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Israel's foreign trade policy: The benefits of its reform

Doron Lavee[a,*], Gilat Beniad[b], Moran Moshe-Jantzis[b]

[a] *Department of Economics and Management, Tel-Hai College, Upper Galilee, 12210, Israel*

[b] *Pareto Group Ltd., 7th Giborei Israel St., Netanya, Israel*

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Abstract

We use an empirical estimation procedure to examine the effect of macroeconomic variables of Israel's trading partners on the country's exports. The main goal of our study is to use the estimation results to point to the optimal trade policy for Israel, and compare it with the current policy.

Using disaggregated panel data on Israel's exports to its 22 main trading partners we were able to implement a unique estimation procedure, which enables a new and closer look at the effectiveness of the country's foreign trade policy. Our model estimates Israel's total export elasticities as well as specific elasticities of exports to each trading-partner. The model produces positive export elasticities with respect to a partner country's total imports and the real exchange rate. Free trade agreements (FTAs) were also examined, and were found to have a considerable positive effect on exports. A higher level of corruption in the destination country was found to be associated with a lower level of Israeli exports.

Using our estimated results, and taking into account the array of Israel's foreign trade policy tools, we formulated recommendations for policy reform, highlighting the potential benefits of this reform on Israel's predicted exports. If no new foreign trade policy is introduced, a total growth of 74% in Israel's exports is expected over the course of 2012–2020; however, if reform recommendations are implemented, the expected growth rate nearly doubles, as Israeli exports are predicted to grow by a total of 135%.p̂

Keywords: Foreign trade policy; Israel; Policy reform; Export performance

1. Introduction

The role of international trade in promoting countries' economic growth has been the focus of extensive economic research over the years (Feder, 1982; Frankel & Romer, 1999; Levine &

* Corresponding author.

E-mail address: doron@pareto.co.il (D. Lavee).

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Fig. 1. Israel's GDP and export growth rates.

Renelt, 1992). Israel's economic growth patterns show a positive and long lasting link between its international trade performance and economic growth, with exports constituting about 40% of its GDP. Fig. 1 shows the annual growth rate of both Israel's GDP and the country's exports.

Being a small country with a limited supply of natural resources, Israel's policy makers' main concern has long been to ensure its ability to compete in international markets. Since the mid-eighties, this understanding has led the country to develop policy aimed at promoting exports. This included a process of trade liberalization, especially with developed countries. Evidence concerning the effect of this policy may be seen in the composition of Israel's exports in 2010, 65% of which were designated to the USA and Europe.

As part of the effort to stimulate international trade and induce openness to foreign markets, FTAs were signed with several developed countries and blocs. The first of these was signed with the U.S. as early as 1985. FTAs were then reached in the mid 1990s with the European Union, EFTA (the European Free Trade Association, which includes Iceland, Liechtenstein, Norway and Switzerland), Turkey and Canada. Several additional FTAs were signed between Israel and its trading partners[1] over the last two decades and as a result, 65% of Israel's exports[2] in 2010 were covered by FTAs.

Despite the focus on stimulating exports to developed countries, the developing countries' share of Israel's exports had risen over the last few years. The most remarkable increase can be seen in exports to China and India, where exports from Israel have increased annually by 22%, on average, over the last decade. This, relative to annual growth of only 7%, on average, in exports to developed countries. This development can be seen in Fig. 2.

This development has led to an increase in the share of exports to developing countries out of total Israeli exports, from about 14% to 25% over the last decade. This is shown in Fig. 3.

The increase in developing counties' share of Israeli exports alongside their fast-paced economic growth in recent years, has called for special attention on the part of policy makers, concerning the potential to steer exports toward these countries. Accordingly, negotiations are being held toward the signing of trade agreements with India, China, Ukraine, Chile, Columbia and South Korea.

[1] Israel–Mexico FTA (2000); Israel-Mercosur (Brazil, Paraguay, Uruguay and Argentina) FTA (over the course of 2010–2011).

[2] This figure is calculated considering total Israeli merchandise exports.