 1985-1986, however, again returned to a deficit position in the next two years. The slowdown in domestic demand helped the balance of payments in 1988 as the volume of civilian imports stagnated with substantial declines in purchases of machinery and nonfuel production inputs. However, with exports of goods and services falling (by 3 percent) in volume terms, the external current account balance in volume terms deteriorated by the equivalent of about 1 percent of GDP. In addition to the loss of competitiveness, shortfalls in agricultural crops and the effects of the disturbances in the administered territories, particularly on tourism, contributed to the weak export performance. In value terms, nevertheless, a 5 percent gain in the terms of trade produced a small improvement of the current account balance, with the deficit narrowing from US$1 billion in 1987 to US$0.7 billion in 1988.

Developments in the balance of payments in recent years, however, have been dominated by capital flows, with large outflows in the periods immediately preceding expected depreciations of the exchange rates and reflows subsequently. In 1988, net sales of foreign exchange by the private sector during the first half of the year were followed by net purchases after midyear, the size of which increased sharply toward year end. As a result, the capital account balance swung from a surplus of US$1.8 billion in 1987 to a deficit of US$0.5 billion in 1988. The loss of official external reserves which had amounted to US$1.4 billion in 1988, however, was recouped in the first two months of 1989, when reserves rose to US$5.7 billion, equivalent to three months' imports of goods and services. Renewed capital outflows at midyear, in anticipation of the end-June depreciation of the sheqel, lowered reserves again to US$5.3 billion, where they have since remained. Israel's external debt position has improved in recent years with gross and net external debt broadly stable in nominal terms since 1985, and thus falling relative to GNP; at the same time debt service payments declined from 27 percent of exports of goods and services in 1985 to 24 percent in the last two years.

The 1989/90 budget was based on an assumed improvement of the balance of payments in the current year, with a recovery of export growth and moderate import demand reducing the civilian external deficit. Together with lower defense imports and larger net transfer

receipts, the current account balance was expected to move back into a small surplus in 1989. Although export performance early in the year was disappointing, it has strengthened since the second quarter; this, coupled with weak imports, has improved the trade balance by about US$0.3 billion during the first eight months of the year as compared with the same period of 1988. Although imports should rise with the recovery of economic activity, a continued strengthening of export and tourism earnings is expected to keep the current account balance in small surplus over the medium term.

Israeli merchandise exports have benefited from free trade agreements with the EC and the United States since 1977 and September 1987, respectively. Consistent with these agreements, as of January 1, 1989 40 percent of imports from the European community and 90 percent of imports from the United States entered Israel duty-free.

Since mid-1985, steps to eliminate various trade and payments restrictions, introduced in the early 1980s to strengthen the trade balance and control capital flows, have been taken. Initially, these concentrated on current transactions. They included elimination of the import deposit requirement; restoration of allowances for support and gifts abroad; removal of the surcharge on airline and sea tickets purchased in Israel and on prepaid travel expenditures; and increased allowances for tourist and business travel. During the last two years, efforts have also been made to liberalize external capital controls. These have included elimination of the 3 percent levy on foreign currency borrowing by residents; broadening of the scope for foreign currency lending by Israeli banks; and initiation of a phased reduction in minimum term requirements for external borrowing by nonbank residents.

The exchange and trade restrictions pertaining to current international transactions still in force include a 2 percent import levy, a 1 percent levy on the purchase of foreign exchange, the requirement of specific authorization for Israeli employers to make wage payments in foreign currency above a certain ceiling to Israeli citizens working abroad, limitations on the rights of tourists to take out local currency and to reconvert local currency into foreign currency, multiple currency practice features of the exchange rate insurance scheme, and a 7.5 percent (lowered from 15 percent from April 19, 1989) levy on imports on tourism. Some imports on a Restricted List are subject to approval. In the aftermath of the depreciation of the sheqel at the beginning of 1989, the premium rate under the exchange rate insurance scheme was raised bringing receipts and payments into virtual balance, thus removing, at that time, the subsidy element. The premium rate was again raised in July 1989.

The Fund welcomes the moves toward liberalizing Israel's exchange and trading system. Of the measures remaining, two--the levy on imports of tourism and the exchange rate insurance scheme--are subject to Fund

approval under Article VIII. Temporary approval was given in 1987 for their retention. However, since then, in the absence of plans for their elimination, the Fund has not approved further retention. Curtailment of the budget deficit and a more active policy of monetary restraint, coupled with an effective incomes policy, are required to further contain inflationary pressures, consistent with using a policy of stable exchange rates as a nominal anchor for other economic policies. Restructuring of the financial and enterprise sectors is an essential element in this process. With such policies, the balance of payments and reserve position should gain sufficient underlying strength to permit and to benefit from further liberalization of the exchange and trade system.