

# GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

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## Committee on Balance-of-Payments Restrictions

### DRAFT REPORT ON THE CONSULTATION WITH ISRAEL AND EXAMINATION OF THE ISRAELI TEMPORARY IMPORT SURCHARGE

1. On 19 December 1973, the Council was informed by the delegation of Israel that the Government had increased the temporary import surcharge (see L/3976). The Council agreed that the matter should be referred to the Committee on Balance-of-Payments Restrictions for examination in relation to the relevant provisions of the General Agreement (C/M/92). The Committee has examined the matter in conjunction with the regular consultation with Israel on its balance-of-payments import restrictions, which took place on 19 March 1974.
2. The Committee had before it a basic document supplied by the Israeli authorities (BOP/145 and Add.1) and a background paper supplied by the International Monetary Fund dated 11 February 1974. It generally followed the plan for such consultations recommended by the CONTRACTING PARTIES (see BISD: 18th Supplement, pages 52-53).

#### Consultations with the International Monetary Fund

3. Pursuant to the provisions of Article XV of the General Agreement, the CONTRACTING PARTIES had invited the IMF to consult with them in connexion with the Israeli measures. The representative of the Fund made the following statement:

"With one exception discussed below, the general performance of the Israel economy prior to the October 1973 hostilities was satisfactory. During 1972 and the first nine months of 1973 the real GDP grew strongly, although the rate of growth slowed down to some extent during 1973. For the third consecutive year Israel experienced an overall balance of payments surplus and in 1972 it amounted to SDR 597 million which was more than triple that of the previous year. During the same period, the surplus on basic balance increased to SDR 637 million from SDR 229 million in 1971 mainly as a result of a large decrease in the deficit on services account; the inflow of unilateral transfers increased by almost 30 per cent. The performance of the trade sector also improved as exports continued to increase while imports were marginally lower, resulting in a reduction of the trade deficit from SDR 830 million to SDR 714 million. During the first nine months of 1973 exports continued to rise rapidly but the trade gap widened as the continued expansion of the economy led to increasing imports. The international reserves of the Bank of Israel stood at SDR 1.1 billion at the end of 1972; they had increased to SDR 1.5 billion by the end of 1973.

The exception to the generally favorable developments was a sharp rise in prices. In addition to the buoyant domestic conditions, other factors contributed to this development including the import surcharge introduced in 1970, the devaluations of 1972 and 1973, large wage increases in 1972, and the higher world prices of imported commodities. The consumer price index increased by 13 per cent in 1972 and is estimated to have increased by about 26 per cent during 1973. To restrain the price increases, monetary and fiscal policy was tightened at the end of 1972 and early 1973 and was further strengthened in the middle of that year when, in addition, a three-month price-freeze was imposed.

The October hostilities and their aftermath have led the authorities to introduce measures of economic austerity designed to divert the use of resources to public consumption, especially defense, and away from the private sector.

Preliminary estimates indicate that for the whole of 1973 the economy is estimated to have grown at about 4 per cent in real terms, considerably less than the annual rate prior to the hostilities. Although the full effects of the hostilities will not be reflected on the balance of payments until sometime in 1974, existing estimates for the whole of 1973 indicate a deterioration of the trade deficit from SDR 714 million in 1972 to an amount that is believed to have been well in excess of SDR 1 billion, with the balance on goods and services increasing from a deficit of SDR 980 million in 1972 to more than SDR 2 billion in 1973.

The measures instituted by the authorities since the October hostilities have been motivated by two major considerations, the maintenance of economic stability and the financing of the direct costs of the war, which are estimated at between \$4.5 billion to \$6 billion. The measures have included compulsory and voluntary war loans, an increase in purchase taxes, a reduction in subsidies on essential goods such as bread, flour, vegetable oils, and milk products and a 5 percentage point temporary increase in the import surcharge from 20 per cent to 25 per cent ad valorem on all but a small group of imports. This latter measure was designed to yield revenues of \$600 million and to slowdown the rise in imports. In appraising the reasons for the maintenance of the surcharge, including the recent increase in its rate, two factors have important bearing. First, during the period under review, with the exception of the surcharge the Israel authorities have continued to implement their long-term plan of trade and payments liberalization. In December 1973 the import deposit scheme introduced in 1970 was eliminated, while in January 1974 the tariff duties on many products were decreased by between 2.5 per cent and 8 per cent. Second, in the period ahead the balance of payments, as well as the economy as a whole, will continue to be dominated by the aftermath of the October hostilities. Despite the restraining

measures mentioned above, inflation is likely to continue in 1974 due, *inter alia*, to the removal of subsidies and increases in purchase taxes as mentioned above, and the rising import prices. At the same time the high defense expenditures, especially abroad, will put serious pressures on the balance of payments. International reserves, which at SDR 1.5 billion were high at the end of 1973, may have to be drawn down considerably in the period ahead to finance the anticipated deficits in the balance of payments.

In view of the expected pressures on the balance of payments in 1974 and the fiscal importance of the surcharge, the general level of restrictions in Israel including the maintenance on a temporary basis of the import surcharge is not unwarranted."

Opening statement by the representative of Israel

4. In his opening statement, the text of which is annexed to this report, the representative of Israel reviewed the balance-of-payments performance of Israel over the past few years, the implication of the recent rise of commodity prices, the economic effects of the October war and various factors that were likely to determine future balance-of-payments developments. Despite the payments difficulties that arose in 1973, the Government had not imposed any additional quantitative restrictions on imports. The items that were still subject to administrative controls represented no more than 8 per cent of total imports, excluding food and fuel imports by Government agencies. The Government had pursued its policy of unilateral tariff reductions and had eliminated the import deposit scheme. When the deterioration of the balance of payments made corrective measures inevitable, the Government had decided against returning to a system of administrative import controls and in favour of measures that would operate through the market mechanism. The Government was convinced that its balance-of-payments policy should rely primarily on export expansion rather than import limitation. For this reason it attributed great importance to further lowering of import duties and to free and fair access to markets of developed countries - through the Multilateral Trade Negotiations - and to improvements in the Generalized System of Preferences.

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

5. In discussing Israel's balance-of-payments position, members of the Committee expressed their full understanding of Israel's present payments difficulties. It was noted that during 1971, 1972 and the first nine months of 1973 Israel experienced an overall balance-of-payments surplus but that the hostilities in October 1973 and their aftermath had led to renewed pressures on the balance of payments. Members of the Committee welcomed the determination of the Israeli Government to overcome the present difficulties by emphasizing expansion of exports rather than restriction of imports. Members of the Committee noted that the

consumer price index was estimated to have increased by about 26 per cent during 1973 as compared to 13 per cent in 1972 and expressed concern about the effects of inflationary pressures on Israel's future balance-of-payments performance. In this connexion one member of the Committee pointed out that the recent increase in the rate of the import surcharge would tend to exacerbate the inflationary problem by making imports more expensive; domestic monetary or fiscal measures to solve the balance-of-payments problem would have avoided such undesirable side effects on the domestic price level. Members of the Committee noted with concern that in 1973 Israel's outstanding foreign debt had reached SDR 4.2 billion or SDR 1,296 per capita.

6. The representative of Israel was invited to comment on the general balance-of-payments prospects for 1974, the export promotion and diversification policies of the Government and its related investment strategy, the measures the Government intended to take to restrain further price increases, as well as the steps it planned to take to cope with the foreign debt problem.

7. Concerning the balance-of-payments prospects for 1974, the representative of Israel informed the Committee that present forecasts showed that the current account deficit would rise by US\$805 million and reach US\$3.5 billion in 1974. The terms of trade were expected to worsen as import prices would increase by 26 per cent and export prices by 15 per cent. A trade deficit of US\$2 billion was forecast. This represented an increase of US\$625 million compared to 1972, resulting from an estimated US\$760 million increase in imports and a US\$135 million increase in exports. As for services, a deficit of US\$1.1 billion was predicted.

8. Regarding export promotion and diversification policies and the related investment strategy of his Government, the representative of Israel pointed out that a return to full production could be expected during the year; the transportation system had been restored and most of the manpower was again available for production. To diversify export earnings the Government had promoted investments in the electronics, metal and chemical industries. Part of the production of these industries had been used for defence purposes during the hostilities; it was now again available for exports. Mineral exports, in particular phosphate exports, were expected to benefit from rising prices, and investments in mineral extracting and processing industries were being increased. Agricultural output was limited by the availability of land and water. The Government had therefore promoted changes from low to high yield crops. A recent emphasis on cotton production had turned out to be particularly profitable. Special efforts were made to increase foreign exchange earnings of the transport and tourism industries. The rising foreign exchange earnings of these industries indicated that they were now increasingly competitive.



9. The Israeli representative emphasized, however, that future export performance did not only depend on domestic production capacity but also on Israel's access to markets and the economic conditions in the export markets. In this context Israel attached great importance to the Multilateral Trade Negotiations and to further improvements in the Generalized System of Preferences. The general slowdown of economic activity in many industrialized countries was likely to adversely affect Israel's exports, particularly of consumer goods. A certain shift of sales away from Israel's traditional export markets towards countries benefiting from the oil price increase would be necessary though this would involve new promotional efforts. The Government supported exporters' efforts in many ways, for example by promoting international trade fairs or exhibitions by individual exporters or by assisting through its trade missions. The Government had the twofold policy of giving producers confidence that their export efforts would continue to be supported while at the same time making them realize that any protection of the domestic market was temporary.

10. In response to questions on measures to restrain inflation, the Israeli representative pointed out that one had to distinguish between domestic and imported inflationary pressures. To fight the domestic cause of inflation the Government had taken numerous measures to reduce internal demand. Thus, it had substantially increased direct and indirect taxes, reduced subsidies on essential goods such as bread and milk, and introduced compulsory and voluntary war loans. All these measures helped to absorb private purchasing power. The Government's efforts to reduce demand, however, had to take into account the legitimate social demands of the existing population and the immigrants. As to imported inflation, the Government was facing a dilemma: while a reduction of import charges would certainly help reduce the price of imported goods these charges were necessary to protect Israel's external financial position.

11. On the debt problem, the Israel representatives commented that debt service payments absorbed about half of Israel's export receipts. The total outstanding foreign debt was expected to reach US\$6 billion by the end of 1974. Already now Israel had the highest per capita foreign debt of the world. However, the structure of the external debt was favourable and the Government was seeking to improve it further by trying to obtain long-term loans with long grace periods and low interest rates.

#### System and methods of the restrictions and effects of the restrictions

12. Members of the Committee commented favourably on the fact that the import deposit scheme, introduced in January 1970, had been abolished in December 1973 and that tariff duties on a broad range of products had been reduced by 2.5 to 8 per cent in January 1974. One member welcomed the decision of the Government of Israel to resort less and less to quantitative restrictions to protect its balance of payments. Another member pointed out, however, that the principal

restrictive technique applied by Israel, namely the import surcharge, required a waiver under the General Agreement. He added that, while the surcharge had originally been introduced as a temporary measure to be eliminated in March 1972, its temporary nature could now be questioned; he therefore suggested that the Government of Israel consider requesting a waiver. The Israeli representative replied that his Government considered the surcharge the best technique available both from a national and international point of view. When notifying the contracting parties of the recent increase in the rate of the surcharge, the Government of Israel had suggested that the measure be examined in the Balance-of-Payments Committee. This suggestion had been accepted by the contracting parties. In reply to the question whether Israel had any plans to phase out the import surcharge, the representative of Israel said that he was not in a position to give a definite answer, but that the uncertainties of the present situation made a phase-out unlikely.

13. In response to queries by several members of the Committee, the Israeli representative explained that the import surcharge did not apply to rough diamonds because over 99 per cent of the imports were re-exported after processing. An additional reason lay in the inherent difficulty of controlling trade in diamonds. Invited to comment on the system of tax rebates on exports, the Israeli representative said that the main purpose of these tax rebates was to reimburse indirect taxes on the exported products and the import charges levied on raw materials and components contained in exported products and to rebate the import surcharge. The present rate of the rebate was I£ 1.42 per US\$1 of export value.

14. In reply to a question by one member of the Committee, the representative of Israel explained that there were at present three bilateral payments agreements in force (with Brazil, Portugal and Bulgaria). Israel's policy had been to move away from the use of bilateral agreements; in recent years some twelve such agreements had been terminated. Those that remained covered only about US\$22 million or less than 1 per cent of Israel's total imports.

### Conclusions

15. The Committee expressed appreciation for the efforts made by the Government of Israel to cope with the numerous problems it faced, both in the domestic market and in its balance of payments. It noted that while Israel's foreign reserves were relatively high at the end of 1973, there were strong indications that they would decline in 1974, in view of the expected balance-of-payments pressures. The Committee welcomed the emphasis placed by the Israeli authorities on the expansion of exports as a policy to achieve equilibrium in its balance of payments, rather than the restriction of imports.

16. The Committee noted that Israel's system of restrictions relied principally on the import surcharge, with quantitative restrictions playing a diminishing rôle. The surcharge, in its application, was found to conform to the criteria laid down in the relevant articles of the General Agreement on import restrictions for balance-of-payments purposes. It regretted, however, that the measure had proved less temporary than originally expected, and urged Israel to consider a phasing-out programme as soon as possible. Members of the Committee also expressed the hope that Israel would soon find it possible to terminate its remaining bilateral trade and payments agreements.

17. The Committee complimented the representatives of Israel for their able presentation of their country's economic situation, and expressed the hope that Israel would soon find it possible to fully implement its policy of trade liberalization and abolish remaining import restrictions.