1. The Committee consulted with Israel on 26 November 1991, 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:

   Basic document submitted by Israel BOP/307
   Background paper by the Secretariat BOP/W/141
   International Monetary Fund, Recent Economic Developments, dated 20 September 1991.

3. In this connection, the Chairman noted that documentation for this consultation had been provided late, mainly due to time and staffing constraints within the Secretariat.

Opening statement by the representative of Israel

4. The representative of Israel, presenting the overall economic situation of his country since the last consultation, emphasized two events with major effects on the Israeli economy, namely massive immigration and the Gulf crisis.

5. Since October 1989, approximately 350,000 immigrants had arrived in Israel. Large-scale immigration was expected to continue for another three years. The economic effects were considerable. Local demand, especially for housing, had grown rapidly and the labour force had increased substantially in quantity and quality. Considerable investment would be needed in the next few years in order to create jobs.

6. Economic activity had suffered a short-term setback as a result of the Gulf crisis. War-induced losses were estimated at 2 per cent of GNP growth in 1991. The economic damage caused by these events was felt in many sectors, including the tourism industry. Increases in fuel prices had also affected the economy.

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7. Concerning the balance-of-payments situation, the representative of Israel noted that the deficit on the goods and services account grew from US$3.8 billion in 1989 to US$5.1 billion in 1990, due to a slowdown in exports and strong growth of import demand. However, unilateral transfers increased by around US$1 billion, contributing to a current account surplus of US$700 million in 1990 and allowing a reduction in net foreign debt.

8. The current account was expected to be in growing deficit in 1991. The trade deficit was US$4 billion for the first nine months of the year, compared with US$2.4 billion in the corresponding period of 1990. This deficit was caused by substantial growth of imports, especially in production inputs and capital goods.

9. In 1990-91, Israel's terms of trade were heavily affected by fluctuations in energy prices.

10. From 1 September 1991, Israel started implementing a trade liberalization programme. This programme was a major element in Israel's efforts to further liberalize its market, rationalize production and create a more competitive environment. Under the programme, administrative and quantitative restrictions applied to industrial goods were replaced by temporary customs duties. These new duties, detailed in Annex I to document BOP/307, were to be gradually reduced over a period of five to seven years, according to the timetable provided in Annex II. At the end of the process, they would remain at levels of 8 per cent for raw materials and 12 per cent for intermediate and finished goods.

11. Other economic reforms undertaken by Israel in the past two years included a gradual reduction of the 15 per cent levy on overseas investment and purchase of services; further liberalization of foreign exchange controls and foreign exchange credits; and a substantial reform in motor vehicle taxation. Several major changes were also made in consumption subsidies, the labour market, the State budget and the domestic capital market.

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 expressed their general support for the economic reforms undertaken by Israel and noted the positive economic developments which had taken place since the last consultation in 1989. In 1989 and 1990, the country's balance-of-payments situation had improved
substantially, but this improvement had been reversed since, mainly as a consequence of the sharp increase in immigration. Accordingly, Israel's current account would close with a substantial deficit in 1991 and the outlook for the coming years was for continuing deficits of significant size. Much would depend on the effects of the economic policies pursued to maintain economic stability while absorbing massive immigration. In this context, the hope was expressed that Israel would continue to address its serious structural problems, pursue prudent fiscal policies, restrain monetary growth and achieve further wage and price moderation.

Systems, methods and effects of restrictions

14. Members welcomed Israel's import liberalization programme and the conversion of quantitative import restrictive measures into temporary price-based measures. The question was asked whether the tariffication process was a first step by Israel towards disinvocation of the balance-of-payments provisions.

15. Concern was expressed by several members that the replacement of licensing by tariffs implied some considerable increases in import duties. These could have substantial trade restrictive effects in the transition period. One member of the Committee noted that the implementation of the new tariff régime had been somewhat chaotic and that his country had to wait two months to receive the tariff list. The new tariff measures were set out using the Harmonized System; however, Israel had not yet submitted any Article XXVIII documents to the GATT. It was therefore difficult to make a concordance with Israel's former tariff, on which its GATT schedule was based. He asked Israel to report yearly its trade data for the tariff items affected by the new measure, to allow analysis of the trade trends. While welcoming the temporary nature of the tariff increases, he noted that they might produce significant shifts in trade flows, especially towards Israel's FTA suppliers. In that context, he encouraged Israel to phase out the higher duties within a shorter time-period than envisaged, in order to minimize any harmful effects on non-FTA exporters. He also sought clarification regarding the apparent non-application of higher tariff rates to EFTA countries which, at present, had no free-trade agreements with Israel.

16. One member of the Committee welcomed the increased transparency of Israel's import régime due to tariffication, while noting that her delegation needed more time to analyse the trade effects of the new measures implemented by Israel on her country's trade. Another member asked whether the tariffication had affected Israel's offer in the Uruguay Round market access negotiations.
17. Members of the Committee encouraged Israel to eliminate the temporary import levy introduced in 1982. One member noted that the levy had been introduced to help pay the costs of the Lebanese incursion, and should no longer be justified. Another noted that the Committee had, at its last consultation, already recommended Israel to remove this measure.

18. One member of the Committee noted that Israel still applied restrictive measures to agricultural products and asked whether these were justified for balance-of-payments reasons. Israel also maintained a variety of other restrictive measures, including its customs valuation practice, the purchase tax system which, in her view, had become a charge similar to a duty, and specific standards requirements. Concern was expressed that more than one measure was used on the same item.

19. The representative of Israel welcomed the support given to his country for the liberalization measures undertaken in recent years. Gradual implementation of the programme was seen by his Government as the only way to proceed.

20. He was of the view that the implementation of the tariffication programme had not been chaotic. Israel had published the tariff lists well ahead of the implementation of the programme. As a National Committee was to monitor the effects of the measures, Israel would also be able to provide the data requested by one member of the Committee. A concordance between the HS and the former Israel classification system would be made available by the end of 1991.

21. The tariffication programme would not change Israel's offer in the Uruguay Round.

22. Concerning the import levy, the representative of Israel confirmed that this levy was introduced at the time of the Lebanon war, but that the reasons justifying its implementation were related to certain balance-of-payments imbalances. As the situation had not changed since then, the levy had not been eliminated.

23. No industrial items remained under licensing. As far as agricultural items were concerned, these were under negotiation in the Uruguay Round. Import licensing on agricultural products was still maintained for balance-of-payments reasons; Israel was not yet in a position to disinvoke the relevant GATT provisions.

24. The application of purchase tax involved no discrimination between domestic and imported products. The TAMA valuation practice was also non-discriminatory and problems which had been raised by Israel's major trade partners were solved satisfactorily. Israel, presently a member of
the Customs Cooperation Council, hoped to accede to the GATT Customs Valuation Code at a time yet to be decided.

25. Israel's entire standards system was under scrutiny. If there were any discrimination against imports, it would be eliminated. Israel intended to apply standards equally to imports and domestic products.

26. Concerning the exemption of certain imports originating in the EFTA countries from the higher new tariffs, the representative of Israel emphasised that all customs duties, including those listed in Annex I to the basic document provided by Israel for the consultation, were applied "erga omnes". There were only four tariff lines, classified at HS eight-digit level, covering only a small volume of trade, on which a newly introduced temporary import levy was not imposed on imports originating in EFTA sources. This special treatment for EFTA countries was given in anticipation of a free-trade agreement under negotiation between Israel and the countries concerned. The levy was temporary and Israel intended to bring it into conformity with the GATT in the near future.

Conclusions

27. The Committee noted the improvements in Israel's current account position which had taken place in 1989 and 1990. It was also noted, however, that Israel's balance-of-payments position had again deteriorated in 1991 and was likely to come under increasing pressure, as a result, inter alia, of the economic consequences of sharply increased immigration.

28. The Committee welcomed the fact that Israel, as a part of a comprehensive trade liberalization programme, had abolished most of the non-tariff measures introduced for balance-of-payments reasons and replaced them by temporary higher customs tariffs with a timetable for reduction.

29. The Committee also noted that the use of import licensing was still maintained on agricultural products and that the tariffication of import restrictions had resulted in high temporary tariffs applied to m.f.n. sources. Members of the Committee, while welcoming the tariffication process in general, expressed concern about the high levels of some temporary tariffs. Some referred to the possibility of discriminatory effects resulting from the non-application of such tariffs to free-trade-area sources and asked Israel to take steps to minimize any harmful effects. They also called attention to the fact that Israel, in introducing additional temporary charges on four trade items, had exempted some m.f.n. partners from their application and urged Israel, in line with its undertaking to the Committee, to bring these charges into conformity with the General Agreement.
30. The Committee encouraged Israel to continue the process of import liberalization including the acceleration of its tariff reduction programme and, to announce a time schedule for the phasing out of remaining restrictions in place for balance-of-payments purposes, including the import levy.
Statement by the IMF Representative to the 1991 Consultation of the GATT Balance-of-Payments Committee with Israel
November 26, 1991

1. The Stabilization programme of 1985 achieved the intended break in the alarming acceleration of inflation, however the performance of the economy has been mixed since then. Incipient recovery was stunted in 1988/89, but economic activity recovered in 1990/1991, when a growth rate of 5 per cent in real terms was achieved, partly propelled by rapid growth of productivity in the business sector. However, the upswing was coupled with rising unemployment and inflation remained in the 15-20 per cent range, where it has been since the stabilization. Monetary and fiscal policy aimed to support the rise in activity, with fiscal policy becoming quite expansionary in 1991.

2. Economic developments were dominated by two major shocks in 1990/1991: the upsurge in immigration to an annual rate of 200,000 from an annual average of only 14,000 in the second half of the 1980s, and the crisis and war in the Middle East. The latter was a temporary factor, interrupting output, increasing defence expenditure, and damaging tourist activity and exports. After the war, output recovered quickly, and there are signs of a recovery of exports and tourism as well. The wave of immigration, however, will have permanent effects on the economy. The initial effects are increases of consumption and investment demand, particularly in housing, and an upsurge in measured and unmeasured unemployment as it takes time to absorb the influx of labour. The structure of demand in 1991 reflects these effects, with consumption expenditures and residential construction dominating. Policies are geared to increase the supply response of the economy, to absorb the immigrants in the private sector, and to contain attendant inflationary pressures. Despite attempts to contain the budget deficit in the face of increasing demands and a decline in grant receipts in relation to GNP, the central Government deficit widened from 3.2 per cent of GNP 1988/1989 to 5 per cent in 1990/1991. Currently the additional demand is putting considerable pressure on the economy. Some of this is absorbed by existing slack in the labour market and the growth in the capital stock, but structural impediments are contributing to inflationary pressure. Some of this has been relieved by a higher level of imports, which has caused the 1989 current account surplus of 2.6 per cent of GNP to turn into a growing deficit during 1990/1991.

3. The authorities are seeking to accelerate structural change through increasing flexibility in the labour market, import liberalization, privatization of public enterprises and banks, and investments in
infrastructure and housing. Fiscal spending policy is turning from support of housing and direct employment toward assuring the necessary infrastructure investment, especially in transportation, to absorb the large influx of immigrants. Despite a sizeable increase in taxation, this policy shift has given rise to a large increase in the fiscal deficit in the first nine months of the 1991 budget year.

4. Monetary policy was expansionary in 1989/1990 and remained relatively easy. Lending rates have fallen and interest spreads, although lower than previously, remained high, reflecting the oligopolistic and segmented financial market. The introduction in 1989 of a band - widened from +/-3 to +/-5 percentage points in March 1990 round a pegged central exchange rate - helped contain speculative capital flows. The authorities continued to undertake adjustments in the central rate from time to time, so as roughly to offset accumulated inflation differentials vis-à-vis partner countries.

5. Considerable strides were made on structural reform: in the financial markets, deregulation involved elimination of credit allocation, relaxation of reserve and investment requirements to those necessary for minimum prudential purposes, substitution of tradable for nontradable bonds in financing of the government deficit. While the authorities intend to privatize the banks, with the immediate target in the three-year budget of selling the shares of at least two of the four banks by end 1992, no progress has been made so far, as there have been difficulties in finding suitable purchasers. Also, pension funds and life insurance companies still hold nontradable bonds with real interest rate guarantees by the Government; and moves to increase flexibility in the labour market, while substantive, still fell short of introducing a truly flexible system of wage determination, particularly in the public enterprises, which have been subject to weak financial discipline. Accordingly, real wages while showing some decline since 1989, remained a factor in preventing a stronger increase in employment and in the failure of profits to improve in 1990.

6. Trade reform has been far-reaching: all remaining quantitative restrictions on imports of industrial goods have been replaced by tariffs, and discretionary import licensing by an automatic licensing procedure. Thus, 1 from September, 1991 imports of industrial goods are freely permitted, although most imports from countries not covered by free-trade arrangements are subject to high transitional tariffs. The typical level is estimated to be about 30 per cent, with the highest ad valorem rate at 75 per cent, applying to certain textile and clothing items. These new tariffs are to be reduced linearly over five years to a maximum rate of 8 per cent for raw materials and 12 per cent on finished goods. For a small number of sensitive products, mostly textiles and wood, the transition period will be seven years.
7. Other reductions of restrictions on trade and payments included abolition of the 1 per cent levy on the purchase of foreign exchange in March 1990, the easing of payments restrictions on exports and imports and on individual residents' travel allowances.

8. Exchange and trade restrictions pertaining to current international transactions still in force include a 2 per cent levy on merchandise imports, 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 reconverst local currency into foreign currency, the features of the exchange rate insurance scheme entailing multiple currency practices, and a 4 per cent levy on imports of tourist services. Some imports remaining on a Restricted List are subject to approval.

9. Israel has indicated that it will move to phase out remaining restrictions on current payments to pave the way for accepting the obligations under Article VIII of the Fund.

10. Israel's economic outlook for 1991 and beyond is subject to large uncertainties, given the continued net immigration and the resulting need for a quicker supply side response, the choice of economic policies and the political setting in which they are to be pursued. Most scenarios suggest the balance of payments will come under increasing pressure in the near future. The labour force is likely to grow faster than employment, raising the unemployment rate to unprecedented levels. Total GDP growth would rise above past average levels, buoyed by domestic demand, particularly investment. Unemployment would decline only slowly in subsequent years as immigration ebbs and more immigrants find jobs. While investment will initially give rise to substantial increases in imports of capital equipment and intermediary goods, exports will also grow more rapidly as supply expands. This implies large, and increasing, current account deficits in the coming several years, and a narrowing of such deficits only during the second half of the decade. Expected cuts in non-productive government expenditures, including defence expenditures, are to keep the current account balance from deteriorating to an extent that might interfere with the liberalization efforts on the trade and payments side. As the initial gap between national saving and gross domestic investment would result in rising external debt, rising debt service will limit the effect of improving trade accounts over the medium term. To help confront these pressures, the authorities built up gross international reserves by end-July 1991, to the equivalent of 3.6 months of 1990 inputs of goods and services.

11. Assuming lower imports for defence and larger transfer receipts in support of immigration, the current account still is projected to turn from
a surplus of 1.4 per cent of GNP in 1990 to an average deficit of 6% per cent of GNP in 1991-96. The associated borrowing requirements imply an increase in gross foreign debt from 65 per cent of GNP in 1990 to 81 per cent in 1996, while keeping international reserves at a level of roughly 2½ months of total imports of goods and services. This compares to debt levels of close to 130 per cent of GNP in the early 1980s. Debt service would rise from some 23 per cent of exports of goods and services in 1990 to 26 per cent in 1996, well below the average 36 per cent recorded in the first half of the 1980s.

12. This scenario assumes the relatively successful absorption of immigrants. To make this possible and to enhance the supply-side response, structural reforms will need to be accelerated through a liberalization of imports, privatization of enterprises and financial institutions, and reduction of rigidities in factor and product markets. With such policies, the economy should gain sufficient strength to ensure that the projected weakening of the external payments position will be temporary, and that the liberalization of the exchange and trade system can be completed.

13. The Fund welcomes the substantial steps taken to liberalize Israel's trade and payments in the face of continuing balance-of-payments difficulties. Two of the remaining restrictions - the levy on imports of tourist services and the exchange rate insurance scheme - are subject to Fund approval under Article VIII; in the absence of scheduled steps for their elimination, the Fund has not approved their retention. Most quantitative restrictions applicable to imports of industrial goods have been abolished and a timetable for tariff reform has been put in place. The Fund encourages Israel to persist in the effort to liberalize its external trade and payments system, including the agricultural sector where significant restrictions remain.