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EBD/76/206
Supplement 1

October 26, 1976

To: Members of the Executive Board

From: The Acting Secretary

Subject: Relations with the GATT - Consultations with the CONTRACTING PARTIES

In the attached report the Committee on Liaison with the CONTRACTING PARTIES to the GATT makes its recommendations with regard to the guidance statements for the Fund representative attending the GATT meeting.

Unless there is an objection by an Executive Director by the close of business on Thursday, October 28, 1976, this recommendation will be deemed approved and will be so recorded in the minutes of the next meeting thereafter.

Att: (1)

Other Distribution:
Department Heads

October 26, 1976

To: Members of the Executive Board

From: Chairman, Committee on Liaison with CONTRACTING PARTIES to the GATT

Subject: Relations with GATT - Consultations with CONTRACTING PARTIES

The Committee on Liaison with the CONTRACTING PARTIES to the GATT has considered the memorandum from the staff concerning preparation for the forthcoming consultation with the CONTRACTING PARTIES (EB/CGATT/76/4, 10/21/76).

The Committee recommends approval of the recommendation in that paper.

October 20, 1976

To: The Chairman of the Committee on Liaison with the CONTRACTING PARTIES to the GATT

From: Acting Director, Exchange and Trade Relations Department

Subject: <u>Consultations with the CONTRACTING PARTIES to the GATT</u>

The Fund has been invited to consult with the CONTRACTING PARTIES in connection with their consultation with Israel, Portugal, South Africa, and Yugoslavia. The Managing Director has recommended that this invitation be accepted and that Mr. Bahram Nowzad, Division Chief, Trade and Payments Division, be designated to represent the Fund during the consultations to be held in Geneva from November 1 to November 17, 1976. This recommendation was approved by the Executive Board on October 18, 1976 (EBD/76/206, 10/13/76).

In accordance with procedures set out in EBD/56/102, (8/29/56) the Fund has transmitted to the CONTRACTING PARTIES its latest Recent Economic Developments report on Portugal and Supplementary Background Material papers on Israel, South Africa, and Yugoslavia. It is expected that the GATT Committee on Balance of Payments Restrictions will request the Fund's view with respect to the consulting countries. It is recommended that in reply to such requests, the Fund representative should be guided by the statements set forth below.

<u>Israel</u>

Developments in the Israel economy in the last two years have been characterized by efforts to adjust to the sharp imbalances caused by the the depression in world markets and the substantial increases in the prices of imported goods and heavy government expenditures that followed the events of the last quarter of 1973. During these years, the trade deficit (including defense imports) increased from a level of a little over SDR 1 billion a year in the years 1970-72 to around SDR 3 billion annually from 1974 onward. Net inflows of transfers and nonmonetary capital in 1974-76 have increased but not sufficiently to prevent the emergence of persistent and large overall deficits, which are estimated to total almost SDR 1.8 billion for these three years. Over this period, the authorities have pursued restrictive domestic policies involving monetary and fiscal measures, designed especially to restrain private and public consumption, and have taken various external measures, including a very large cumulative depreciation of the Israel pound since November 1974, aimed at inducing a major shift of resources toward the export sector.

As a consequence of these measures, real GNP rose only marginally in 1975 following increases of about 6 per cent per year in 1973-74, and is expected to grow by about 3 per cent in 1976, which is well below the long-term average. Associated with this slower growth in economic activity, there has been a substantial decline in real gross investment and a fall in real disposable income which has depressed the level of real private consumption. Consumer prices, after increasing by 56 per cent in 1974, rose by 24 per cent during 1975, but are expected to accelerate again in 1976 and increase by about 35 per cent due in part to certain policy measures undertaken in the framework of longer-term stabilization, such as the introduction of a value-added tax and the reduction of consumer subsidies.

Given the time needed to produce a structural change in the economy conducive to a sustained and large increase in exports, the balance of payments has been slow to respond to the above-mentioned policies. The trade deficit reached SDR 3.1 billion in 1975, and, with a deficit of SDR 0.2 billion on the services account, the deficit on goods and services exceeded SDR 3.3 billion and was 18 per cent greater than in 1974. During 1975 export growth was hindered by the world recession and by the low profitability of Israel's industrial exports, so that total merchandise exports grew by 8 per cent in value (measured in terms of SDRs) and by only 3 per cent in volume; meanwhile, the value of imports grew by 10 per cent, although when direct defense imports are excluded, civilian imports declined by 2 per cent in value and by 6 per cent in volume, reflecting the extent to which official policies reduced the growth of domestic demand. The net inflow in respect of transfers in 1975 remained at the same level as in the previous year, (about SDR 1.4 billion), while net inflow of nonmonetary capital increased by more than SDR 0.8 billion to SDR 1.4 billion, mainly in connection with the increase in defense imports, but also on account of greater use of short-term financing facilities. Because of the larger net inflow of nonmonetary capital, the net foreign assets of the banking system, which had fallen by over SDR 1 billion in 1974, declined by only SDR 420 million in 1975. Gross reserves of the Bank of Israel at the end of 1975 amounted to SDR 1.0 billion, equivalent to less than two months' imports of goods and services at the 1975 level, and by the end of September 1976 they had risen slightly to SDR 1.1 billion. On the basis of available information, the deterioration in the trade account appears to have been halted in the first eight months of 1976, and a moderate improvement is forecast for the year as a whole. The overall balance of payments deficit in 1976 is expected to be somewhat smaller than the deficit of SDR 420 million registered in 1975.

Exchange rate action has been one of the main elements in Israel's policy of export promotion. Since June 1975, Israel has followed a flexible exchange rate policy under which the Israel pound is depreciated by small amounts at frequent intervals, and since July 1976, the exchange rate has been determined daily on the basis of a basket of five currencies, representing primarily the structure of Israel exports. As of September 29, 1976, the trade weighted depreciation of the Israel pound from the parities existing on May 1, 1970 amounted to 60 per cent. In addition, since March 1976 the authorities have periodically adjusted the rates at which indirect taxes are rebated to exporters pari passu with the depreciation of the exchange rate. Taking into account the increases in domestic costs that have taken place in the recent past, the combined effect of the policy to adjust the exchange rate and the rebate rates has been to maintain the overall profitability of industrial exports.

The Government has continued with its policy of tariff reductions on a wide range of imports and further reductions are scheduled. The temporary prohibition of November 1974 on imports of automobiles was lifted in September 1975, and the advance import deposit requirement introduced in May 1974 was abolished in November 1975. The import surcharge which was also introduced as a temporary measure, and which now amounts to 15 per cent, is still in effect, and in February 1976, it was extended to cover payments for certain invisibles, the most important of which are for foreign travel. In March 1976, the tax on foreign travel was raised and the travel allowance for some categories of travelers was reduced. The Fund granted approval of the multiple currency practice involved in the application of the surcharge to certain invisibles and of the increase in the travel tax until December 31, 1976. On October 20, 1976, the approval was extended until June 30, 1977. The Fund will review this matter in the context of the mid-term review of the stand-by arrangement also approved by the Executive Board on October 20, 1976.

In view of the continued serious balance of payments situation, the present restrictions in Israel, including the maintenance of the temporary import surcharge, may be viewed as warranted to prevent a deterioration in the balance of payments until more fundamental policy measures can be implemented.

Portugal

Since the events of April 1974 the economy of Portugal has passed through a difficult period. Temporary disruptions in production have accompanied efforts to bring about a major redistribution of income. The granting of independence to the former overseas territories upset long standing trade patterns and brought an inflow of refugees equivalent to about 9 per cent of the total population. Simultaneously, the economy experienced the effects of the world recession as export markets weakened, the emigration of Portuguese workers to France and Germany came to a halt contributing further to heavy unemployment, and workers' remittances as well as receipts from tourism declined. Real gross domestic product grew by only about 4 per cent in 1974 and declined by some 3.5 per cent in 1975, despite a favorable agricultural season. Gross fixed investment declined by nearly 40 per cent in 1975, while domestic economic activity was sustained by consumption. The index of industrial wage rates rose by 35 per cent in 1974 and 23 per cent in 1975, while the consumer price index advanced by 25 per cent in 1974 and 15 per cent in 1975.

The balance of payments position deteriorated sharply in 1974 and continued to be serious in 1975, as a result of adverse developments in both the current and capital accounts. Imports were about 40 per cent higher in 1974-75 than in 1973, largely because of higher import prices, especially of oil. In addition, export volumes declined, partly because of reduced competitiveness, but also because of supply disruptions, the loss of markets in the former territories, and restrictions imposed in other countries effecting certain Portuguese exports. Consequently, the trade deficit in 1974-75 was about double the 1973 level. The current account balance swung from a surplus of SDR 291 million in 1973 to deficits of SDR 685 million in 1974 and SDR 691 million in 1975. Capital movements, which were positive in 1974 as enterprises borrowed abroad, shifted to a negative position in 1975 so that the overall deficit doubled to SDR 884 million. Gross international reserves declined from SDR 1,922 million at the end of 1974 to SDR 1,310 million at the end of 1975. Almost SDR 1 billion of these reserves was in the form of gold, valued at $42.22. In the first months of 1976 the current account deficit continued at about the same level as in 1975. Capital outflows appear to have accelerated, but during the summer there was some improvement in invisible receipts. The overall balance of payments deficit for the year as a whole is anticipated to be a little larger than in 1975. By mid-1976 Portugal's net foreign exchange reserves were negative, and a substantial proportion of the gold stock had been pledged as collateral for official foreign borrowing. Gross foreign exchange reserves stood at SDR 414 million or the equivalent of six to seven weeks of 1975 imports.

In addition to running down official reserves to finance balance of payments deficits and undertaking compensatory borrowing from foreign governments, Portugal drew SDR 30 million, the gold tranche, from the IMF in 1975, SDR 115 million under the IMF oil facility in early 1976, and SDR 58 million under the compensatory financing facility in July 1976.

The effective exchange rate remained fairly stable through 1975 but gradually depreciated by a total of about 9 per cent in the first five months of 1976. The policy of gradual depreciation, however, stimulated speculation and capital flight, and was discontinued in June primarily because of unfavorable effects on emigrants' remittances.

As an emergency measure Portugal introduced an import surcharge on May 31, 1975, at rates of 20 and 30 per cent on approximately 38 per cent of imports, effective until December 31, 1975. It was renewed on December 17, 1975, until March 31, 1976 and a second time on April 1, 1976 until December 31, 1976, with slightly reduced coverage. Although the surcharge contributed toward the 25 per cent drop in import volumes during 1975, the main factor in this decline was the weakness of investment and exports.

The new Government, which took office in July 1976, presented a general program for reactivating the economy to the Assembly of the Republic in August. A more concrete list of initial proposals to be introduced in October and November 1976 was announced on September 10. The Government's main objectives are to stimulate productive activity and reduce the balance of payments deficit. The recovery of production and investment is to be pursued essentially through a more flexible price policy to improve the profitability of business enterprises, and through adoption of new regulations governing labor relations and the expansion of public investment. The role of the private sector is to be defined and incentives provided for private investment. A new Foreign Investment Code has already been published. The Government intends to moderate inflationary pressures by avoiding further increases in the budget deficit and reducing the social security deficit. Taxes have already been increased and collections improved. Monetary policy will provide for credit expansion in line with the growth of nominal GNP. A new National Council for Incomes and Prices has been established.

With respect to the external sector the Government intends to encourage merchandise exports, although it recognizes that this policy will take time to implement, partly because of supply constraints. In view of the reserve position and the prospective increase in import requirements as the economy is reactivated, the Government is attempting to contain the growth of imports by establishing a foreign exchange budget for the public sector, by restricting credit for purchases of consumer durables and increasing sales taxes on these items, and by restricting fuel consumption. On October 8, the Government announced that as a temporary measure the rates of the import surcharge would be increased from 20 per cent and 30 per cent to 30 per cent and 60 per cent; the latter rate applies to only about 1.3 per cent of total 1975 imports. At the same time an import deposit requirement of 50 per cent was introduced applying mainly to the imports subject to the 30 per cent rate of surcharge. These restrictions are to be applied in a nondiscriminatory manner.

The authorities regard the import surcharge and the other trade restrictions as temporary actions to help contain the current account deficit while alternative policies are being formulated and implemented. The Fund concurs with this view and, as noted in the decision of the Fund's Executive Board on September 17, 1976, "The Fund hopes that Portugal will as soon as possible adopt a comprehensive program of domestic policies and external measures to achieve the required adjustment in its balance of payments." The adoption of such a program would allow Portugal to reduce its reliance on trade restrictions for balance of payments purposes.

South Africa

Over the past 15 years, South Africa has generally experienced deficits in the current account of the balance of payments which have been more than covered by private long-term net capital inflows. This trend continued in 1974 and early 1975, although the current account deficits were unusually large in this period.

A rapid expansion in domestic activity in 1974 was initially the major cause of the deterioration in the external accounts. Since the end of 1974, however, a decline in the terms of trade and weak overseas demand have contributed to a widening in the current account deficit. To help correct the imbalance in the current account and also, in part, to stem speculation against the rand, the authorities depreciated the rand vis-à-vis the U.S.

dollar by 4.8 per cent in June 1975 and again by 17.9 per cent in September 1975. In support of these changes, monetary policy was tightened during the second half of 1975 by way of increases both in the liquid asset requirements of the banks and in key interest rates.

Financial policies were tightened further during the first half of 1976. Credit ceilings on bank lending to the private sector were imposed in February, and a restrictive budget for the fiscal year 1976/77 was introduced in March. Supplementing the monetary and fiscal measures, the temporary policy of voluntary price and wage restraints introduced in October 1975 was extended for six months in March 1976.

Despite these policy changes and a continuation of the slowdown in domestic activity, particularly in the first half of 1976 when real GDP appears to have declined, the large external imbalance persisted during the first half of 1976 when the current account deficit rose to SDR 1,100 million. Simultaneously with the further deterioration of the current account, there was a marked weakening in the balance of private external capital transactions, in part reflecting uncertainties of a political nature. Of necessity, substantial recourse had to be made by official entities to short-term foreign borrowing of a compensatory nature. In addition, in order to strengthen the foreign exchange component of reserves, the Reserve Bank in March 1976 entered into a gold swap agreement with overseas parties, whereby it sold at market-related prices approximately 5 million ounces of gold spot and repurchased it forward. Gold reserves (valued at SDR 35 per ounce) thus declined from SDR 621 million at end-1975 to SDR 450 million at end-March 1976. Total reserves at end-March 1976 stood at SDR 1,280 million (SDR 240 million higher than at end-December 1975), with the more readily usable foreign exchange component at SDR 783 million (more than SDR 400 million higher than at end-1975). Since March, however--and notwithstanding further compensatory borrowing--the reserve position has weakened at an average monthly rate of over SDR 100 million.

In August 1976, the Fund granted South Africa a new stand-by arrangement. However, South Africa's external position continued to deteriorate as political uncertainties constrained the authorities' ability to increase official borrowing still further or even to roll over some of the short-term credit which had built up during the first half of the year; in the third quarter of 1976, the net inflow of private capital is estimated to have been extremely small, perhaps in part due to the uncertainty in gold markets. By end-August 1976, total reserve assets had fallen to SDR 720 million (about one month's imports), compared with SDR 1,025 million at end-May 1976, and net official foreign liabilities had risen from R 305 million at end-May to R 630 million at end-July.

The policies adopted by the South African authorities to redress the external position and contain inflation include a credit policy aimed at containing the annual growth in net domestic credit to 11 per cent (in the year to June 1977) and a fiscal program which contains the annual growth in government credit to 12 per cent. Also, the Government intends to work toward a continuation of voluntary arrangements to moderate wage and price increases and to continue quantitative ceilings on the growth of bank credit to the private sector. In order to help bolster confidence in the rand and to facilitate the refinancing of the short- and medium-term official borrowing which would fall due in the second half of 1976, the authorities introduced, in August, an import deposit scheme under which a 20 per cent deposit of the f.o.b. value of most imports is required at the time of customs clearance. The scheme is likely to have a sharp short-term effect on imports and liquidity which would be reversed when the scheme is removed.

As already mentioned, on August 6, 1976 the Fund granted South Africa a stand-by arrangement. In the context of this arrangement the South African authorities indicated their intention to terminate the import deposit scheme as soon as circumstances permit, and in any event not later than February 2, 1977. The Fund staff will review the import deposit requirement in the context of South Africa's balance of payments situation in the course of the next consultation discussions scheduled to take place early next year.

The Fund believes that the imposition of the import deposit requirement was, under the circumstances, warranted as a short-term measure to prevent a further deterioration in the balance of payments position. It is too early to assess the effectiveness of the policy measures undertaken in August 1976; however, in view of the continuing reserve losses in the past few months, the instability of the gold price, and the sharp reduction in capital inflow, it may be necessary for South Africa to adjust to its current account position more rapidly and thus perhaps to modify economic policies further than was thought necessary at the time when the financial program was drawn up.

Yugoslavia

The Yugoslav economy grew strongly in 1974, responding initially to export demand and later to a high level of domestic demand. In the following year, measures were taken to reduce demand pressure and the growth of private consumption was sharply curtailed. The growth rate of social product fell from 8 per cent in 1974 to 4.5 per cent in 1975. Investment demand, which had remained at a high level in 1975, moderated in the first part of 1976. A revival in output growth in mid-1976 supported by strong export demand should permit the 1976 target growth of 5.5 per cent in social product to be achieved.

The high level of domestic demand in 1974 and unfavorable developments in world prices combined to raise industrial producer prices by 30 per cent in that year. Since then, domestic demand pressure has been reduced, world prices have moved less sharply and domestic price policies have been more effective. These factors have combined to reduce the rate of increase of industrial producer prices to 22 per cent in 1975 and 11 per cent in the year ending June 1976.

The trade and current accounts of the Yugoslav balance of payments suffered a severe deterioration in 1974, leading to a trade deficit of SDR 3.1 billion and a current account deficit of SDR 1 billion. The greater part of this was due to an adverse movement of 10 per cent in the terms of trade. However, other factors included a stagnation in export volume (partly caused by import restrictions imposed by Yugoslavia's trading partners) and a 20 per cent increase in import volume. No improvement was registered in the trade account until the middle of 1975. Despite the lower level of economic activity in Western Europe, Yugoslav earnings from tourism and remittances from Yugoslav workers employed abroad remained strong and contributed to an improvement in the current account of 1975.

Long-term capital inflows in 1974 were at a similar level to those received in earlier years, but served to finance only 40 per cent of the current account deficit. Thus resort had to be made to short-term foreign borrowing and a draw down of net international reserves. The overall balance of payments deficit was SDR 322 million and gross reserves fell to the equivalent of 1.4 months' imports of goods and services. In 1975, the smaller current account deficit of SDR 782 million was almost entirely financed by long-term capital inflows. The overall deficit was reduced to SDR 44 million but gross official reserves fell further to the equivalent of 1.2 months of imports.

Considerable progress was made in liberalizing the basic system of import licensing in the period up to April 1974. Since that date, and in response to balance of payments pressures, a number of additional import restrictions have been imposed, including the placing in April 1975 of 1,930 items on the list of imports requiring individual approval and the institution of ad hoc licensing for some 30 per cent of imports in June 1975. These measures expired at the end of December 1975. In April 1975, the basic rate of the temporary import surcharge was raised from 6 to 10 per cent, and the reduced rate (for imports of equipment for priority sectors) from 2 to 5 per cent. On January 1, 1976, the reduced rate was raised again from 5 to 7 per cent, 7.5 per cent, 8 per cent or 9 per cent, depending on the degree of priority of the import in question. Also on January 1, 1976 the equalization ("contingency") tax applied to all dutiable imports was raised from 3 to 5 per cent, and on the same date all tariff rates below 5 per cent (unless GATT-bound) were raised to 5 per cent. These tariff increases were to some extent offset by tariff reductions of between 20 and 50 per cent on some imports for priority sectors. The changes in customs duties were an interim measure pending the introduction of a new Customs Law on September 1, 1976.

In addition to the changes in the trade and payments system just described, other changes have resulted from the gradual implementation of the February 1974 Constitution. The new Constitution envisages that the economy be regulated by decisions of the enterprises themselves rather than by state decrees. Enterprises, grouped by branches within the Chamber of the Economy, have been made responsible for limiting their demand for imports to the available foreign exchange generated by the branch or by allied branches from exports and other sources. This form of self-regulation has become increasingly widespread and effective in 1975 and 1976.

The Yugoslav balance of payments has shown a sharp improvement starting mid-1975 as demand revived for Yugoslav exports and the various import restrictions took effect. The trade deficit in the year ending June 1976 was reduced to SDR 2.4 billion, compared with SDR 3.2 billion in the previous 12 months. In the first seven months of 1976, exports were 23 per cent above those of the corresponding period in 1975, and imports declined by 12 per cent. At the end of August 1976, reserves stood at the record level of SDR 1,623 million, or the equivalent of over three months of 1975 imports of goods.

In view of the strong recovery of the Yugoslav balance of payments and the likelihood of sustained demand for Yugoslav exports, the Fund believes that the program of import liberalization, interrupted in mid-1974, should be resumed.