Chapter 7:
Balance of Payments Issue: Openness to International Trade in Israel and around the World

- The share of international trade in GDP in Israel is quite low by international comparison. The country could benefit greatly from the removal of trade barriers.
- In the past two years, there has been an important reform in Israel's foreign trade policy, including the removal of import barriers and a reduction in customs rates.
- Customs rates on imports of agricultural produce to Israel are high, and the volume of Israel's agricultural imports is low compared to OECD countries.
- The reform in the regulatory system and in agricultural imports is expected to contribute to an increase in the wellbeing of Israeli consumers and in the efficiency of the economy.
- The concern of a regression in the globalization process has weighed on expectations of global growth. The US and UK, which led the globalization process in the past, have raised international trade barriers this year.
- The US imposed tariffs on a long list of products, mainly those originating in China; the UK is in the process of exiting the eurozone.
- So far, the mutual imposition of tariffs between the United States and China is not expected to cause real damage to the Israeli economy.
- A one percentage point increase in the bilateral tariff rate, with the remaining factors constant, reduces the volume of imports by 0.8 percent.

1. INTRODUCTION

There is widespread agreement among economists regarding the advantages of openness to international trade. International trade enables an economy to specialize in the production of products and services in which it is efficient relative to the world, and to acquire a large variety of those that have been produced efficiently in other economies. By doing so, it increases productivity and improves consumer wellbeing. Trade barriers reduce trade with the rest of the world, thereby negatively impacting the economy's productivity and economic wellbeing. Lerner[1] (1936) showed that the effect of imposing a tariff on imports is equivalent to the effect of imposing a tax on exports: tariffs will increase the worthwhileness of producing for the domestic market instead of for export, thereby harming exports, and thus will not contribute to a reduction of the deficit in the current account.[2] Empirical experience shows that countries that have instituted high tariffs over time have been characterized by low productivity and slow growth.[3] While reducing tariffs and removing barriers to trade may increase economic inequality in advanced economies, a study of 154 countries over 50 years (1963 to 2014) found that raising tariffs led to an increase in inequality and unemployment and led to a decline in GDP and in productivity.[4]

International trade has grown rapidly and continuously for 50 years. Its share in global output increased from 12 percent in 1967 to 31 percent in 2008, and recognition of its advantages led to a gradual reduction of trade barriers. The reduction of customs rates and the technological improvements in the transportation and logistics sectors have enabled the various economies to establish their comparative advantages in production processes and to benefit from a range of inexpensive and varied products. As the specialization deepened and the range of products expanded, the advantages of trade increased, and the process was strengthened. However, since the global crisis, the growth rate of world trade has slowed considerably, and there has been some withdrawal from the process of globalization. The United States, which in the past led the process, is working to improve its own trade balance; Britain has decided to exit the European Union, and more recently, support for opponents of the globalization process has increased in France, Italy and other countries. Although the opposition to globalization in Europe and in Britain mainly reflects the opposition to immigration, and trade restrictions imposed by the United States mainly reflect the concern that China is exploiting its power to achieve unfair trade advantages, the response to these feelings was also reflected in restrictions on trade. The decline in the globalization

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[1] Lerner, A. P. (1936),"The Symmetry between Import and Export Taxes", Economica, 1936, 3 (11), 306–313.
[2] Costinot, A. and I. Werning (2017). "The Lerner Symmetry Theorem: Generalizations and Qualifications", NBER working paper 23427.
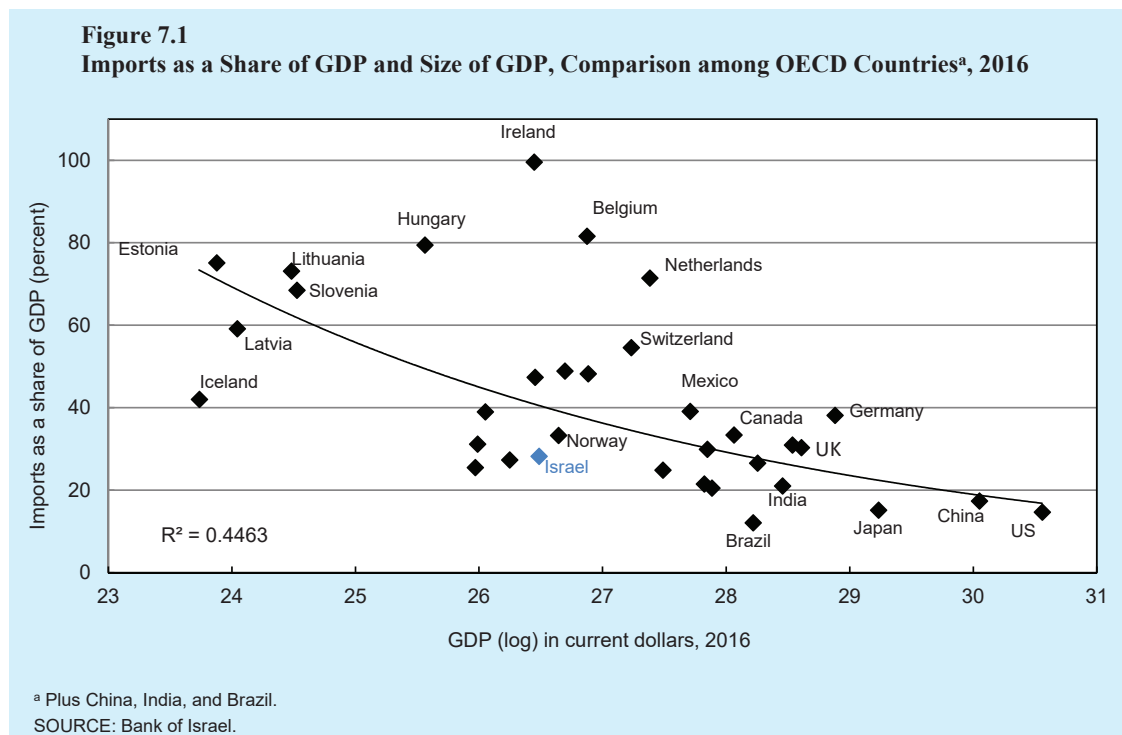[3] Tariffs may be useful as a temporary protection measure for infant industries, but not as a permanent policy.
[4] Furceri, D., S. A. Hannan, J. D. Ostry and A. K. Rose (2019). "Macroeconomic Consequences of Tariffs". IMF working paper wp/17/151.

process was reflected in a downward revision of the forecasts for the growth of world trade and global output, and probably also in the decline in world investments in 2018.

The main concern this year was the intensification of the conflict between the world's two largest economies – the United States and China – during which the United States imposed tariffs on imports from China, China reacted similarly, and so forth. At the beginning of the year there was also concern about the fate of United States' trade agreements with the European Union, Mexico and Canada, but trade agreements between the United States and most of its major trading partners (with the European Union, Mexico, Canada and South Korea) were ratified. At the same time, in 2018 continued progress was made in the openness to trade in other parts of the world: free trade agreements were signed between the European Union and Japan and between Japan, Mexico, Canada, Australia, Malaysia, Vietnam, Singapore, Chile, Peru, New Zealand and Brunei[5] (TPP). If negotiations between the United States and China will be successfully concluded, the concern of a regression in the globalization process will be greatly reduced.

> The main concern this year was the intensification of the conflict between the world's two largest economies—the US and China.

Figure 7.1
Imports as a Share of GDP and Size of GDP, Comparison among OECD Countries[a], 2016

[a] Plus China, India, and Brazil.
SOURCE: Bank of Israel.

> Based on accepted indicators, the Israeli economy's degree of openness is low.

One of the accepted indicators of an economy's degree of openness is the share of imports of goods and services in GDP; according to this index, Israel is ranked 45th out of 58 high-income countries (2010–16 average). Israel's ranking regarding

[5] The United States withdrew from this agreement in January 2017.

the share of goods imports in GDP is even lower.[6] The openness of an economy is a function of the size of the GDP, the level of per capita GDP, and other factors. Based on the estimated share of imports and exports in GDP, given only the GDP and per capita GDP, it was found that Israel's actual international trade volume is much smaller than the fitted value: Israel should be ranked in 16th place in the openness index.[7] Therefore, there are other factors that impact heavily on Israel's volume of trade with the world.

The factors that may account for the low level of trade include Israel's distance from the major markets (Western Europe, North America and East Asia), the Arab-Israeli conflict, the fact that Israeli exports have a relatively small component of imported inputs[8] (because Israel specializes in the export of services), Israel's customs and regulatory policy, and more. In order to examine these factors, we estimated a gravity model: the scope of bilateral trade between pairs of countries as dependent on the following variables: the GDP of each of them, the geographical distance between them and the existence or non-existence of a common border and sea access (non-landlocked) for the importer. The database contains 104 countries, which report the volume of imports from each of their trade partners (in 2016). We totaled the expected volume of imports from each of the countries, and compared those fitted values. The model indicates that Israel's geographical position is not the reason for the low share of imports in its GDP: Israel's expected share of imports is only 2% lower than the average of the expected share of imports of other countries.[9]

Table 7.1 presents the results of the gravity model. The basic estimate shows that the scope of bilateral trade (in goods) is affected by the size of the GDP of each of the countries (the exporter and the importer), the distance between them, the existence of a common border and sea access for the importer. Given these parameters, Israel's

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[6] In the share of goods imports in GDP, Israel ranks 41st out of 62 high-income countries. The share of imports of goods and services in Israel's GDP is 32 percent, compared with 46 percent for the median country (South Korea). (The distribution of countries by level of income is based on the World Bank index). The data is affected by fluctuations in the exchange rate, and therefore we preferred to examine the average for the years 2010 to 2016. The index is not optimal, because the share of imports used as input for exports differs from country to country, but it is a simple and accessible index, and therefore acceptable.

[7] Regarding the extent of unrealized trade (the difference between the actual and forecast share of exports and imports in the GDP) reveals that Israel is ranked 95th; only 7 out of the 102 countries have a greater unrealized potential.

[8] OECD data for 2011 indicate that 25 percent of Israel's goods imports serve as an intermediate input for the production of export goods, compared with 30 percent in OECD countries (average and median). Israel is not exceptional compared to most OECD countries. Ten OECD countries have a lower rate than Israel and 24 have a higher rate (Luxembourg, Ireland, Hungary, the Czech Republic and Slovakia have an especially high rate). This factor—the import of intermediate inputs for the production of export goods—can explain a gap of up to 5 percent between Israel's actual and potential imports, but the gap is much larger.

[9] A gap that is not significantly different from zero.

Table 7.1
Estimates of scope of imports in a gravity model, 2016
Dependent variable: Log of imports in 2016

	1	2	3	4
Dummy for Israel	-1.22	-1.24	-1.24	-1.30
Importer's GDP (log)	1.02	1.01	0.98	0.97
Exporter's GDP (log)	1.34	1.33	1.34	1.27
Distance (log)	-1.35	-1.27	-1.22	-1.15
Shared border (dummy variable)	0.58	0.68	0.75	0.84
Importer is landlocked (dummy variable)	-0.60	-0.46	-0.40	-0.40
Importer and exporter are EU members	0.23[a]	0.28	0.31	-0.09[a]
Customs rate (simple average)	-	-0.02	-	-
Customs rate (weighted average)	-	-	-0.04	-0.03
Free trade agreement	-	-	-	0.38
Importer's GDP per capita	-	-	-	+
Exporter's GDP per capita	-	-	-	+
R^2	0.690	0.691	0.688	0.692
Observations	11,002	9,299	8,452	8,452
Israel's imports relative to forecast[b]	0.68	0.71	0.71	0.64

[a] All the coefficients are significantly different from zero, except those marked with an "a".
All the estimations include a constant.
[b] Israel's imports relative to the forecast are based on the above regressions without the
dummy variable for Israel.

SOURCE: Based on World Bank and World Trade Organization data.

actual imports are 32% lower than the potential.[10] In estimates 2 and 3, we added the customs rate to the estimation equation. As Israel's customs rate (the weighted average of customs on all goods) is not different from the norm in advanced economies (Table 7.2), it cannot explain the low volume of imports.[11] In estimate 4, we also added the per capita GDP of the exporter and the importer and the trade agreements between them. The fact that Israel has a relatively high per capita GDP and important trade agreements with the European Union and the United States increases its import potential. (In this estimation, the gap between Israel's potential imports and actual imports reaches 36%, and is the highest.[12]) According to the model, Israel's imports from neighboring countries are expected to be high: imports expected from Egypt and Jordan are approximately 10 percent and 3 percent, respectively, of Israel's total expected imports, but actual imports from the two countries are negligible (Table

Israel's customs rate is not different from the norm in advanced economies, so it cannot explain the low volume of imports.

[10] This estimate was obtained from Regression 1 in Table 7.1, without the dummy variable for Israel. All the estimations in Table 7.1 included a dummy variable, which receives the value 1 when both the importer and the exporter are members of the European Union (and otherwise, zero).
[11] The share of international-trade tax revenue in Israel's total tax revenues (0.7 percent in 2015) is low compared with the US, Japan, Korea, Canada, Australia and Switzerland (an average of 1.6 percent).
[12] This gap is calculated from an estimate in which the dummy variable for Israel was removed.

Table 7.2
Average customs rate in selected countries

	Customs on all goods World Bank data		Customs on agricultural output WTO data	
	Weighted average	Simple average	Simple average	Customs greater than 15%[a]
Israel	2.25	4.6	78.1	81.2
US	1.71	3.6	4.9	5.5
Eurozone	1.96	5.7	11.8	23.9
Japan	1.31	4.8	18	22.9
China	4.33	10.9	15.7	35.5
South Korea	4.65	13.9	57.9	75.5
Australia	1.41	5.7	3.4	3.5
Canada	0.97	3.3	16	8.9
Switzerland	0.12	9.9	45.5	40.3
Norway	0.37	10	133.5	48.5
New Zealand	1.5	2.1	6.1	13.6

[a] Share of product groups with customs rate greater than 15 percent in 2017.
SOURCE: World Bank data and World Trade Organization.

7.3). In view of the extent of Israel's trade with its neighbors, it can be compared to island economies that have no common borders with other countries. The island countries' share of imports in GDP is not much lower than other countries that have a common border with at least one country and are not landlocked. This indicates that island economies were able to compensate for the lack of land-based trade relations; however, this is in part through a relatively liberal tariff policy, which contributed to an increase in the volume of their total imports.[13]

World Bank data indicate that the import process to Israel is longer and more expensive than that of the other OECD countries (Table 7.4), meaning that its simplification could contribute to the realization of Israel's trade potential.[14] In addition, Israel has over 600 different import standards, many of which are unique to the country.[15] In the past, representatives of the Manufacturers Association of

Israel has over 600 different import standards, many of which are unique to it. The process of importing to Israel is longer and more expensive than to other OECD countries.

[13] Island economies: Japan, Australia, New Zealand, Indonesia, the Philippines, Cyprus, Iceland, Jamaica, Madagascar, Malta, Mauritius and the Seychelles Islands. The customs rate of island economies is 1.1 percentage points lower than that of other non-landlocked countries. When the effect of the customs rate is neutralized, the imports of an island are found to be approximately 4 percent lower than that of other non-landlocked countries.

[14] It is difficult to expect Israel to compare to the OECD countries since many of them are members of the European Single Market, where trade is almost devoid of barriers.

[15] "Canned Corn without Strings and Tomato Sauce without Flavor: the Practice of Blocking Imports to Israel, the Full List", Ora Coren, The Marker, September 27, 2018.

Table 7.3
Estimates of scope of Israel's bilateral imports[a], and actual imports, 2016 ($ billion)

	Model's estimate[a]	Actual imports	Ratio, as a percent
US	15.2	8.1	53
China	11.2	5.9	53
Egypt	8.8	0.1	1
Germany	7.3	4.1	56
Turkey	6.0	2.6	43
Italy	4.8	2.7	56
France	4.2	1.7	40
UK	4.2	3.7	89
India	2.9	1.8	63
Jordan	2.8	0.3	11
Japan	2.7	2.4	89
Russia	2.4	0.9	40

[a] As derived from the gravity model presented in Table 7.1.
SOURCE: Based on World Bank.

Israel participated in setting standards, and there are claims that they exploited this to protect domestic output. A committee in Israel is currently reviewing all official standards and cancelling the additions unique to Israel (unless the unique addition is approved by the committee, the Minister of Finance and the Prime Minister). Recent studies[16] have found that reducing the difference in regulation vis-a-vis trade partners has a marked impact on the volume of trade: the gap in the volume of bilateral trade between countries with notably similar standardization and countries with notably different standardization than their trade partners is equivalent to a gap stemming from a reduction of 8 percentage points in the customs rate. This important reform in standardization joins a long series of changes that are expected to reduce the import barriers in the economy and to contribute to increased productivity and consumer wellbeing.

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[16] Cadot, O., J. Gourdon and F. van Tongeren (2018). "Estimating Ad Valorem Equivalents of Non-Tariff Measures: Combining Price-Based and Quantity-Based Approaches", OECD Trade Policy Papers, No. 215, OECD Publishing, Paris.

Table 7.4
Bureaucratic barriers to import, Israel compared with OECD, 2018

	Israel	OECD
Time to import, documentary compliance (hours)	44	4.2
Time to import, border compliance (hours)	64	9.5
Cost to import, documentary compliance (US$)	70	28.5
Cost to import, border compliance (US$)	307	108.5
SOURCE: World Bank data.		

2. LIBERALIZATION OF ISRAEL'S FOREIGN TRADE POLICY

> The reform in standardization joins a long series of changes that are expected to reduce the import barriers to the economy and to contribute to increased productivity and consumer wellbeing.

This year saw the beginning of implementation of an important reform on the subject of regulatory approvals for imported products: international standards were adopted and barriers to the operation of private standards laboratories were removed. In addition, importers of wireless communications equipment no longer require special approval from the Ministry of Communications (the "Wi-Fi Reform") and the importers of food and cosmetics do not require a special import license (except for sensitive products)—the importer's declaration that the product has undergone laboratory testing is sufficient (the "Cornflakes Reform" and the "Colgate Reform"). The reforms simplify the import process for those who are not exclusive franchisees, including for obtaining the necessary approvals from the Ministry of Health and for obtaining a kosher stamp from the Rabbinate[17]. Another reform grants an almost blanket exemption from complying with the import standard for personal imports via the Internet. Households may order up to 30 identical items valued at a total of up to $1,000 per shipment, or 5 items costing more than $1,000, without it being considered a commercial import and without the need for regulatory approvals. The market power of exclusive importers in Israel[18] is diminishing along with the rise in the power of global e-commerce retailers, who mediate very efficiently between the Israeli consumers and the importers and merchants around the world, and this reduces the consumer price of certain products.

> The customs rate on imports of agricultural produce to Israel is high, and the scope of agricultural imports to Israel is low compared to OECD countries.

The scope of Israel's agricultural imports is lower than that of OECD countries (Table 7.5), and the customs rate on imports of agricultural produce to Israel is much higher than in most advanced economies (World Trade Organization data for 2017). In this context, the reform in the milk and dairy products sector may reduce the cost of living, thereby leading to a significant improvement in consumer wellbeing. The government decided on a gradual reduction in tariffs on the import of cheeses and

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[17] The kosher stamp is given to products manufactured at a factory abroad with general annual supervision.

[18] Importers who have received (or purchased) from the manufacturer the right to market their products in Israel exclusively.

similar products[19], and at the same time, on a lowering of the minimum price of the milk sold by the dairy farms. This decision will contribute to a streamlining of the dairy farms and the dairy sector: opening the economy to imports will result in the entrance of cheaper products, forcing local producers to choose manufacturing techniques that will reduce the cost in the long run. These changes are expected to improve the allocation of the economy's resources and general well-being. In addition, in the transition process to the new steady state, there may be real adverse impact to dairy farmers, especially those with small dairy farms, some of which are expected to close. This is especially so in view of the fact that local milk production involves fodder costs, which are more expensive in Israel than abroad (as the animals are provided with feed, as opposed to grazing in open areas). If it turns out in the future, as is hoped, that the economy will have a comparative advantage in milk production, this damage will be slight. However, if it turns out that many small dairy farms will close, the government will compensate them, and for this purpose, NIS 450 million has been allocated for compensation.[20]

Table 7.5
Share of agricultural imports in total imports, Israel and OECD median, 2016 (percent)

	Israel	OECD
Fruits and nuts	0.4	0.8
Beverages, alcoholic beverages, vinegar	0.5	0.7
Dairy products, chicken eggs, natural honey (and edible products of animal origin not specified elsewhere)	0.2	0.5
Vegetables, roots and edible tubers	0.2	0.4
Animal or vegetable fats and oils, products, animal or vegetable waxes	0.2	0.4
Meat and fish	0.1	0.3

SOURCE: UN Comtrade database.

As part of the reform in the import of meat, the customs on the import of calves was canceled. The customs on the import of fresh beef has been gradually decreasing since 2016, and the rate is expected to stabilize at 12% by 2020. In the context of the reform, the import of livestock and their products increased by 52% over the last four years. However, the consumer price index of beef declined between 2015 and 2018

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[19] Customs on the import of cheese will decrease gradually from NIS 7.90 to NIS 3 per kilogram (in 2026). Customs on milk and cream, which currently is 40 percent, will be reduced to 5 percent. The customs on dairy spreads, which is currently 140 percent, will be reduced to 17 percent. The customs on cheese substitutes with vegetable fat and cheese substitutes with soy will be reduced from 25 percent to 3 percent. In addition, the quota for milk powder imports will increase.
[20] Imports of dairy products increased by 14 percent in 2017, and by 36 percent in the first three quarters of 2018 compared with the corresponding period last year. The import of hard cheeses in the duty free quota began in late 2014.

by only 1 percent.[21] In order to reduce the consumer price, in the past two years the distribution of quotas has been based on a tender between the importers competing over the consumer price (i.e., the winner is the importer that offers the cheapest price). At the same time, consideration should be given to whether to continue using the quota system or to initiate a gradual opening of the industry while establishing regulations that will ensure the standards required for the quality of the meat. As to the reform's impact on domestic production, Ministry of Agriculture data (until 2017) indicate stability in the revenues of domestic meat producers.[22]

At the end of 2017, the Minister of Finance announced the cancellation of purchase taxes and customs on a long list of products.[23] Customs on apparel products were reduced from 6 percent to zero, and customs on refrigerators and ovens declined from 12 percent to zero. At the same time, the clothing price index declined by approximately 3 percent, and the index of refrigerator and oven consumer prices declined by 5 percent (the September 2018 CPI compared to September 2017).[24] After the reduction of customs duties, there was a sharp increase in imports of household goods, apparel, footwear and electrical appliances (Table 7.6). The reduction in customs did not lead to an exceptional decline in domestic production (Table 7.7).

Removing trade barriers and customs is good for the economy and contributes to wellbeing, but the removal of mutual tariffs is better yet. Israel is conducting bilateral negotiations on free trade agreements with a number of large and important economies: India, China, Thailand, South Korea and Vietnam. The signing of trade agreements with these countries will enable Israeli exporters to integrate into Asia's large and growing markets more easily, and will increase the resilience of Israeli exports to regional shocks. A unilateral reduction of customs rates reduces the incentive for trade partners to remove mutual tariffs, and thus its disadvantage.[25] In this context, it should be noted that a free trade agreement was recently signed between Israel and the Ukraine, and the free trade agreement between Israel and the EFTA countries (Switzerland, Norway, Iceland and Liechtenstein) was broadened to include many food and agricultural products.

> At the end of 2017, purchase taxes and customs on a long list of products were cancelled, following which the imports of textiles and electronics increased considerably.

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[21] US beef prices declined in the same period by approximately 10 percent.

[22] Opponents of the opening of the economy to agricultural imports argue that this will harm small periphery communities, which rely mostly on agriculture (and indirectly, the periphery towns as well), endanger the supply of food in times of emergency, damage the landscape and more.

[23] The reduction was defined as a temporary order for one year, but was extended again to 2019. Half of the cost of the measure was attributed to the elimination of import customs on textile products (from 6 percent to zero). Close to half was for the cancellation of customs duties and purchase taxes on the import of electrical and electronic goods; products on which customs were reduced from 12 percent to zero: ovens, refrigerators, food mixers, lamps, light fixtures, toys and cosmetics. The 15 percent purchase tax was cancelled on projectors, LCD monitors and display screens, smart cards, converters, amplifiers, video equipment and microphones.

[24] During the period, the nominal exchange rate of the shekel appreciated by 4 percent against the currency basket. It should be noted that the price of the consumer product includes local costs (marketing, transport, insurance, etc.).

[25] In Switzerland and in Norway tariffs are high, and the exemption from them gives the Israeli exporter a real advantage.

Table 7.6
Consumer goods imports in 2017 and in 2018

(percentage change)

	Electric products (and furniture)	Household items	Clothing and footwear
2018[a]	9	31	11
2017	-4	3	0

[a] January through August compared with the corresponding period of 2017.
SOURCE: Central Bureau of Statistics.

Table 7.7
Industrial production indices of selected industries, 2017 and 2018

(percentage change)

	Textiles	Clothing items	Leather and related items	Low technology
2018[a]	-3	1	0	2
2017	-2	4	1	0

[a] January through August compared with the corresponding period of 2017.
SOURCE: Central Bureau of Statistics.

Israel is likely to benefit greatly from the opening of the economy to the import of services, the share of which is gradually increasing in world trade. For example, the agreement on aviation arrangements between the EU and Israel (the "Open Skies" reform) led to a marked increase in the activity of foreign airlines in Israel and doubled the number of Israelis travelling abroad by air (from 3.9 million departures in 2012 to 7.8 million in 2018). The reform led to an increase in incoming tourism to Israel of almost 50 percent (the number of incoming tourists by air increased from 2.5 million in 2012 to 3.6 million in 2018), contributed to increased efficiency of Israeli airlines and increased the wellbeing of Israeli vacationers. Exposure to competition from abroad generally involves a painful and damaging adjustment process in the exposed industry, but at the same time it contributes to the growth of other industries in which the economy has a comparative advantage. In this case, however, the exposed industry was not adversely affected: In 2018, the hotel occupancy rate reached 68 percent, compared with an average of 64 percent in the previous five years[26], on average, and the number of passengers flying with "El Al" increased from 4.1 million in 2012 to 5.6 million passengers in 2018.

Foreign companies are very active in the infrastructure fields: in the construction of the seaports, the Dan region (metropolitan Tel Aviv) subway and the light railway

The "Open Skies" reform led to a marked increase in the activity of foreign airlines in Israel and doubled the number of Israelis travelling abroad by air.

[26] Forty-six percent of total person-nights were tourists, compared with only 41 percent in the previous five years.

In October 2016, six large foreign construction companies were permitted to operate in the residential construction sector, but foreign firms' activity in the industry remains too limited.

in Jerusalem, the laying of new railway lines, the electrification of the trains, the excavating of the Carmel Tunnels and more (in some cases in collaboration with local companies). In contrast, the activity of foreign companies in the residential construction sector is limited. In October 2016, six large foreign construction companies were permitted to operate in the residential construction sector. Each of the six companies was authorized to employ up to 1,000 foreign workers in framing and construction jobs. These quotas were stipulated in the tender, in which 50 foreign companies participated, provided they cooperate with a local contractor. Looking ahead, it is important to ensure that the rules set by the government will reflect the potential advantages of foreign firms, including the use of advanced building techniques, advanced management and manpower professionalism, so that this will lead to increased competition, increased use of physical capital and reduced apartment prices. In this context, it is important to ensure that fair competition is created in relation to the hiring of foreign workers, which requires a restriction on the hiring of foreign workers by these firms.

The import of insurance and financial services in Israel is low compared to OECD countries.

Comparison of the composition of Israel's services imports with that of the OECD countries shows that the import of insurance and financial services in Israel is low: this import constitutes only 2.7 percent of the total import of services, compared with 9.7 percent in OECD countries. The shares of computer and communications service imports and of tourism service imports in Israel's services import and the OECD are quite similar. The share of transport service imports in Israel's services imports is higher (29 percent compared to 23 percent in the OECD).

The liberalization in imports is expected to contribute to increased productivity and to an improvement in consumer wellbeing.

In summary, in the past two years a series of laws and regulations have been promoted, which together constitute a kind of trade reform. The economy adopted accepted international import standards, the import process became simpler and faster, customs duties were reduced on a long list of consumer goods, and progress was made in exposing some of the services and agriculture industries to imports. The liberalization is expected to contribute to an improvement in consumer wellbeing and to increased productivity by increasing competition with imports and enhancing the economy's specialization in sectors in which it has a comparative advantage. Since the reform is being carried out while unemployment is low, the cost of the resulting adjustment processes is relatively small.

3. THE CHANGE IN UNITED STATES TRADE POLICY

In September, the US imposed a 10 percent tariff on goods imported from China and threatened to increase it to 25 percent.

At the beginning of 2018, about a year after the current president was elected, the United States decided to raise tariffs on solar panels and washing machines (February) and on steel and aluminum (in March); in July, a 25 percent tariff was imposed on a range of products imported from China amounting to $50 billion; in September, a 10 percent tariff on was imposed on goods imported from China (amounting to $200 billion); in May 2019, the tariff was raised from 10 percent to 25 percent. The United States threatened to impose a customs duty of 25 percent on the remaining goods

imported from China (in the amount of $260 billion). In response, China imposed a customs duty on goods amounting to $110 million imported from the United States and threatened to impose tariffs on the remaining goods imported from the United States as well (amounting to $40 billion).

a. The impact of the change in United States trade policy on the Israeli economy

From Israel's point of view, the main question is the impact of the conflict between the US and China on the Israeli economy. The OECD assesses that the imposition of bilateral tariffs will harm other countries, and especially those with close trade relations with the US and China. For example, the organization expects that a 25 percent tariff imposed on all trade between China and the US will result in a quarter of a percent drop in the GDP of Canada and Mexico, where half of their goods exports are destined for the US .[27] By the same logic, since a quarter of Israel's export of goods is destined for the US, Israel's GDP is also likely to be negatively impacted. In contrast, the International Monetary Fund (and the CPB in the Netherlands) estimated that Europe is expected to benefit from the increase in bilateral tariffs between China and the US.[28] The imposition of bilateral tariffs will result in a diversion of trade: US imports from China (and China's from the US) will be partly replaced by more expensive imports from other countries that may benefit from the struggle. This indicates that the imposition of mutual tariffs between the US and China is not expected to cause real damage to other economies around the world, including Israel.[29] More important would be a settlement reached between the US and China at the end of the "trade war": Israel would benefit if China reduced its customs duties and removed trade barriers with all countries, and would be harmed if China reduced import barriers only to imports from the United States.[30]

The imposing of mutual tariffs between the US and China is not expected to cause real damage to the Israeli economy.

It is important to note that the change in US trade policy has not only touched on the increase in the customs rate, but has been reflected in a wider range of policy measures, including a change in the taxation method of US-owned multinational corporations in the US tax reform of 2018. Another development relevant to Israel relates to the new US aid agreement to Israel (signed during the previous president's tenure). The

Israel is expected to increase the scope of defense imports from the US, and maybe the scope of agricultural imports as well.

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[27] The scenario predicts that if a 25 percent bilateral tariff is imposed on all trade between China and the US, then US GDP will decline by 0.75 percent. The OECD estimated that the bilateral tariff increases between China and the US (including that planned for the beginning of 2019) would deduct 0.5 percent of the GDP of each of them (in 2020).

[28] The IMF estimated that the impact on Europe was positive in the short term and negligible in the long term. The CPB estimated that in the long term (2030), European GDP would increase by 0.2 percent, US GDP would decrease by 0.3 percent, and China's GDP would decrease by 1.2 percent, in relation to the tariffs imposed by the US on goods from China in the amount of $50 billion, as well as the tariffs imposed by the US on the import of aluminum and steel and China's reciprocal tariffs.

[29] Except for an extreme scenario (with a low probability), according to which there will be a severe negative impact to investor confidence.

[30] Israel's exports are US market-oriented, so a trade agreement that benefits the US economy could indirectly benefit Israel.

agreement determines that the aid component that can be used in procurement from Israeli industries will gradually decrease from $815 million in 2019 to $450 million in 2025 and zero in 2028. In addition, the IDF will no longer be able to use the aid money to purchase jet fuel from the United States, and the funds will be used to increase the purchase of American products. Another important development is the negotiations to reduce trade barriers on imports of US agricultural products to Israel.

b. Factors in the imposition of customs duties

Imposing tariffs is not desirable, and at times it derives from short-term considerations for narrow interests.

There is widespread agreement among economists regarding the advantages of removing trade barriers in general and customs in particular. As such, how can the fact that customs is such a common tax be explained? The probability of tariffs being imposed increases in economies with a large and ongoing deficit in the current account: the fear that such a deficit will end with a sharp and sudden devaluation and an economic crisis may motivate policymakers to limit imports. The imposition of customs also increases domestic demand for domestic output, and may allow the government to record a short-term achievement reducing the unemployment rate. Another economic explanation for the imposition of customs stems from the realm of political economics, according to which the activity of a political lobby for the imposition of a tariff on a particular product is worthwhile to its promoters because the profit from it is divided among the few and the loss is divided among many.[31] The imposition of tariffs on a specific trade partner could constitute a strategic move to force the trade partner to remove bilateral tariffs. As mentioned above, the profit from removing bilateral trade barriers is greater than the profit from unilaterally removing trade barriers, and therefore has the potential to develop into a "trade war", especially between large economies. Regarding the China-US relationship, we note that in recent years there has been a change in China's conduct: the surplus in its current account has gradually narrowed from 9 percent of GDP (in 2006 to 2008, on average) to 1.4 percent of GDP in 2017, and the barriers to imports of goods and services and to international movement of capital and money are diminishing. Both China and the US will benefit from the continued removal of barriers to the movement of goods, services and capital.

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[31] Grossman, M.G. and E. Helpman (1994). "Protection For Sale", *The American Economic Review* 84, No. 4, 833–850.

4. QUANTIFYING THE EFFECT OF CHANGES IN CUSTOMS RATES ON THE VOLUME OF TRADE

A study by Bergstrand, et al. (2015)[32] examined the average impact of 42 free trade agreements signed in the 1980s and 1990s.[33] The study found that a free trade agreement increased the bilateral trade in goods by an average of 50 percent over 20 years (compared to the hypothetical state in which a trade agreement had not been signed). Caliendo and Parro (2009)[34] found that the NAFTA agreement had a particularly large impact on the volume of trade: the customs rate imposed by Mexico, Canada, and the United States on imports from the other NAFTA members before the agreement was 12.5 percent, 4.2 percent and 2.7 percent, respectively, and it dropped to zero. The study found that due to the agreement the volume of trade of Mexico, Canada, and the United States with the other NAFTA members rose by 118 percent, 11 percent, and 41 percent, respectively. A relatively small number of studies[35] directly estimated the effect of a change in the customs rate on the volume of trade. A study by Baier and Bergstrand (2001)[36] found that an increase of one percent in the customs rate reduces the volume of bilateral trade by 2–4 percent (i.e., elasticity of 2 to 4, in absolute value). In a study by Haveman et al. (2003)[37] a lower effect was found—elasticity of 1.6.

To examine the impact of customs on the volume of trade, we used detailed data recently published by the World Bank. The data include customs rates imposed by 165 countries on each of their trade partners in each of 96 different product groups.[38] The data relate to the years 1996 through 2013 (but they are not complete[39]). We focused on imports from only 36 economies. The 36 source countries were chosen according to their importance in world trade: they are the source for most trade. Our estimates are based on a gravity model. The dependent variable is the volume of imports of the reporting country from its trade partner. The explanatory variables include the

[32] Baier, S.L., J. H. Bergstrand and M. Feng (2014). "Economic Integration Agreements and the Margins of International Trade", *Journal of International Economics* 93, 339–350.

[33] Including the EU Agreement, the North American Free Trade Agreement (NAFTA), the South American trade agreement, and bilateral agreements, including Israel's trade agreements with the US, the EU, EFTA, Canada, Hungary, Turkey and Mexico.

[34] Caliendo, L., and F. Parro (2015). "Estimates of the Trade and Welfare Effects of NAFTA", *Review of Economic Studies*, Oxford University Press, 82(1), 1–44.

[35] Extensive research literature examines the question of whether the increase in trade is due to an increase in the exports of firms that did not export previously or to an increase in the exports of veteran exporting firms. See for example:Chaney, T. (2008). "Distorted Gravity: The Intensive and Extensive Margins of International Trade" *American Economic Review*, 98 (4), 1701-1721.

[36] Baier, S. and J. Bergstrand (2001). "The Growth of World Trade: Tariffs, Transport Costs, and Income Similarity", *Journal of International Economics*, 2001, 53, issue 1, 1–27.

[37] Haveman, J., D. U. Nair-Reichert and J. G. Thursby (2003). "How Effective are Trade Barriers? An Empirical Analysis of Trade Reduction, Diversion, and Compression", *Review of Economics and Statistics* 85(2), 480–485.

[38] The database does not present the imports of EU countries at the individual level.

[39] Data exists for several countries from 1989. Data for the years before 1995 are very sparse.

size of the GDP of the reporting country (the importer), the size of the GDP of the trade partner (the exporter), the geographical distance (in kilometers) between the importer and exporter and the existence or absence of a common border between the two countries (dummy variable).

In estimations 1 and 2 in Table 7.8, it was found that a one percentage point rise in the bilateral tariff rate reduced trade by 0.8 percent, a low estimate compared to most of the studies quoted above. An increase of one percent in the GDP of the importing country increased the volume of bilateral trade by 0.7 percent, and an increase of one percent in the GDP of the exporting country increased trade volume by 0.75 percent. As expected, the geographical distance and the common border had a statistically significant effect. The estimate of the effect of customs on the volume of trade remained unchanged when the dummy variables for years were omitted[40], and slightly decreased (from 0.8 percent to 0.7 percent), when dummy variables were added for the importing countries and for the exporting countries; the addition of dummy variables to each group of goods reduced the estimate to only 0.4 percent (Column 4 in Table 7.8).

A one percentage point rise in the bilateral tariff rate, other factors being unchanged, reduces trade by 0.8 percent.

Table 7.8
Estimate of the impact of customs on scope of bilateral trade[a,b] in a gravity model, 1996–2013

	1	2	3	4
Bilateral customs rate[c]	-0.008	-0.008	-0.007	-0.004
Importer's GDP (Log)	0.701	0.703	0.626	0.745
Exporter's GDP (Log)	0.737	0.744	1.159	1.263
Distance (Log)	-0.833	-0.835	-1.192	-1.393
Shared border (Dummy)	1.245	1.223	0.814	0.9
Dummy for year	-	+	+	+
Dummy for importer	-	-	+	+
Dummy for exporter	-	-	+	+
Dummy for product group	-	-	-	+
Overall R^2	0.235	0.237	0.305	0.480
Observations	3,425,509	3,425,509	3,425,509	3,425,509

[a] All the coefficients are significantly different from zero.
[b] The dependent variable is the scope of bilateral trade between a pair of countries in the specific product group in the specific year. Every observation marks the scope of imports of one of the 165 countries in one of the 36 selected trading partners in one of the 96 specific product groups, in a specific year, in current dollars.
[c] The custom rate is the (simple) average of the customs rates imposed by the importer on certain shared trade in a certain product.
SOURCE: Based on World Bank data.

[40] We also estimated separate equations for each year and found that the estimate is stable over the years.

We also performed estimations using the Fixed Effects method, enabling trade between countries in a given product group to be monitored over time. (This estimation is equivalent to the addition of a large number of dummy variables to Model 1 in Table 7.8—a separate dummy variable for each trade movement between each pair of countries in a product group.[41]) Due to technical limitations, we performed separate estimates for each of the 96 product groups. This has an advantage because each group is affected differently by the explanatory variables (some are sensitive to the increase in the GDP, some to the distance, etc.) The estimates included the previous explanatory variables: the GDPs of the importing country and of the exporting country, the distance between them and the existence of a common border; two additional variables: the customs rate imposed by the reporting country on imports from the trade partner in the relevant product group; and another variable – the average (weighted) customs rate imposed by the reporting country on imports from other countries, in that product group.[42] In this way, we estimated the effect of a change in the bilateral customs when all the other variables, including the customs imposed on other countries, remain unchanged. Table 7.9 presents the average value of the 96 coefficients and their standard deviation, as well as the median value of the coefficients. An increase of one percentage point in the customs rate imposed by Country A on Country B will reduce Country A's imports from Country B by an average of 1.3 percent. The median coefficient indicates a much more moderate effect – only 0.6percent.[43] We repeated the entire process after adding 25 dummy variables to the list of explanatory variables, one for each year. The estimates of the average and of the median remained unchanged (Column 2). In the estimation using the Random Effects method, the average effect of an increase in the customs rate on the volume of trade was found to be slightly greater – 1.4 percent (Column 3 in Table 7.9).

According to the estimate (Estimate 2 in Table 7.9), the imposition of a 25 percent tariff on all trade between China and the United States is expected to reduce the volume of trade between them by approximately 16 percent, which is equivalent to half a percent of total world trade.[44] The estimates obtained are lower than those of the OECD[45] and are higher than only those of Linde and Pescatori (2017).[46] The estimates suggest that the decrease in the customs rate is not the main factor in the

The imposition of a 25 percent tariff on all trade between China and the US is expected to reduce the volume of trade between them by approximately 16 percent, which is equivalent to half a percent of total world trade.

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[41] Equivalent to the addition of 96 * 36 * 165 dummy variables (minus one), each of which refers to the trade movement between a specific pair of countries in a specific product group.

[42] The weighted average of the customs rate on all other countries.

[43] The large gap between the average and the median indicates that the effect of customs on trade in the various product groups is not distributed symmetrically: the volume of trade in certain product groups is particularly sensitive to the imposition of customs duties.

[44] In 2016, the average tariff rate on trade in goods (non-agricultural) between China and the US was 5 percent.

[45] The OECD estimated that a 25 percent tariff on all trade between China and the US would reduce world trade by 1.25 percent. World trade, excluding the US and China, is expected to fall by 0.9 percent.

[46] Lindé, J. and A. Pescatori (2017). "The Macroeconomic Effects of Trade Tariffs: Revisiting the Lerner Symmetry Result", IMF Working Paper WP/17/151.

accelerated growth of world trade. According to our sample, the average customs rate around the world declined by 6 percentage points during the years 1995 to 2013, while the volume of world trade increased by 150 percent during the same period (and even more according to World Bank data). According to the estimate, customs reductions increased world trade volume by up to 8 percent. It should be noted that the absence of precise customs data at the individual product level biases the estimate downward, whereas the fact that sometimes the tariff reductions are part of a comprehensive move to encourage imports leads to an upward bias.

Table 7.9
The impact of a 1 percentage point increase in the bilateral customs rate on the scope of trade, estimates for 1989-2013

	1	2	3
	Fixed Effect	Fixed Effect	Random Effect
Median of the 96 coefficients	-0.634	-0.632	-0.655
Average of the 96 coefficients	-1.262	-1.29	-1.413
(standard deviation)	(1.70)	(1.72)	(1.81)
Dummy variables for years	No	Yes	Yes

The coefficients were obtained from separate estimations of 96 product groups. The dependent variable is the scope of trade (imports) between each pair of countries in a specific product group. The independent variables are: the GDP of the importing country and of the exporting country, the distance between them, the existence of a shared border, the customs rate imposed by the importer on a trading partner in the product group, and the (weighted) average customs rate imposed by the importer on the other countries in the product group.
SOURCE: Based on World Bank data.
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