INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/111

ISRAEL

2018 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

May 2018

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Israel, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis, following discussions that ended on March 14, 2018, with the officials of Israel on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 13, 2018.
- An **Informational Annex** prepared by the IMF staff.

The document listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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May 1, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation with Israel

On April 30, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Israel, and considered and endorsed the staff appraisal without a meeting.[2]

Israel is enjoying strong economic growth, at 3.4 percent in 2017, supported by solid domestic demand and higher global growth. Unemployment has declined steadily, to below four percent in early 2018, supporting broad-based wage growth. Nonetheless, inflation remains below the 1–3 percent target range of the Bank of Israel (BoI), reflecting the appreciation of the shekel, increased competition including internet shopping, and government measures to lower the cost of living. The BoI has held the policy rate at 0.1 percent since February 2015 and has stated that monetary policy in Israel will remain accommodative as long as necessary to entrench inflation within the target range. Israel's fiscal deficit was two percent of GDP in 2017—but 2.9 percent excluding one-off revenues—and public debt declined to 61 percent of GDP.

Israel's growth is expected to reach about 3.4 percent in 2018 and remain around this level in the next few years owing to the completion of major projects. Domestic and international conditions are supportive of an increase in inflation, yet significant uncertainty remains around the timing of such a rise. Housing price increases have slowed to only two percent alongside a decline in turnover, but housing affordability remains a problem. In the longer term, however, Israel faces challenges to growth and stability from modest productivity growth despite its dynamic high-tech sector, sizable infrastructure needs that are especially evident in high traffic congestion, and high poverty partly reflecting the lower skills and labor participation of population groups that will rise as a share of the working age population in coming decades.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Executive Board Assessment

In concluding the 2018 Article IV consultation with Israel, Executive Directors endorsed the staff's appraisal as follows:

Israel's strong macroeconomic conditions offer an opportunity to implement further reforms to sustain strong and inclusive growth. Growth of almost 3½ percent in 2017 helped bring unemployment below four percent. But core inflation remains below the 1–3 percent target range. Growth is expected to remain at about 3½ percent in the next few years thanks in part to the completion of major projects, before moderating to around three percent. But in the longer term, a rise in population share of groups with lower labor productivity and participation combined with sizable infrastructure needs could weigh on Israel's growth potential and raise poverty.

Monetary policy should remain accommodative pending a durable rise in inflation and inflation expectations. The BoI maintained an appropriately accommodative stance in 2017 given low inflation and the spillovers from easy monetary policies in major advanced economies. The BoI's guidance that policy will remain accommodative as long as necessary to entrench the inflation environment within the target range has also helped anchor long term inflation expectations. Yet, with expectations for the next few years below or close to the lower target bound, policy tightening should wait until inflation is clearly heading back to target, with the pace of eventual rate hikes being data driven. The external position is broadly in line with fundamentals and desirable policy settings. Given comfortable foreign reserves and with the economy at full employment, exchange rate flexibility should continue to be the first line of defense in the event of external shocks, with foreign exchange intervention limited to addressing disorderly market conditions, which may arise from significant exchange rate deviations from fundamentals.

Reinforcing the financial stability framework is critical to complement the progress being made on enhancing competition. Measures being implemented by the authorities are expected to strengthen competitive pressures. Already, the sources of credit are shifting, making it urgent to approve legislation to establish the FSC to avoid gaps in financial system oversight. Entry by new banks would be welcome, with appropriate deposit insurance and resolution arrangements to contain fiscal costs from potential failure. Banking supervision should continue its efforts to operationalize a risk-focused approach and the adoption of Solvency II by the CMISA is welcome. Financial regulators should harmonize regulations in areas of overlapping activity to avert regulatory arbitrage. Safeguarding the operational independence of financial regulators remains critical to their effectiveness. Slowing housing construction despite still high housing prices calls for continued reforms to make supply more responsive to needs and to improve housing affordability.

Fiscal policy should support Israel's growth potential while building buffers. In 2018 fiscal reserves are allocated to welcome subsidies for after-school childcare, but an expansion of disability benefits should be coupled with a reform of eligibility requirements and testing for new entrants to protect labor participation and contain fiscal costs. The 2019 budget supports technical training in schools and expands the EITC, but adhering to the former deficit target of 2.5 percent of GDP is preferable to gradually reduce debt in normal times. Ensuring the Buyer's Price program is temporary would also support Israel's fiscal health.

Stronger public investment management would help address infrastructure needs and adequate fiscal buffers must be preserved. The development of an integrated long-term national infrastructure strategy through 2030 is welcome. An immediate priority is to ensure that the existing infrastructure is efficiently utilized through demand management tools. The framework for managing infrastructure investment needs to be strengthened to ensure investments are high-quality and timely. If public investment is increased, any rise in the public debt ratio should be modest and temporary, with liabilities from PPPs managed carefully and reported in line with international best practices. The low level of Israel's civilian spending, together with reform needs in education, training, and active labor market policies, indicate that revenues should be the main source of non-debt financing, focusing on reducing tax benefits to limit the drag on growth.

Fundamental upgrades of the business environment are critical, especially reducing bureaucratic bottlenecks. Progress on electricity sector and other reforms is welcome and reforms should continue, including replacing trade barriers on agricultural products with targeted subsidies. Numerous regulations and their high compliance costs remain major impediments to competition and investment, calling for simple and timely administration of regulations, such as a "one-stop shop" that would assess all regulatory requirements within a reasonable period. All proposals for new regulations should be subject to robust regulatory impact assessments. The lengthy process of contract enforcement indicates a need to make court procedures more efficient, and the establishment of a specialized court for complex antitrust cases would support competitive markets.

The government should undertake deep reforms of education and training to reduce the gaps in labor productivity and participation while enhancing redistribution carefully. The effectiveness of schools should be increased, such as through higher standards for teachers, covering core subjects at all grades in Haredi schools, improving Hebrew teaching in Arab schools, and extending the short school day. Enhanced vocational training can also play a large role in reducing skills gaps with expanded active labor market policies further aiding employability. To raise labor participation and work hours of women, childcare support needs to be further expanded, especially for younger children, and increases in the female retirement age should continue without introducing new incentives for early retirement. Alongside enhancing public transportation, enabling workplaces to locate near communities would promote labor participation. Inequality and poverty can be reduced while supporting participation by substantially expanding the EITC and implementing it more effectively, with fiscal costs contained by making transfers more targeted.

It is proposed that the next Article IV consultation with Israel take place on the standard 12-month cycle.

Israel: Selected Economic Indicators, 2014–2020

	2014	2015	2016	2017	2018	2019	2020
				Prel.		Projections	
Real Economy (percent change)							
Real GDP	3.5	2.6	4.0	3.4	3.4	3.4	3.3
Domestic demand	4.2	3.4	6.0	3.5	3.4	3.5	3.0
Private consumption	4.5	3.9	6.1	3.3	3.4	2.9	3.0
Public consumption	3.5	3.2	3.9	3.2	3.0	3.0	3.0
Gross capital formation	4.2	2.4	8.1	4.5	3.9	5.6	3.0
Gross fixed investment	0.8	-0.8	11.9	2.8	3.4	5.6	3.0
Foreign demand (contribution to growth)	-0.5	-0.8	-1.9	-0.2	0.0	-0.1	0.3
Potential GDP	3.7	3.4	3.4	3.3	3.3	3.4	3.3
Output gap (percent of potential)	0.1	-0.6	0.0	0.1	0.1	0.1	0.1
Unemployment rate (percent)	5.9	5.3	4.8	4.2	4.2	4.2	4.2
Overall CPI (percent change, end of period)	-0.2	-1.0	-0.2	0.4	1.0	1.5	2.0
Overall CPI (percent change, average)	0.5	-0.6	-0.5	0.2	0.7	1.3	1.8
GDP Deflator (percent change, average)	1.0	2.7	1.0	0.1	0.2	1.5	1.9
Saving and investment balance							
Gross national saving (percent of GDP)	24.2	24.7	24.0	23.7	23.7	24.0	24.3
Foreign saving (percent of GDP)	-4.0	-4.9	-3.5	-3.0	-2.8	-2.7	-3.1
Gross capital formation (percent of GDP)	20.2	19.8	20.5	20.7	20.9	21.3	21.2
Public Finance (percent of GDP)							
Central government							
Revenues and grants	25.7	25.8	26.4	26.9	25.9	25.7	25.7
Total expenditure	28.4	27.9	28.5	28.9	28.8	28.6	28.6
Overall balance	-2.7	-2.1	-2.1	-2.0	-2.9	-2.9	-2.9
Structural balance 1/	-2.8	-2.0	-2.6	-2.9	-2.9	-2.9	-2.9
Cyclically adjusted primary balance 1/	0.7	0.5	0.3	0.3	-0.6	-0.7	-0.6
General Government							
Overall balance	-3.3	-2.1	-2.1	-2.2	-3.2	-3.3	-3.4
Structural balance 1/	-3.4	-1.9	-2.6	-3.4	-3.2	-3.4	-3.4
Debt	66.1	64.2	62.3	60.9	61.5	61.4	61.3
Of which: Foreign currency external debt	14.9	13.6	13.1	12.8	12.8	12.8	12.8
Balance of Payments (percent of GDP)							
Current account balance	4.0	4.9	3.5	3.0	2.8	2.7	3.1
Goods and services balance	1.5	2.8	1.9	1.5	1.1	1.1	1.5
Exports of goods and services 2/	32.2	31.3	30.3	29.2	30.0	30.3	30.5
Real growth rate (percent)	1.9	-2.7	2.5	3.7	4.3	4.5	4.5
Export prices growth (percent)	0.1	-4.0	0.5	2.6	5.7	0.9	1.6
Imports of goods and services 2/	30.8	28.3	28.2	27.5	28.9	29.2	29.0
o/w Oil imports (billions of U.S. dollars)	12.8	7.4	5.8	7.4	9.1	8.8	8.6
Real growth rate (percent)	4.0	-0.3	9.4	4.3	4.4	5.0	3.6
Import prices growth (percent)	-0.7	-10.5	-2.9	2.9	7.5	0.3	1.1
Foreign reserves (eop, US$ billions)	86.1	90.6	98.4	113.0	120.6	125.8	132.7
Exchange Rate							
NIS per U.S. dollar (period average)	3.58	3.89	3.84	3.60	…	…	…
Nominal effective exchange rate (2005=100)	106.4	108.0	111.6	119.1	…	…	…
Real effective exchange rate (2005=100)	103.5	103.3	104.8	109.7	…	…	…
Terms of trade (2010 = 100)	96.5	106.7	108.2	104.5	102.2	102.8	103.3

Sources: Bank of Israel; Central Bureau of Statistics; Haver Analytics; and IMF staff estimates and projections.
1/ Percent of potential GDP.
2/ National Accounts data.

INTERNATIONAL MONETARY FUND

ISRAEL

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

April 13, 2018

KEY ISSUES

Israel's economy is growing well with inflation remaining low and the housing market cooling. Growth of about 3½ percent in 2017 helped bring unemployment below four percent in early 2018, supporting robust wage rises averaging 3¼ percent. Yet, partly owing to the appreciation of the shekel, inflation remained below the 1–3 percent target range. House price increases slowed to below two percent as proposed tax measures deterred investor interest. Prospects for the next few years are for growth to remain around 3½ percent with inflation rising gradually.

But Israel faces major challenges to growth and stability in the longer term:

- Despite a dynamic high-tech sector, productivity is low and growing only modestly.
- Infrastructure gaps are a contributing factor, most evident in high traffic congestion.
- High poverty partly reflects the lower skills and labor force participation of communities that will rise as share of the working age population.

Reforms and investment should be combined to sustain high and inclusive growth:

Closing gaps in productivity and participation requires broad-based reforms:

- Education and training reforms are key to enhance the productivity and employability of communities with low household incomes.
- Improving the business environment, especially modernizing regulation and its administration, can support inclusiveness as well as boost productivity and incomes.
- The Earned Income Tax Credit should be further expanded and administered more effectively to reduce inequality while enhancing labor participation.

Infrastructure investment should be raised efficiently and demand better managed:

- Demand management policies are a priority to better utilize existing infrastructure.
- Infrastructure investment should be carefully managed to maximize growth benefits.
- Higher investment should be funded in a way that preserves adequate fiscal buffers.

Macroeconomic policies should help sustain growth while protecting fiscal buffers:

- Monetary policy should remain accommodative pending clear signs of a durable rise in inflation, while remaining prepared to tighten more rapidly if needed.
- The deficit of the general government should be limited to 3 percent of GDP by 2019, to allow a gradual reduction of debt in normal times.

Approved By
Philip Gerson (EUR) and Gavin Gray (SPR)

Discussions were held in Jerusalem and Tel Aviv during March 4–14, 2018. The team comprised Mr. Beaumont (head), Mses. Mineshima and Nguyen (all EUR), and Mr. Chociay (FIN). Mses. Ftomova and Vega (all EUR) assisted the mission from headquarters. Mr. Etkes (OED) joined most meetings. The mission met with Bank of Israel Governor Flug, senior representatives of the Ministry of Finance and Prime Minister's Office, other senior officials, academics, and trade union and private sector representatives.

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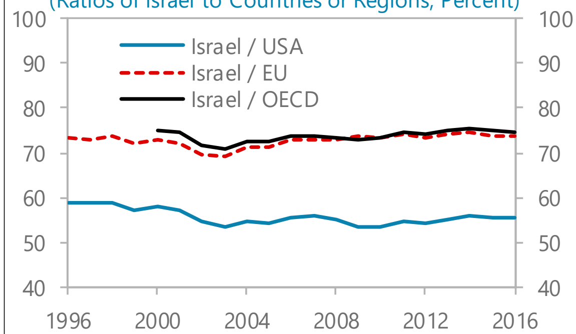
CONTEXT

1. Israel is often characterized as a dual economy, with a dynamic high-tech sector but the remainder with relatively low productivity.[1] Israel's high-tech sector is famous for startups but it also includes R&D centers of many major technology companies, with average wages in the high-tech sector being more than double those in the rest of the economy. However, Israel's overall labor productivity growth has averaged only ¾ percent y/y in recent decades, so its sizable productivity shortfalls have not narrowed.

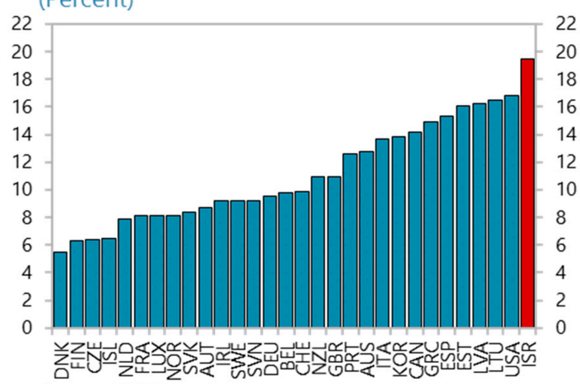
Hourly Labor Productivity 1/
(Ratios of Israel to Countries or Regions, Percent)



Source: OECD
1/ Data in US dollars at constant prices, 2010 PPPs.

2. Inequality and poverty are high relative to other advanced economies, but there are economic and political challenges to increasing redistribution. Israel's relative poverty based on disposable income is the highest among advanced economies. Poverty is especially prevalent within the Israeli-Arab and Haredi populations, mainly due to their low labor participation and skills.[2] Although Israel's tax progressivity is comparable to that of peers, the redistributional impact of government policies is the lowest in advanced economies. This partly reflects deep welfare reforms in the early 2000s, including reductions in child benefits that fell most heavily on the Haredi and Israeli-Arab populations, especially the Haredi as they often have large families.[3] Although these reforms initially raised inequality and poverty, they had the important benefit of promoting higher labor participation and lower inequality in market incomes.

Relative Poverty, 2015 or the latest available
(Percent)



Source: OECD

3. Traction of Fund advice is generally good. A number of recommendations from the Financial System Stability Assessment (FSSA) in 2012, technical assistance on medium-term fiscal management in 2015, and technical assistance on banking supervision in 2016, have been implemented or are in the process of implementation (Annex I). Consistent with the recommendations of the 2017 Article IV consultation, the authorities subsequently expanded the amount and coverage of the Earned Income Tax Credit (EITC), although it remains modest.

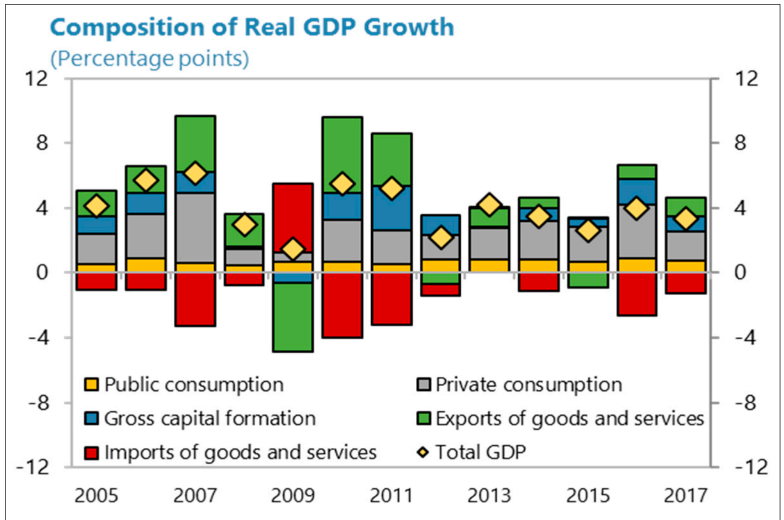
[1] See Gilad Brand, "Why Does the Start-Up Nation Still Have Low Productivity?" Taub Center Policy Research, 2017.

[2] Arabs with Israeli citizenship are about 21 percent of the population. Haredi are ultra-orthodox Jews, who stand at about 11 percent of the population, but about one-fifth of children under 15 years of age.

[3] The low equivalized incomes of Haredi households partly mirror their high number of children and the focus of Haredi secondary schools for males on religious studies rather than math, science, and other marketable skills.

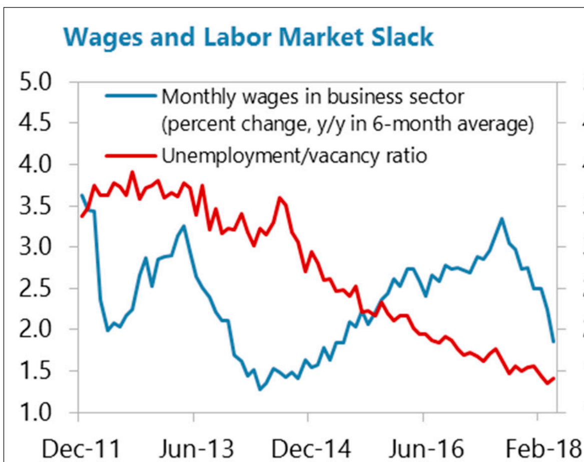
RECENT DEVELOPMENTS

4. **Israel continues to enjoy strong macroeconomic performance.** Despite a reversal of one-off factors boosting 2016 GDP, the economy grew 3.4 percent in 2017 owing to robust domestic demand and higher global growth lifting exports by 3.7 percent. Consumption growth reverted to 3.3 percent after an unusually high increase in 2016 when car purchases surged ahead of vehicle tax hikes. Fixed investment rose 2.8 percent even after a double-digit increase in 2016, bolstered by imported machinery, such as Intel facility upgrades, and non-residential construction.

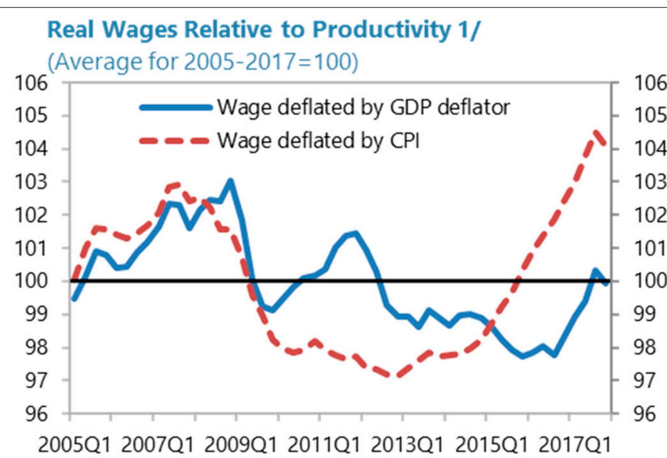


Sources: IMF World Economic Outlook; and IMF staff calculations.

5. **Solid wage growth is supported by low unemployment and terms of trade gains.** Employment growth remained strong at 2¼ percent in 2017, bringing unemployment down to historical lows of 3¾ percent in January–February 2018, and labor participation steadied near historical highs. At the same time, vacancies continued to rise, with a declining unemployment/vacancy ratio supporting a rise in nominal wage growth to 3.3 percent in 2017. Wages have risen significantly relative to the CPI even as real product wages remain broadly in line with labor productivity. In addition to government measures reducing the cost of living, this divergence reflects terms of trade gains driven by declining energy prices and an earlier strengthening of the U.S. dollar (main export destination) against the euro (main import source) (BoI 2017). Recent U.S. dollar weakness may lead to some unwinding of these terms of trade gains.

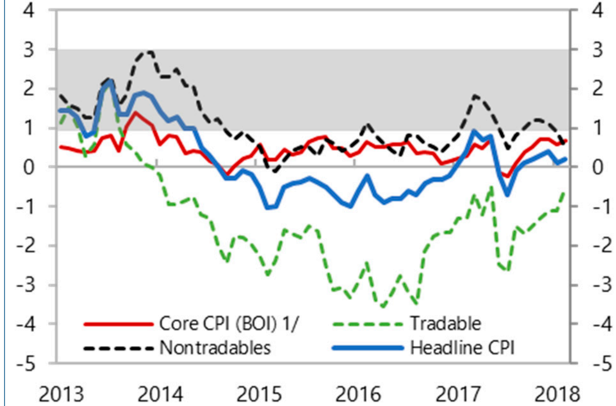


Sources: Haver Analytics; and IMF staff calculations.



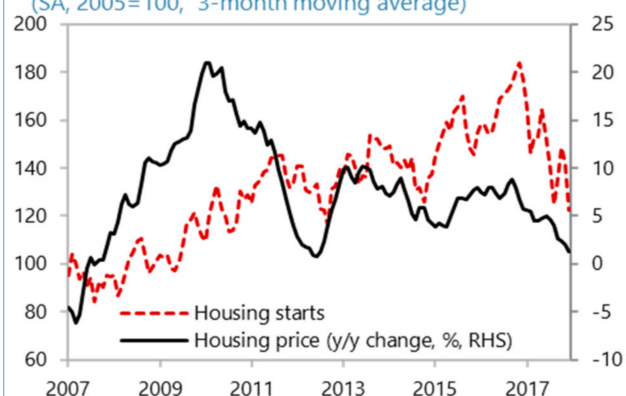
Sources: Haver Analytics; and IMF staff calculations
1/ Ratio of 4-quarter average real wages to trend in labor productivity.

6. Yet, CPI inflation remains low, partly owing to shekel appreciation. Inflation has risen recently after dipping in mid-2017, but remains below the BoI's 1–3 percent target range. Tradable goods prices continued to decline owing to the 6¾ percent appreciation of the nominal effective exchange rate in 2017, low inflation in key import origins (e.g., Europe, China), and increased retail competition.[4] Policy efforts to reduce the cost of living also contributed to lower inflation in 2017. Excluding such measures, core CPI inflation was 0.7 percent y/y in February 2018.



Sources: Central Bureau of Statisstics, Bank of Israel, IMF staff calculations
1/ Excludes energy, vegetables and fruit, and government measure to reduce prices.

7. Housing price increases have slowed significantly but supply may also be weakening. After more than doubling since 2008, house price rises slowed to under two percent y/y in 2017, below household income growth. Transactions also declined, with investor activity likely affected by the proposed tax on owners of more than two apartments, and first-time buyers waiting to see the "Buyer's Price" program impact.[5] But residential investment began to decline in mid-2017, and a 16 percent y/y fall in starts in H2'2017 suggests further falls to come.



Source: Haver Analytics.

OUTLOOK AND RISKS

8. Some special factors are expected to support growth in the next few years and a gradual pick up in inflation is anticipated, although its timing remains uncertain. In 2018, an advance in car purchases ahead of a January 2019 vehicle tax hike is expected and exports are projected to firm owing to stronger trading partner activity, with overall growth forecast at around 3½ percent. In 2019–20, growth of 3¼–3½ percent is aided by the completion of a few major investment projects (i.e., Intel's facility upgrades and the Leviathan natural gas project). Absent such drivers, on current policies growth is projected to return to around three percent, in line with trends in the labor force and productivity. With the output and employment gaps broadly closed, a continuation of solid nominal wage growth together with some firming of international inflation

[4] BoI (2017) estimates that increased competition in the domestic tradable goods market—especially increased access to retail Internet sites—lowered the CPI by 0.3–0.6 percentage points in 2016.

[5] See Annex III of the Staff Report for the 2017 Article IV Consultation on the Buyer's Price program.

rates will likely translate into higher CPI inflation over time. Yet, prolonged low inflation in recent years despite solid growth and job creation cautions that significant uncertainty remains around the timing of such an increase.

Macroeconomic Indicators

(Percent change y/y, unless noted)	2014	2015	2016	2017	2018	2019	2020
Real GDP	3.5	2.6	4.0	3.4	3.4	3.4	3.3
Total domestic demand	4.2	3.4	6.0	3.5	3.4	3.5	3.0
Exports	1.9	-2.7	2.5	3.7	4.3	4.5	4.5
Imports	4.0	-0.3	9.4	4.3	4.4	5.0	3.6
Trading partner GDP	3.0	3.0	2.3	3.2	3.2	3.1	2.7
CA balance (percent of GDP)	4.0	4.9	3.5	3.0	2.8	2.7	3.1
Terms of trade	-3.9	10.6	1.4	-3.0	-2.2	0.5	0.6
Employment	3.0	2.6	2.7	2.4	2.5	2.2	2.2
Unemployment rate (percent)	5.9	5.3	4.8	4.2	4.2	4.2	4.2
CPI (percent change, end of period)	-0.2	-1.0	-0.2	0.4	1.0	1.5	2.0

9. Medium-term risks are wide ranging, but growth vulnerabilities are contained by well-developed policy frameworks, shekel flexibility, and healthy balance sheets (Annex II):

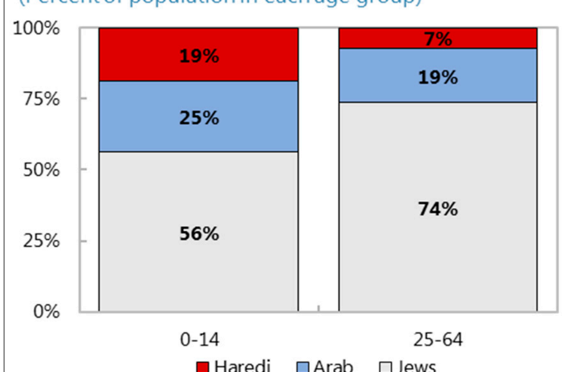
- **Regional/security**: Israel is highly exposed to regional geopolitical risks including developments in the West Bank, with the potential to impact growth through tourism and domestic demand.

- **Housing**: A moderate decline in housing prices would be welcome to improve affordability and reduce inequality. Risks of a sharp price decline appear modest, and financial stability is protected by low household debt and healthy banks, but growth could be significantly affected.

- **External**: Weak growth in Israel's main trading partners would weigh on Israeli exports and growth. Shekel depreciation and the operation of automatic fiscal stabilizers could help cushion the impact on growth, yet monetary policy currently has reduced space.

10. But Israel's growth and fiscal sustainability face major long-term challenges. Currently just over one-quarter of the working age population is Haredi or Israeli-Arab, groups that on average have poor market skills and low labor participation. This share will rise greatly over time as these groups constitute almost half of school age children. Moreover, there are infrastructure gaps, most evident in high traffic congestion. Together these factors could slow labor supply gains and be a drag on productivity, weakening potential growth notably in coming decades. Slower revenue growth would come as demands for social support increase, with rising deficits and debt threatening stability.

Population by Ethnic and Age Groups, 2015
(Percent of population in each age group)



Source: Central Bureau of Statistics

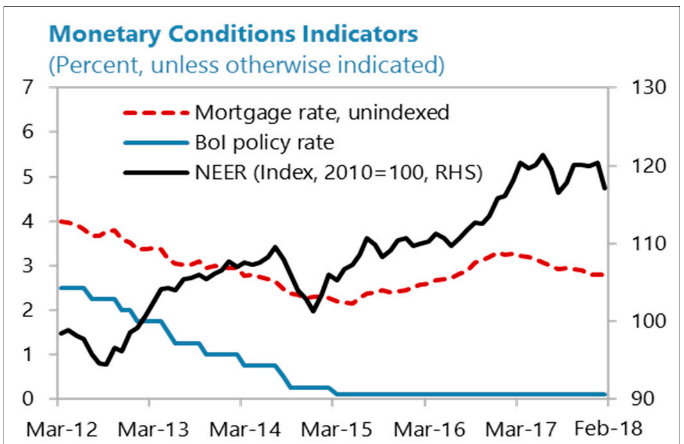
11. The Israeli authorities held similar views on the macroeconomic outlook. They assessed that underlying growth in 2017—excluding the unwinding of one-offs—was above 3½ percent, benefitting from exports strengthening after a period of sluggish growth. Their medium-term projections for growth and inflation were similar to those of staff and they remained alert to risks. Looking to the long-term, the authorities fully agreed on the challenges to sustaining Israel's solid growth owing to the shifting demographic composition in coming decades.

POLICY DISCUSSIONS

12. Deep structural reforms and infrastructure upgrades are needed to address Israel's productivity and poverty challenges. In a context of sound near-term macroeconomic prospects, a healthy financial system and greater housing market stability, Israel should focus on ensuring the sustainability of growth in the longer term. Implementing reforms across four main areas would have mutually-reinforcing benefits: (i) infrastructure investment; (ii) education and training; (iii) labor force participation; and (iv) regulatory frameworks and administration. Macroeconomic and financial policies should maintain a stable environment, including to realize the full benefits of such efforts.

A. Monetary and Exchange Rate Policies

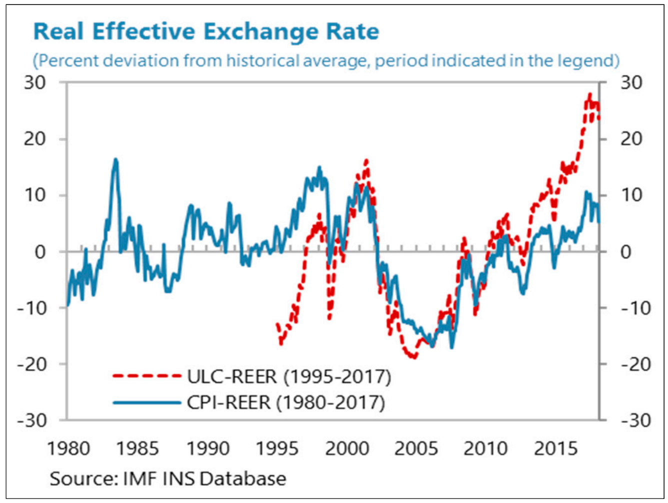
13. Accomodative monetary conditions continued in 2017. The policy rate has remained at 0.1 percent since February 2015. The shekel's effective exchange rate appreciated notably until Spring 2017, but has since been broadly stable. On the other hand, mortgage rates (unindexed) have declined moderately, reflecting cooling housing activity. The BoI is committed to maintaining an accomodative policy as long as necessary to entrench inflation within the target range.



Sources: Bank of Israel; and IMF staff calculations.

14. Monetary policy should remain accommodative pending a durable rise in inflation and inflation expectations. As noted, domestic and international conditions are supportive of an increase in inflation, yet significant uncertainty remains around the timing of such an increase. While financial market inflation expectations are anchored within the target range over the medium to longer term, expectations for the next few years remain below or close to the lower bound (Figure 3). Hence, there is need to avoid a premature monetary tightening before inflation is clearly heading back to target. At the same time, inflation could rise relatively quickly down the road given the already tight labor market, so the pace of eventual interest rate hikes will need to be data driven.

15. Sharp appreciation of the shekel has been associated with a decline in the current account surplus. Israel's real effective exchange rate (REER) has been on an upward trend for a decade, to stand some 26 percent above historical averages on a ULC basis in January. This appreciation likely contributed to the significant decline in the global market share of Israeli goods exports in recent years, whereas services exports, led by high-tech, continued to rise. Overall, the current account surplus has narrowed from 4.9 percent of GDP in 2015, to 2.7 percent of GDP in 2017 (excluding one-off vehicle imports).

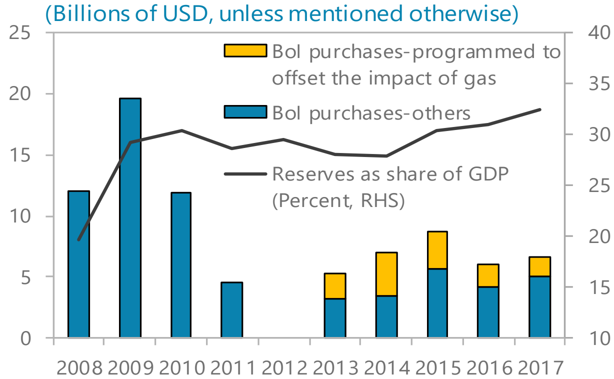


16. The external position is broadly in line with fundamentals and desirable policy settings (Appendix I). The current account surplus continues to exceed the EBA-based norm (deficit of one percent of GDP) with a current account gap of 3½ percent of GDP, implying an undervaluation of about 15 percent. However, this result likely overstates shekel undervaluation as (i) the 2017 current account may not yet reflect the full impact of the substantial shekel appreciation; (ii) Israel's current account surplus in part reflects low investment which needs to be addressed by improving infrastructure, education, and the business environment; and (iii) the EBA norm does not take into Israel's high level of transfer and grant inflows and its mandatory pension contributions. In contrast, analysis focused on the equilibrium real exchange rate indicates the shekel is broadly consistent with fundamentals on an REER-CPI basis applying an EBA-Lite Analysis and 17 percent overvalued using the EBA REER Level Analysis. However, as noted above, the REER-ULC has appreciated substantially more than the REER-CPI, suggesting that in ULC terms, the shekel might be more overvalued than indicated by the REER models.[6]

17. FX intervention continued in 2017 at a similar pace to 2016 with the level of foreign reserves remaining comfortable. Intervention in 2017 amounted to US$6.6 billion, compared with US$6.0 billion in 2016, and was mostly conducted in the first half of the year when appreciation pressures intensified, although intervention renewed briefly in early 2018 as the shekel appreciated further. Reserves rose to US$113 billion by end 2017 (32 percent of GDP), with over half of the increase due to revaluation gains. The level of reserves exceeds standard metrics for adequacy for precautionary purposes, but does not appear excessive given Israel's geopolitical risks and low export diversification. The BoI's purchases seek to avert shekel overvaluation, with about one-quarter of 2017 purchases under a pre-announced program to offset lower imports owing to natural gas production. Given comfortable reserve levels and the strong cyclical position, exchange rate flexibility should continue to be the first line of defense in the event of external shocks, with FX intervention limited to addressing disorderly market conditions, which may arise from significant exchange rate deviations from fundamentals.

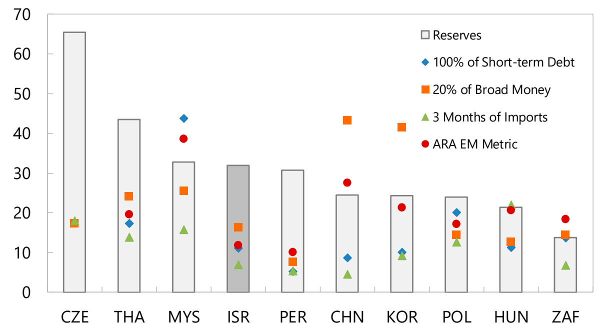
[6] Recent research finds that the ULC basis real effective exchange rate has a strong negative correlation with the external balance, while this relationship is absent for measures on a CPI or GDP deflator basis.

Foreign Reserves and FX Intervention
(Billions of USD, unless mentioned otherwise)



Sources: Bank of Israel and IMF staff calculations.

Indicators of Reserve Adequacy 1/
(In percent of GDP, as of September 2017)



Sources: IMF WEO Database and IMF staff calculations.
1/ Comparator countries have similar tolerance for external risks based on indicators for economic flexibility, market maturity and market access.

18. **The BoI shared similar views on monetary policy but it finds the shekel to be overvalued and considers its FX intervention appropriate.** The BoI forecasts inflation to return to the target range by end 2018, yet at this stage inflation is well below target and the current assessment is that its level is away from fulfilling the condition of being entrenched within the target range. The BoI's analysis finds the shekel is overvalued (on REER models) or is broadly in line with fundamentals (current account models), where it gives the former more weight as the current account lags REER developments. Looking forward, the REER models seem to be more relevant for future policies as the government aims to increase public investment, which is expected to reduce the current account surplus. The BoI noted that its policy framework allows FX intervention to address deviations in the shekel exchange rate from the range consistent with the economy's fundamental equilibrium, and is not limited to addressing disorderly market conditions. The BOI added that currency intervention is part of the set of monetary policy tools which is preferred over using negative interest rates or QE in Israel, and has been employed during a period when the major economies have very expansionary monetary policies through QE or negative interest rates.

B. Financial Sector and Housing Policies

19. **Israel's banking system is healthy**. Capitalization, loan quality, and profitability continued to improve in 2017. The leverage ratio rose to 7.5 percent, exceeding that in most advanced economies. All five of the largest banks met the capital requirement, enabling them to resume or raise dividend payouts in 2017.[7]

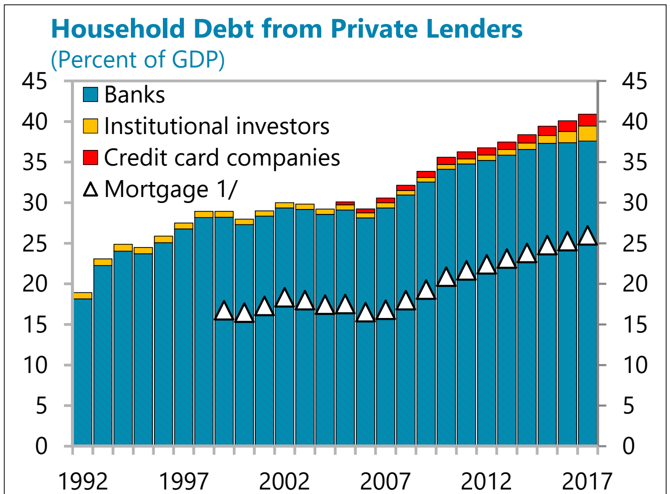
Table. Banking System Soundness Indicators, 2014–2017
(End-period, in percent)

	2014	2015	2016	2017 Q3
Regulatory capital to risk-weighted assets 1/	14.3	14.0	14.7	14.5
Regulatory Tier I capital to risk-weighted assets 1/	9.7	9.9	10.9	11.1
NPL to total gross loans	2.2	1.8	1.6	1.4
NPL net of loan-loss provisions to capital	6.1	3.4	2.2	1.1
Return on average assets (before tax)	0.8	1.0	1.0	1.0
Return on average equity (before tax)	11.8	14.4	13.9	13.7
Customer deposits as a percent of total (non-interbank) loans	115.8	117.8	121.6	120.1

Source: IMF Financial Soundness Indicators Database.
1/ The calculation of capital base follows rules under Basel II.

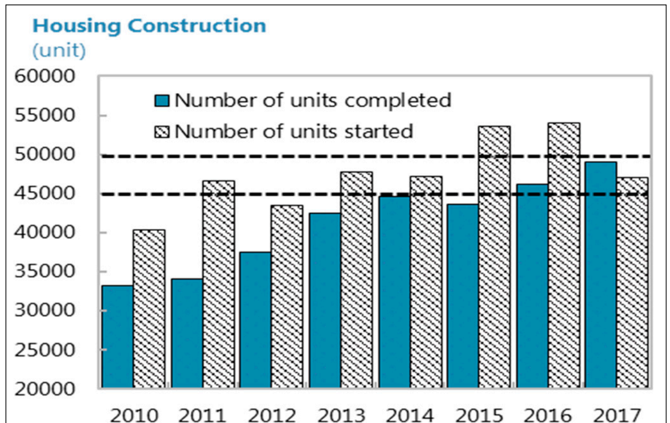
[7] The requirement is Tier 1 capital of 10 percent of risk-weighted assets for the two largest banks and nine percent for other banks. This requirement was relaxed temporarily (by 0.2 percentage points on average) for the banks that have been implementing multi-year efficiency programs to reduce their non-interest expenses in relation to gross income.

20. Household debt remains relatively low, with well-contained risks, and business debt has stabilized after declining significantly. The household debt ratio has been rising for a decade, but remains low at just over 40 percent of GDP. The BoI has maintained strong macroprudential measures in the housing area (see Annex IV of the 2017 SR). As a result, new mortgages with LTVs over 75 percent have been almost eliminated, and the share of lower LTV loans has risen. However, consumer credit, which usually has a variable interest rate, is almost two-fifths of total household debt, calling for close monitoring.[8] Business sector debt has declined to below 70 percent of GDP, with the stock of corporate bonds falling to 19 percent of GDP by 2017, 9 percent of GDP less than their former ratio. Limited supply and the global search for yield may be contributing to low spreads on these bonds.



Sources: Haver Analytics; and IMF staff calculations.
1/ Includes debt to banks and institutional investors.

21. Slowing housing construction despite still high housing prices calls for reforms to make supply more responsive to needs and to improve housing affordability. The authorities estimate that 45–50 thousand new housing units are needed annually during 2015–2020, rising to 60 thousand annually by 2026–35. Completions appear sufficient in 2016–2017, but shortfalls could return given recent falls in housing starts. Hence, continued reform efforts are needed:



Sources: Central Bureau of Statistics
1/ Estimate based on Q1-3 data.

- **Land supply, competition, and regulation**. Increased land auctions are needed to avoid supply constraints and to help make construction more responsive to variations in demand. Construction costs and time to build should be reduced by streamlining building regulations and expanding foreign construction company access.

- **Municipal incentives.** To encourage timely municipal approval of residential development, residential property taxes should be raised—while avoiding work disincentives—coupled with predictable central government support to municipalities for the up-front costs of additional infrastructure and public services.

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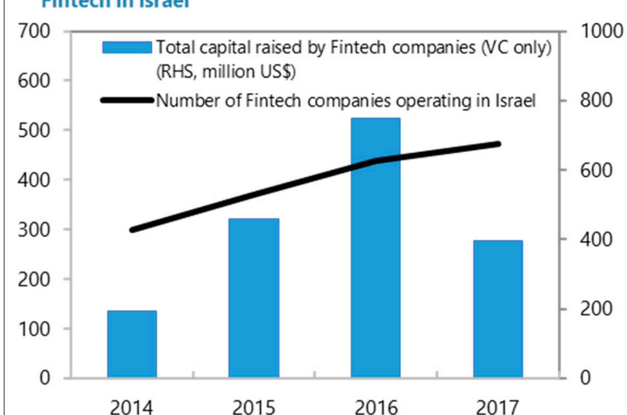
[8] To prevent a situation where customers finance part of the equity through a consumer credit loan, which is more expensive and less appropriate for financing the purchase of a dwelling, in March 2018, the BoI announced a reduction in risk weights on mortgage loans to first-time homebuyers with an LTV of 60–75 percent.

- **Expand commutable areas and increase urban density.** Well-developed public transportation can expand commutable areas and relieve demand in major centers, hence plans to establish metropolitan authorities are welcome. Urban renewal should be increased as density in Tel Aviv is relatively low, including through the proposed fast-track approvals of mixed use development.

22. Establishing the Financial Stability Committee (FSC) is critical to complement the progress being made on enhancing competition. The banking system remains highly concentrated, with five locally-owned banking groups accounting for 95 percent of banking sector assets, and the two largest groups for over 60 percent of assets. Accordingly, the authorities are taking a range of measures to promote competition in the sector (Annex 3). Entry by new banks would be welcome, with appropriate deposit insurance and resolution arrangements to contain fiscal costs from potential failure. Already, the sources of credit are shifting, making it urgent to approve legislation to establish the FSC to avoid gaps in financial system oversight.[9] Consistent with technical assistance recommendations, the Banking Supervision Department should continue to make progress in operationalizing a more risk-focused approach to supervision to lower compliance costs while maintaining high standards. It is welcome that the Capital Market, Insurance, and Saving Authority (CMISA) adopted the Solvency II framework in 2017 with an aim to achieve full compliance by end-2024. It is essential for financial regulators to harmonize regulations in areas of overlapping activity to avert regulatory arbitrage. Safeguarding the operational independence of each financial regulator from political pressures remains critical to their effectiveness.

23. The authorities are taking welcome steps to enhance the management of technological risks, including those from Fintech, and improve Cyber Security. In 2017 there were 474 Fintech companies in Israel, up from around 300 in 2014. Israeli Fintech firms are generally oriented to international markets, but they also help banks and insurance firms enhance efficiency by providing personalized services to customers in a more convenient manner. Most Fintech loans are backed by financial institutions. The BoI supports innovation in the banking system by streamlining the approval process for new products, while allowing for digital banks, cloud technology, and the sharing of IT and operational infrastructure. At the same time, the BoI intends to step up the monitoring of risks that could emerge as Fintech activities increase. Close coordination among regulators in relation to Fintech may better facilitate Fintech development and utilization. The BoI, in conjunction with the National Cyber Authority, the MoF, and banks, established a Banking Cyber Center in 2017 to facilitate inter-agency sharing of intelligence about cyber alerts and help deal with cyber events that affect banks.

Fintech in Israel



Source: Start-Up Nation Central Finder

[9] The FSC comprises the BoI (chair); MoF; CMISA; and Israel Securities Authority.

24. The authorities generally agreed with staff's assessment. The financial regulatory agencies emphasized the urgency of approving legislation to establish the FSC to best facilitate coordination. The BoI will maintain its ongoing efforts to enhance its implementation of a more risk-focused approach to supervision. The BoI and CMISA recognized the need for regulatory harmonization, and noted progress being made in this respect in some areas of credit provision. Furthermore, to supplement the Central Credit Register, which will not cover nonbank credit, the BoI and CMISA plan to intensify coordination, including information sharing. Regarding entry of new banks, the authorities are still developing their views, seeing the potential for some arrangement to provide support to new entrants, yet also wishing to contain potential fiscal costs and stability risks.

C. Fiscal Policy and Infrastructure

25. Following the two-year budget for 2017–18, the Knesset has approved a budget for 2019 well ahead of schedule, partly in view of elections due by November that year. In 2017, the central government deficit excluding one-off items came in at 2.9 percent of GDP, in line with the budget target yet slightly expansionary despite solid growth, and general government debt declined to 61 percent of GDP.[10] The deficit target for 2018 remains 2.9 percent of GDP as originally adopted, with the reserve fund of 0.3 percent of GDP allocated to social spending (e.g., disability benefits, subsidies for after school childcare, and old-age benefits). The Knesset approved the 2019 budget in mid-March 2018, with this unusually early timing aimed at mitigating election-related spending pressures and promoting political stability. As has become long-standing practice, fiscal consolidation was deferred, with the target for 2019 raised to 2.9 percent of GDP from 2.5 percent. The 2019 budget also breaches the expenditure ceiling.[11]

26. A modest consolidation in 2018–19 would have been preferable in this favorable economic environment. Adhering to the former target of reducing the central government deficit to 2.5 percent of GDP by 2019 would entail little drag on growth at a time that the output gap is broadly closed and growth in 2018–19 is expected to be a little above trend. Such an adjustment would imply a general government deficit of around three percent of GDP,[12] sufficient if subsequently maintained to gradually reduce debt in normal times.[13] Ensuring the Buyer's Price program is temporary would also support Israel's fiscal health as the subsidies given through heavily discounted land sales are reducing receipts from the Land Authority.

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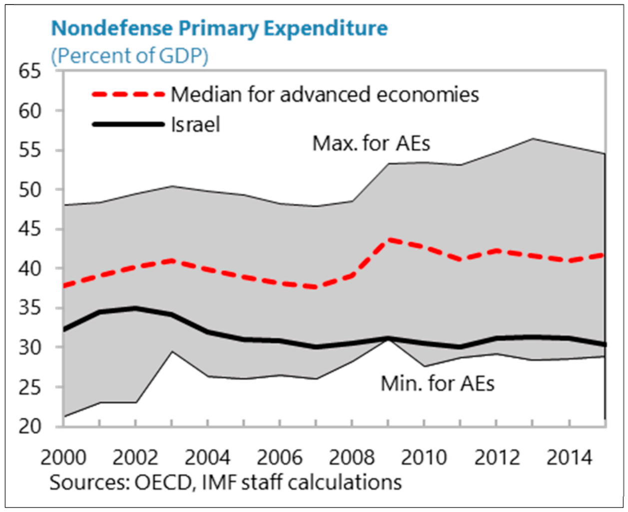
[10] The headline budget deficit was two percent of GDP in 2017, benefitting from one-off revenues from the sales of Israeli companies (i.e., Mobileye, Keter Plastics, and Tamar Petroleum), and an exceptional dividend tax collection from a surge in dividend distributions owing to a temporary tax benefit granted by the Tax Authority.

[11] The expenditure ceiling sets the real increase in government expenditures in accordance with population growth in the past three years plus the ratio of 50 (an implicit long-term anchor for the debt ratio) to debt-to-GDP in the last year. The ceiling in real terms is converted to nominal terms using the average CPI inflation in the past three years.

[12] This deficit target assumes nominal GDP growth averaging five percent and an annual stock-flow adjustment of around ½ percent of GDP.

[13] The general government GFS deficit tends to be larger than the central government deficit, but the deviation varies. The five-year average for 2012–16 was 0.5 percent of GDP, although there was no deviation in 2016.

27. There is little room for tax cuts with civilian spending already low. Following recent U.S. tax cuts, and with elections approaching in 2019, the authorities are considering further cuts in personal and corporate income taxes.[14] However, high-tech firms already enjoy 6 or 12 percent rates and the adoption of the new tax on owners of more than two apartments remains uncertain. Moreover, Israel's low civilian spending and rising needs in infrastructure, education and training, and active labor market policies, indicate that tax cuts would be difficult to finance through offsetting expenditure cuts. Rather, these initiatives should be financed in a growth-friendly manner, such as by scaling back tax benefits, which total about five percent of GDP.



28. Looking further ahead, the government is developing plans to address Israel's infrastructure needs. Cross-country benchmarks suggest an infrastructure gap on the order of 20 percent of GDP, which is broadly confirmed by a more granular sectoral analysis of infrastructure needs, with high traffic congestion the most prominent issue (Box 1). A government committee is developing an integrated long-term national infrastructure strategy through 2030 ("Infrastructure 2030"), while also preparing a list of additional projects for implementation for the next five years.

29. Ensuring that current and prospective infrastructure is efficiently utilized is the first priority. Given the lengthy processes to complete new infrastructure, such as in mass transit, there is a need for frontloaded action to manage demand. Implementing demand-side tools (e.g., ride sharing and car-pooling) could have near-term benefits at low cost. In this regard, the "Going Green" initiative is a welcome pilot that should be ramped up. Charging for road use at peak hours is an approach used successfully in cities around the world, although it would need to be coupled with flexibility in working hours to be most effective in practice. If bottlenecks remain after these steps, the areas that should be the focus of additional public investment are more clearly identified.

30. The framework for managing infrastructure investment needs to be strengthened to maximize the benefits of higher public investment.[15] Growth benefits from raising public investment can vary substantially depending the quality and timeliness of spending. For example, under a scenario with public investment raised by 1.5 percent of GDP for 15 years, staff estimate a cumulative output gain ranging from four to six percent depending on investment efficiency.[16] Israel should therefore take several steps to enhance the management of public investment:

[14] The corporate income tax rate was cut to 24 percent in 2017 and 23 percent starting in January 2018.

[15] IMF, Making Public Investment More Efficient, June 2015.

[16] See chapter I of the Selected Issues Paper.

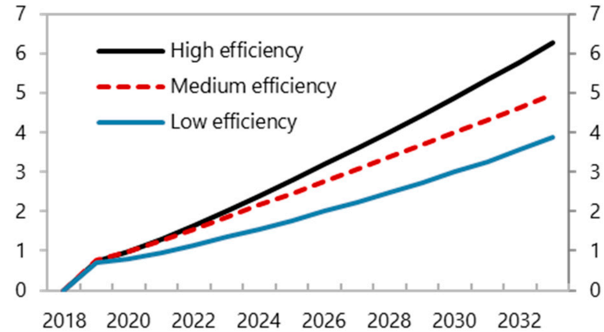
- Establish a body with clear accountability and sufficient powers for upgrading Israel's infrastructure, supported by staff with the necessary technical expertise.

- Make project evaluation and selection more rigorous and transparent, including by ensuring consistency with the long-term infrastructure strategy.

- Streamline zoning and permitting processes and address other bureaucratic impediments to timely project implementation.

- Improve coordination between ministries and between the central and local governments. Broadening the coverage of the medium term fiscal framework to the general government could contribute to improved coordination and planning as local governments implement around three-quarters of public investment.

Output Increase from Investment Scale-up 1/
(Percent deviation from output without investment scale-up)



Source: IMF staff estimates.
1/ The additional real output when investment increases by 1.5 percent of GDP per year over 15 years under different efficiency levels. The efficiency in public investment is defined as the proportion of investment that is translated into capital stock. High, medium, and low efficiency levels correspond to 85, 76, and 67 percent of an increase in investment turns into capital accumulation over 15 years, respectively.

- Phase any scaling up of public investment judiciously to avoid waste.

- Use public-private partnerships (PPP) only in cases where bringing in private sector know-how improves efficiency, and design and monitor PPPs carefully to protect the public interest.

- Maintain a high level of transparency around the level and composition of investment, including to help protect public investment against short-sighted cuts

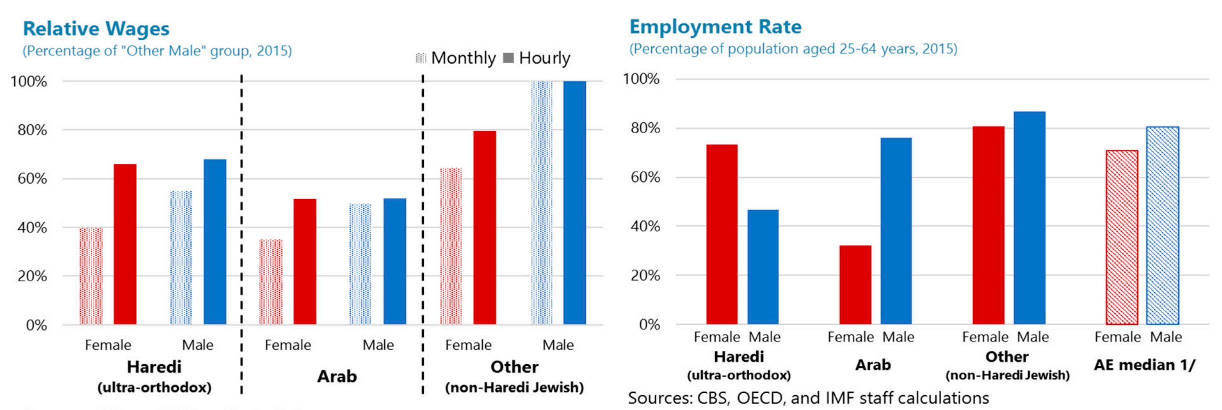
31. **If public investment is increased, adequate fiscal buffers must be preserved**. As infrastructure enhances potential GDP and revenue over a long horizon, there is a case for smoothing taxes and financing a portion with debt or PPPs. Israel has some fiscal space, yet it faces wider uncertainties than most advanced economies, so a significant buffer relative to the 85 percent debt threshold usually applied to advanced economies is appropriate. It is also important to retain some fiscal space to manage potential front-loaded costs from reforms to enhance the sustainability of Israel's growth (next section). Any increase in the public debt ratio should therefore be modest and temporary, and liabilities from PPPs should be managed carefully and reported in line with international best practices. Within revenues, the focus should be on sources with the least drag on potential growth, especially reducing tax benefits which total five percent of GDP.

32. **Given the low level of civilian spending, there is a case for refining the current expenditure rule to provide flexibility to accommodate new initiatives if they are financed**. A key step would be to include revenue measures within the rule as a basis for higher spending, thereby making the expenditure rule consistent with recently adopted commitment controls (the Numerator rule). A further refinement would be to replace the current adjustor for deviations of the public debt ratio from 50 percent with one based on deviations in the balance from the medium-term deficit target, so the spending rule supports steady progress toward that target.

33. The authorities broadly concurred with staff's assessment and recommendations. The authorities generally agree on keeping public debt on a declining path in normal times as Israel is a small open economy highly exposed to geopolitical risks. The MoF noted that relatively high deficit targets could limit space to cushion shocks, yet, in practice, it saw scope for deficits to again come in below target, as had occurred in recent years. Regarding the financing of higher infrastructure spending, the MoF is cautious about any temporary increase in the deficit or debt, given the political difficulty of ensuring that additional space is used for productive spending as intended. While agreeing that PPPs need careful management, they also have advantages in pre-committing spending on infrastructure into the future. The authorities are still digesting the implications of the U.S. tax reforms, with the Finance Minister considering tax cuts to remain competitive. Regarding the expenditure rule, the BoI supports a review to accommodate much needed social and investment spending without increasing deficits, whereas the MoF finds the current ceiling helps contain spending pressures and is cautious about modifying rules too frequently.

D. Doing Business Inclusively

34. Long-term growth and stability hinges on closing the gaps in participation and productivity among large population groups and genders. Compared with the hourly wages of non-Haredi Jewish men, those for non-Haredi Jewish women are about one-fifth lower; those for Haredi (both men and women) are about one-third lower; and those for Israeli-Arabs are about half. Employment rates of Haredi men (47 percent) and Arab women (35 percent) are very low. Haredi women are approaching the employment rates of non-Haredi Jewish women, which are comparable to those of non-Haredi Jewish men. However, women tend to work shorter hours, reducing monthly wages and impeding career progression. To illustrate the potential gains, closing the gaps in employment and labor productivity (and hence hourly wages) by half would raise potential output by 14 percent; an increase in full-time workers sufficient to reduce monthly-wage gaps by half would raise potential output by 22 percent. An estimated two-thirds of these gains are attributable to narrowing gaps between men and women. Such gains would do much to help Israel maintain adequate growth in per capita GDP into the longer-term, underpinning fiscal sustainability.



Sources: CBS, and IMF staff calculations

Sources: CBS, OECD, and IMF staff calculations
1/ Median employment rate across 31 advanced economies in the OECD database.

35. Reforms of the education system are essential as it is characterized by large variations in results across groups.[17] Education spending has been raised recently, primarily through increases in teachers' pay. But the academic qualifications expected of teachers remain low and the teaching day unusually short.[18] Educated in the separate schools of the Haredi community, many Haredi men lack education in math, science, English, and other market-oriented disciplines, contributing to substantial gaps between Haredi and non-Haredi Jews on international assessments of adult proficiency in key information-processing skills. Arab schools are receiving increased support and there are signs of quality improvement, but there are still large gaps, including in Hebrew skills, which affect employability.[19] It is therefore critical that the effectiveness of schools be increased, including through higher standards for teachers, covering core subjects at all grades in Haredi schools, improving Hebrew teaching in Arab schools, and extending the short school day.

36. Enhanced vocational training can also play a large role in reducing skills gaps with expanded active labor market policies (ALMP) further aiding employability:

- **Vocational training reforms being developed should ensure that the courses offered meet business needs and the quality of courses should be evaluated**. Close involvement of suitable experts from the business community in the selection and design of courses is important. The modalities for delivering training should facilitate participation by the Haredi and Arab communities. Career centers should guide job seekers to suitable training, which may include business-oriented Hebrew. Low wage workers should receive support for training costs to upgrade their skills, and the government could also introduce a transfer program that is conditional on completing eligible classes and courses or participating in job training.

- **Additional resources would increase the impact of effective ALMP measures**. Career Centers are providing employment services within 46 communities. External analysis of the Employment Circles program to enhance the "soft skills" of welfare recipients finds significant employment gains, especially among the Arab population, with the program paying for itself after only seven months. Preliminary results from a second ALMP program show that subsidizing mobility to jobs outside the home town of jobs seekers is also effective. Hence, the total ALMP spending of only 0.2 percent of GDP should be raised to expand its impact on participation.

37. Meeting targets to raise the employment rates of key groups likely requires a tailored package of measures. The Israeli authorities, led by the Ministry of Labor, are currently updating targets for the employment rates of key population groups through 2030, and developing policies to reach those targets. To raise labor participation and work hours of women, childcare support

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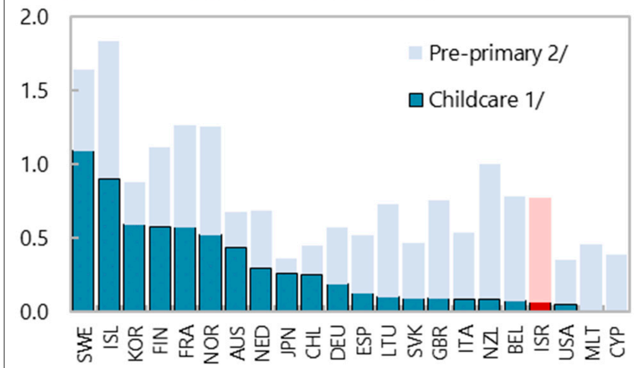
[17] Hebrew-speaking student PISA outcomes exceed the OECD average, but the results are biased upward as Haredi boys do not participate, while results for Arab-speaking students are poor. Among Hebrew-speaking students, girls tend to underperform boys in math and science.

[18] Dan Ben-David and Ayal Kimhi, An Overview of Israel's Education System and its Impact, Shoresh Research Paper, December 2017.

[19] Taub Center, 2017, The Arab education system in Israel: Are the gaps closing?

needs to be further expanded, especially for younger children. Moreover, increases in the retirement age for women toward equalization with men should continue without introducing new incentives for early retirement.[20] For minority groups, enhancing public transportation, such as bus services, can ease access to workplaces. But, in some cases, e.g., Arab women, enabling workplaces to locate within or close to their communities may also be valuable to support greater participation.

Government Spending on Childcare
(Percent of GDP, 2013 or latest available)



Source: OECD
1/ Includes in-cash of in-kind support to formal day-care services (e.g., creches, daycare centers, and family daycare, generally aimed at children aged 0-2).
2/ Includes in-cash of in-kind support kindergartens and daycare centers for children aged 3-5.

38. Upgrades of the business environment, especially reducing bureaucratic bottlenecks, would support inclusiveness and enhance productivity and real incomes. The government has undertaken useful product market reforms including progress on long-delayed reforms of the electricity sector and liberalizing personal imports (Annex I). More can be done to reduce living costs, e.g., in agriculture, by replacing quotas, price guarantees, and tariffs with direct subsidies to farmers. However, the domestic business environment remains unfavorable, with numerous regulations and their high compliance costs being major impediments to competition and investment (Box 2). The proposed reforms of fire safety regulation and business licensing are important steps forward, and the initiative underway to reduce the number of regulations could also be useful. But there is a need for dramatic change to achieve simple and timely administration of regulations, such as a "one-stop shop" that would assess all regulatory requirements within a reasonable period. In addition, all proposals for new regulations should be subject to robust regulatory impact assessments. The lengthy process of contract enforcement indicates a need to make court procedures more efficient, and the establishment of a specialized court for complex antitrust cases would support competitive markets.

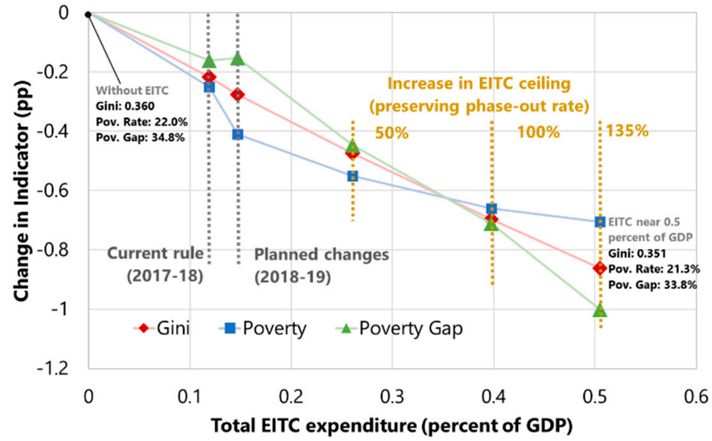
39. Redistributive measures to contain poverty can also support participation and productivity if carefully designed. Priorities are threefold:

- **Further expand the amount and coverage of the Earned Income Tax Credit (EITC).** An EITC incentivizes labor participation as only those who pay income tax are eligible for the tax credit. As wages are the main source of income for 60 percent of population below the poverty line, expanding the EITC can effectively reduce poverty. The amount and coverage of Israel's EITC has been expanded over time, but it remains small, with a fiscal cost of 0.16 percent of GDP annually, compared with 0.4–0.5 percent in the U.S. or the U.K. Staff analysis estimates that doubling the EITC ceiling would bring spending into that range, reducing indicators of poverty by about

[20] Israel's female labor participation rate for age 60–64 years and 65–69 years is 54 percent and 30.5 percent, respectively, higher than the OECD average of 42½ percent and 20 percent, respectively.

0.5 percentage points.[21] The impact could be larger in practice, as experience in other countries indicates that expanding the EITC increases take-up by the eligible population, with a larger impact on poverty if participation rises.

Simulations of EITC Impact
(Change in indicators, in percentage points)



Sources: CBS Household Expenditure Survey 2016, and IMF staff calculations.

- **Implement the EITC more effectively.** At present, the EITC can be claimed only at the end of each year, and is received with a delay. More frequent and timely payments would better incentivize work and streamlined administration could improve take-up.

- **Make transfers more targeted, including to support EITC expansion.** Israel's current transfer system is not progressive, providing a similar shekel amount to all households, even those in the top income decile. This is due mainly to child allowances, which are not income-tested. Modifying the transfer system to better target it to low income households can reduce poverty at less fiscal cost. Using the resources released to expand the EITC, as well as for transfers that are conditional on undertaking additional education and training, would ensure they reinforce incentives to work and upgrade skills. Although reducing poverty through enhancing work income is the priority, the most vulnerable populations cannot be reached through the EITC, and the modest levels of welfare support should be reviewed with an eye toward increasing them while carefully protecting labor force participation.

40. The authorities continue to work on developing and implementing reforms to sustain Israel's strong growth, including by making it more inclusive. The MOF noted that the 2018 budget and the associated arrangements law includes measures to support female labor participation, protect those on low incomes, and address key regulatory problems. A committee is preparing recommendations on further raising employment rates of population subgroups, including through reforms of vocational training, with an additional emphasis on raising wages in cases where substantial progress on participation has been made. A separate committee will soon release proposals to improve the administration of regulations. The Antitrust Authority agreed that establishing a specialized court for complex antitrust cases would support competitive markets. While agreeing that the EITC helps reduce inequality without undermining work incentives, the authorities consider that further adjustments should await an analysis of the impact of forthcoming EITC increases. While recognizing benefits from increasing the frequency of EITC credit refunds, the authorities saw risks that payments via employers could be partly offset by lower wages.

[21] See chapter II of the Selected Issues Paper.

STAFF APPRAISAL

41. Israel's strong macroeconomic conditions offer an opportunity to implement further reforms to sustain strong and inclusive growth. Growth of almost 3½ percent in 2017 helped bring unemployment below four percent. But core inflation remains below the 1–3 percent target range. Growth is expected to remain at about 3½ percent in the next few years thanks in part to the completion of major projects, before moderating to around three percent. But in the longer term, a rise in population share of groups with lower labor productivity and participation combined with sizable infrastructure needs could weigh on Israel's growth potential and raise poverty.

42. Monetary policy should remain accommodative pending a durable rise in inflation and inflation expectations. The BoI maintained an appropriately accommodative stance in 2017 given low inflation and the spillovers from easy monetary policies in major advanced economies. The BoI's guidance that policy will remain accommodative as long as necessary to entrench the inflation environment within the target range has also helped anchor long term inflation expectations. Yet, with expectations for the next few years below or close to the lower target bound, policy tightening should wait until inflation is clearly heading back to target, with the pace of eventual rate hikes being data driven. The external position is broadly in line with fundamentals and desirable policy settings. Given comfortable foreign reserves and with the economy at full employment, exchange rate flexibility should continue to be the first line of defense in the event of external shocks, with foreign exchange intervention limited to addressing disorderly market conditions, which may arise from significant exchange rate deviations from fundamentals.

43. Reinforcing the financial stability framework is critical to complement the progress being made on enhancing competition. Measures being implemented by the authorities are expected to strengthen competitive pressures. Already, the sources of credit are shifting, making it urgent to approve legislation to establish the FSC to avoid gaps in financial system oversight. Entry by new banks would be welcome, with appropriate deposit insurance and resolution arrangements to contain fiscal costs from potential failure. Banking supervision should continue its efforts to operationalize a risk-focused approach and the adoption of Solvency II by the CMISA is welcome. Financial regulators should harmonize regulations in areas of overlapping activity to avert regulatory arbitrage. Safeguarding the operational independence of financial regulators remains critical to their effectiveness. Slowing housing construction despite still high housing prices calls for continued reforms to make supply more responsive to needs and to improve housing affordability.

44. Fiscal policy should support Israel's growth potential while building buffers. In 2018 fiscal reserves are allocated to welcome subsidies for after-school childcare, but an expansion of disability benefits should be coupled with a reform of eligibility requirements and testing for new entrants to protect labor participation and contain fiscal costs. The 2019 budget supports technical training in schools and expands the EITC, but adhering to the former deficit target of 2.5 percent of GDP is preferable to gradually reduce debt in normal times. Ensuring the Buyer's Price program is temporary would also support Israel's fiscal health.

45. Stronger public investment management would help address infrastructure needs and adequate fiscal buffers must be preserved. The development of an integrated long-term national infrastructure strategy through 2030 is welcome. An immediate priority is to ensure that the existing infrastructure is efficiently utilized through demand management tools. The framework for managing infrastructure investment needs to be strengthened to ensure investments are high-quality and timely. If public investment is increased, any rise in the public debt ratio should be modest and temporary, with liabilities from PPPs managed carefully and reported in line with international best practices. The low level of Israel's civilian spending, together with reform needs in education, training, and active labor market policies, indicate that revenues should be the main source of non-debt financing, focusing on reducing tax benefits to limit the drag on growth.

46. Fundamental upgrades of the business environment are critical, especially reducing bureaucratic bottlenecks. Progress on electricity sector and other reforms is welcome and reforms should continue, including replacing trade barriers on agricultural products with targeted subsidies. Numerous regulations and their high compliance costs remain major impediments to competition and investment, calling for simple and timely administration of regulations, such as a "one-stop shop" that would assess all regulatory requirements within a reasonable period. All proposals for new regulations should be subject to robust regulatory impact assessments. The lengthy process of contract enforcement indicates a need to make court procedures more efficient, and the establishment of a specialized court for complex antitrust cases would support competitive markets.

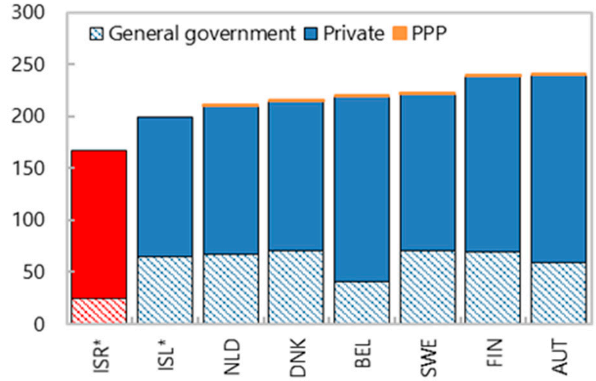
47. The government should undertake deep reforms of education and training to reduce the gaps in labor productivity and participation while enhancing redistribution carefully. The effectiveness of schools should be increased, such as through higher standards for teachers, covering core subjects at all grades in Haredi schools, improving Hebrew teaching in Arab schools, and extending the short school day. Enhanced vocational training can also play a large role in reducing skills gaps with expanded active labor market policies further aiding employability. To raise labor participation and work hours of women, childcare support needs to be further expanded, especially for younger children, and increases in the female retirement age should continue without introducing new incentives for early retirement. Alongside enhancing public transportation, enabling workplaces to locate near communities would promote labor participation. Inequality and poverty can be reduced while supporting participation by substantially expanding the EITC and implementing it more effectively, with fiscal costs contained by making transfers more targeted.

48. It is proposed that the next Article IV consultation with Israel take place on the standard 12-month cycle.

Box 1. Israel's Infrastructure Needs

Public investment declined over the past two decades, from around three percent of GDP in the second half of the 1990s to around two percent in 2017, so Israel's stock of public capital is now substantially below that in peers. The reduction in public investment was part of the fiscal consolidation process, but the amount and quality of infrastructure development was also affected by issues with public investment management (especially at local levels), the lack of land registries in the Arab towns, and the regulation of network industries.

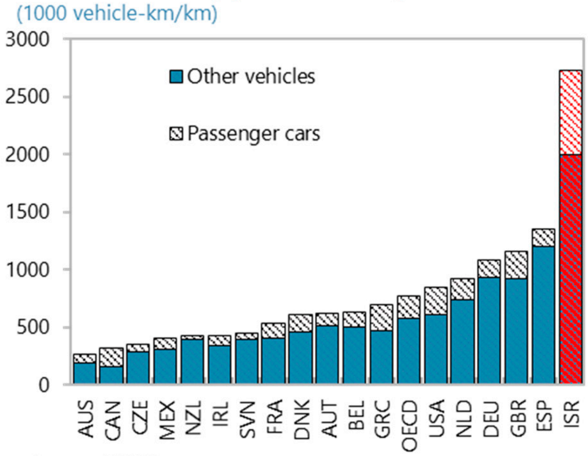
Total Capital Stock, 2015
(Percent of GDP)



Sources: "IMF Investment and Capital Stock Dataset, 2017"
Note: Data on PPP are not available for countries with "*."

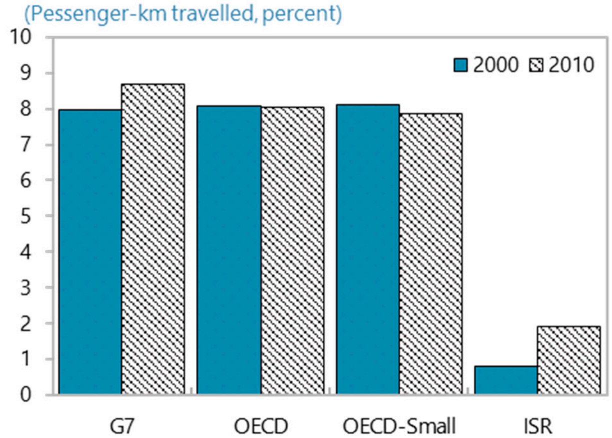
A more granular sectoral analysis by the Israeli authorities, supported McKinsey & Company, finds a range of infrastructure needs. Public transport infrastructure in major cities is vastly inadequate given Israel's income level. For example, traffic congestion was causing an average loss of 60 minutes per road-user per day in 2012, with signs of deterioration over time, dragging on productivity growth. The share of train travel in total motorized travel in Israel is substantially below the average in advanced economies. A lack of competition for managing ports and airports has also lowered efficiency.

Road Traffic Intensity per Network Length, 2014
(1000 vehicle-km/km)



Source: OECD

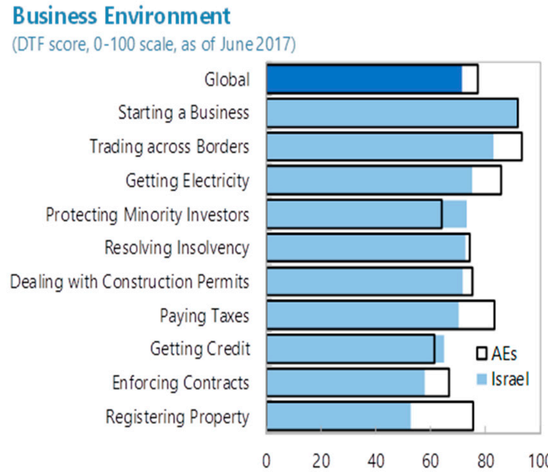
Share of Train Travel in Total Motorized Travel
(Pessenger-km travelled, percent)



Source: OECD

Box 2. Some Headaches of Doing Business in Israel

According to the World Bank's Doing Business[1] Israel's overall performance is below the average of advanced economies:



Sources: World Bank Doing Business 2018 and IMF staff calculations.

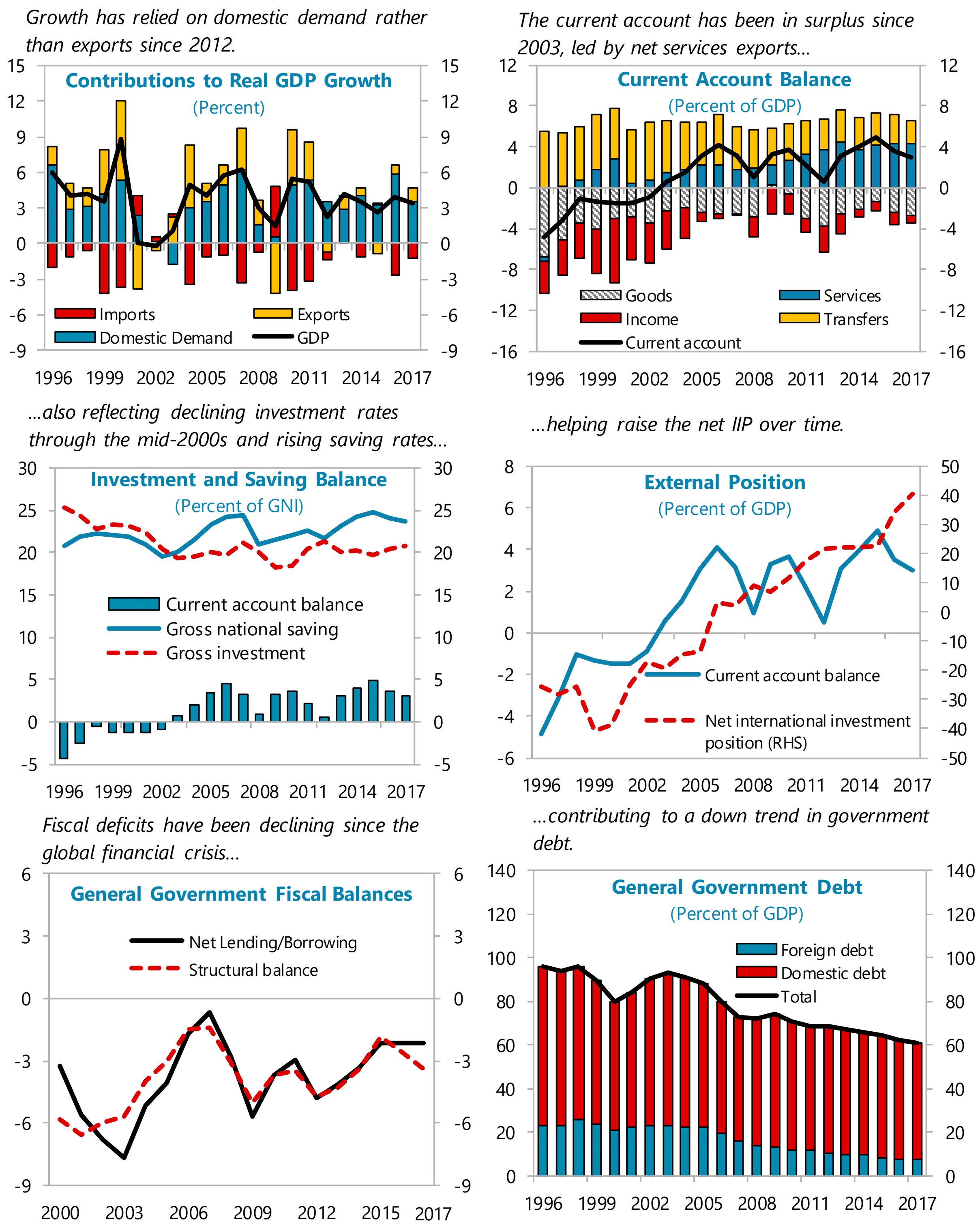
- **Property registration:** 81 days are required compared to a 25 day advanced economy average, with procedures costing 8.3 percent of property value versus 4.7 percent.[2]
- **Contract enforcement.** The average time for completing judicial processes is 975 days in Israel, versus 567 days on average in advanced economies.[3]
- **Paying taxes.** Tax rates in Israel are comparatively low, but the time required to comply with tax procedures, and to obtain VAT refunds, is unduly long.
- **Getting electricity.** The cost of electricity in Israel is close to the frontier, but the number of procedures and the time involved (102 days) to obtain electricity is high.

[1] The Israeli Chambers of Commerce noted that the Doing Business data is primarily based on information from relatively few large businesses, who may not have the same experience as the many small businesses in Israel.

[2] One drag on the registration process is the roughly 68 days required to file a transaction report and obtain tax clearance from municipalities.

[3] Key factors behind the long time to complete judicial processes include the lack of a dedicated commercial court, the maximum number of adjournments, and electronic filing system.

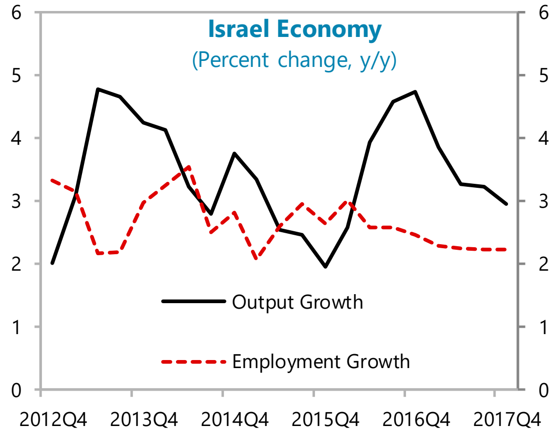
Figure 1. Israel: The Long View



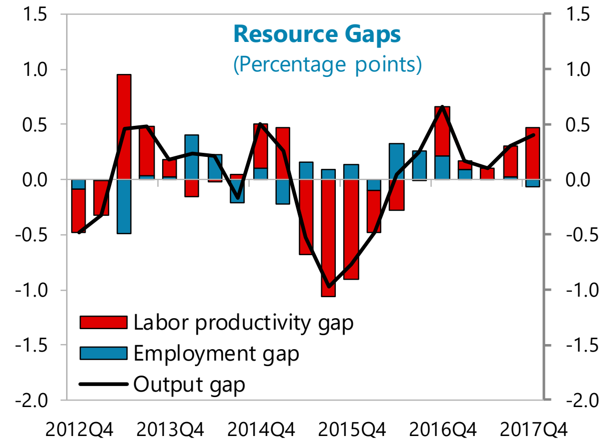
Sources: Bank of Israel; Central Bureau of Statistics; IMF Information Notice System; and IMF staff calculations.

Figure 2. Israel: Recent Economic Developments

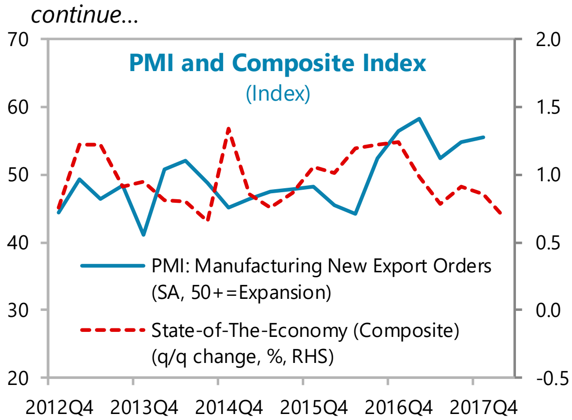
Following high growth of 4 percent in 2016, the economy grew by 3.4 percent in 2017…



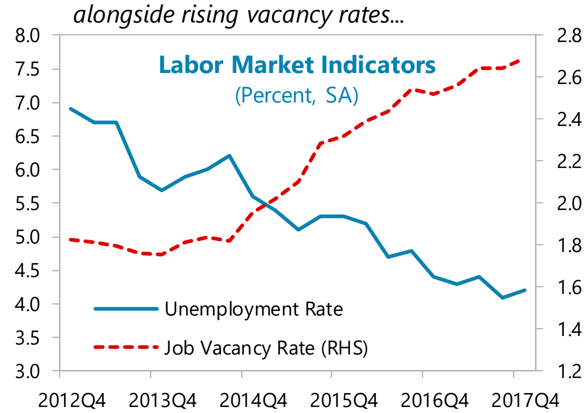
…with employment gaps nearly closed.



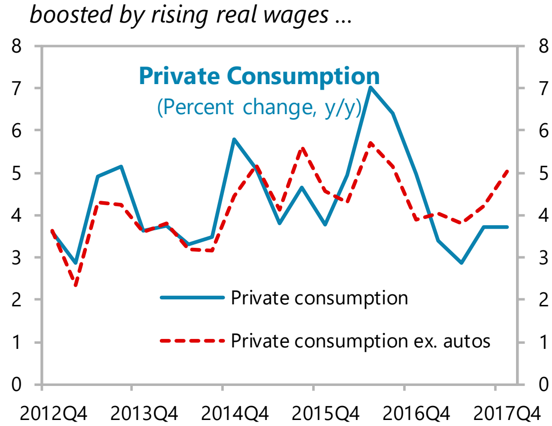
High-frequency data suggest solid growth will continue…



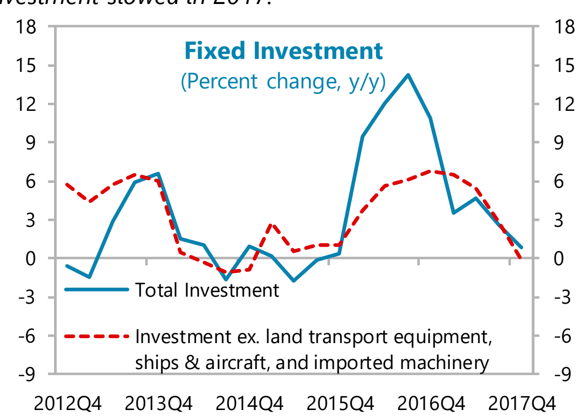
…while unemployment fell to historic lows alongside rising vacancy rates…



…contributing to strong consumption, partly boosted by rising real wages …



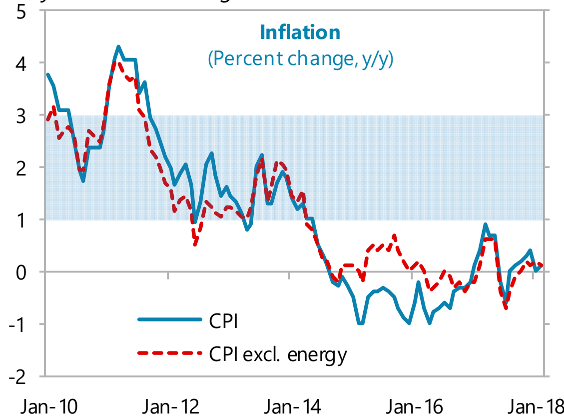
Following a hike in fixed investment in 2016 due to a temporary surge in car purchases ahead of tax hikes, investment slowed in 2017.



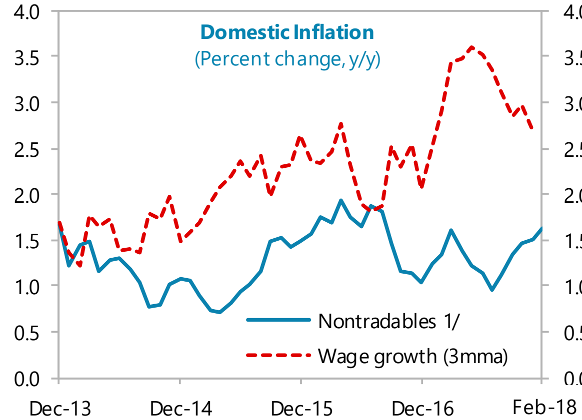
Sources: Bank of Israel; IMF World Economic Outlook; Central Bureau of Statistics; Haver; and IMF staff calculations.

Figure 3. Israel: Inflation and Monetary Indicators

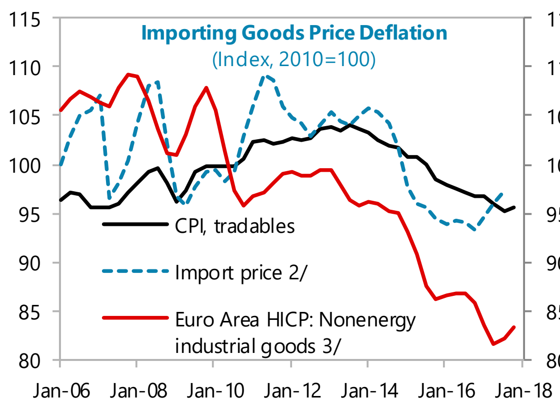
Headline inflation is returning to positive teritory, yet below the target band..



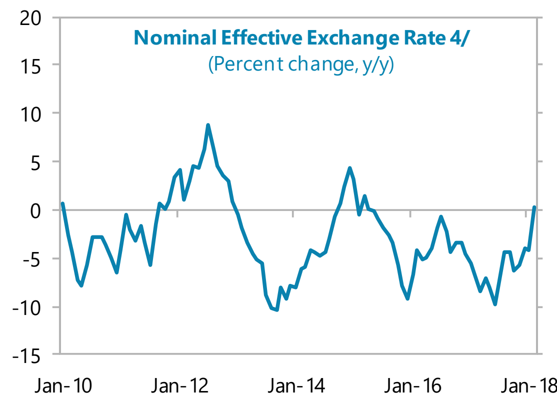
...despite solid nominal wage growth of around 3 percent and nontradable inflation within the band...



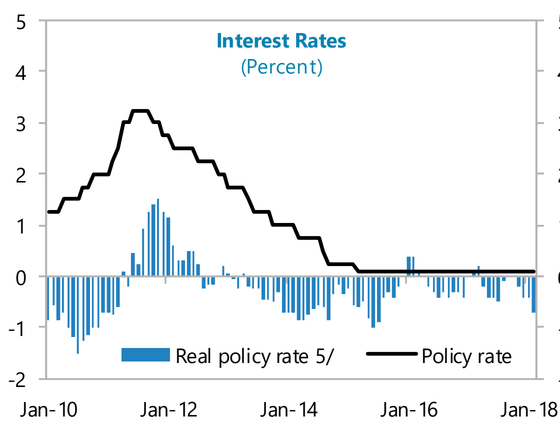
...owing partly to low trading partner inflation...



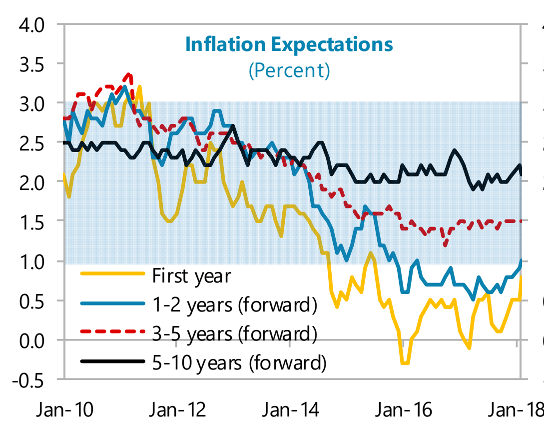
...and shekel appreciation.



Against this backdrop, the BOI has kept the policy rate stable...

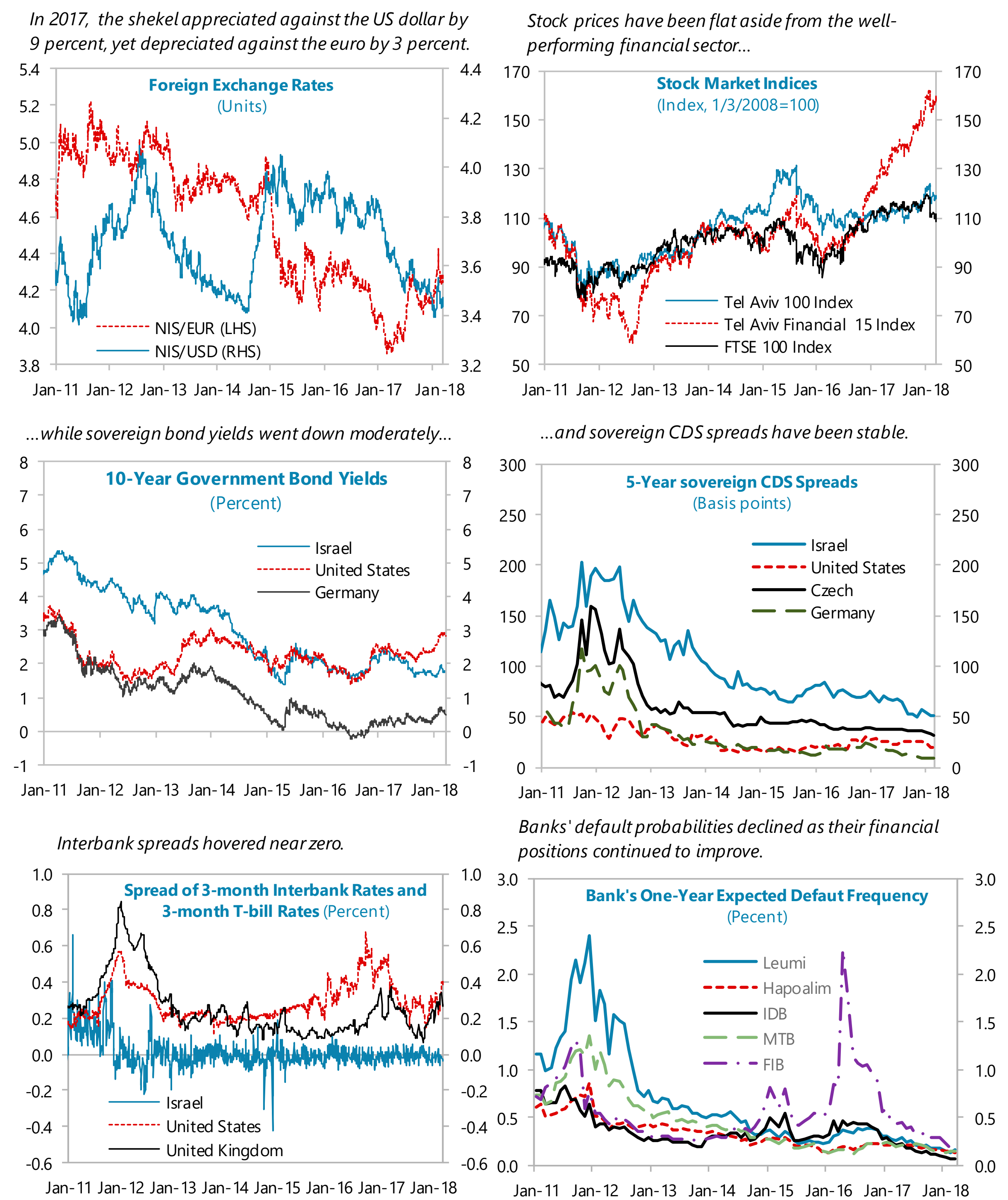


...and long-term inflation expectations remain well anchored.



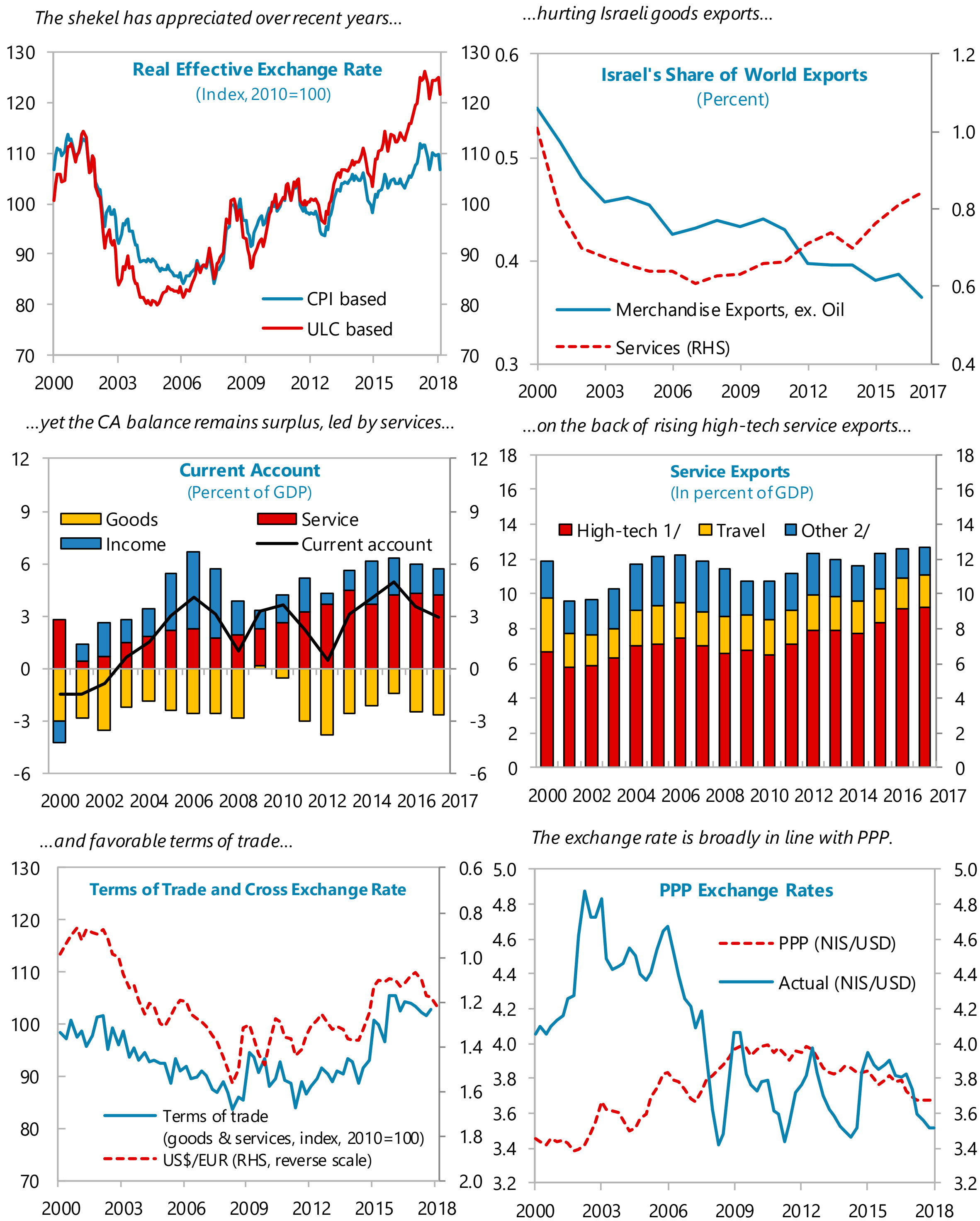
Sources: Haver Analytics; BoI; IMF WEO database; and IMF staff calculations.
1/ Excluding fruit and vegetables, and estimated impact of government measures.
2/ Excluding ships, aircrafts, diamonds, and fuel.
3/ Converted to Shekel.
4/ A negative change indicates appreciation of the shekel.
5/ Real policy rate is calculated as the difference between nominal policy rate and one-year ahead inflation expectations.

Figure 4. Israel: Selected Financial Indicators



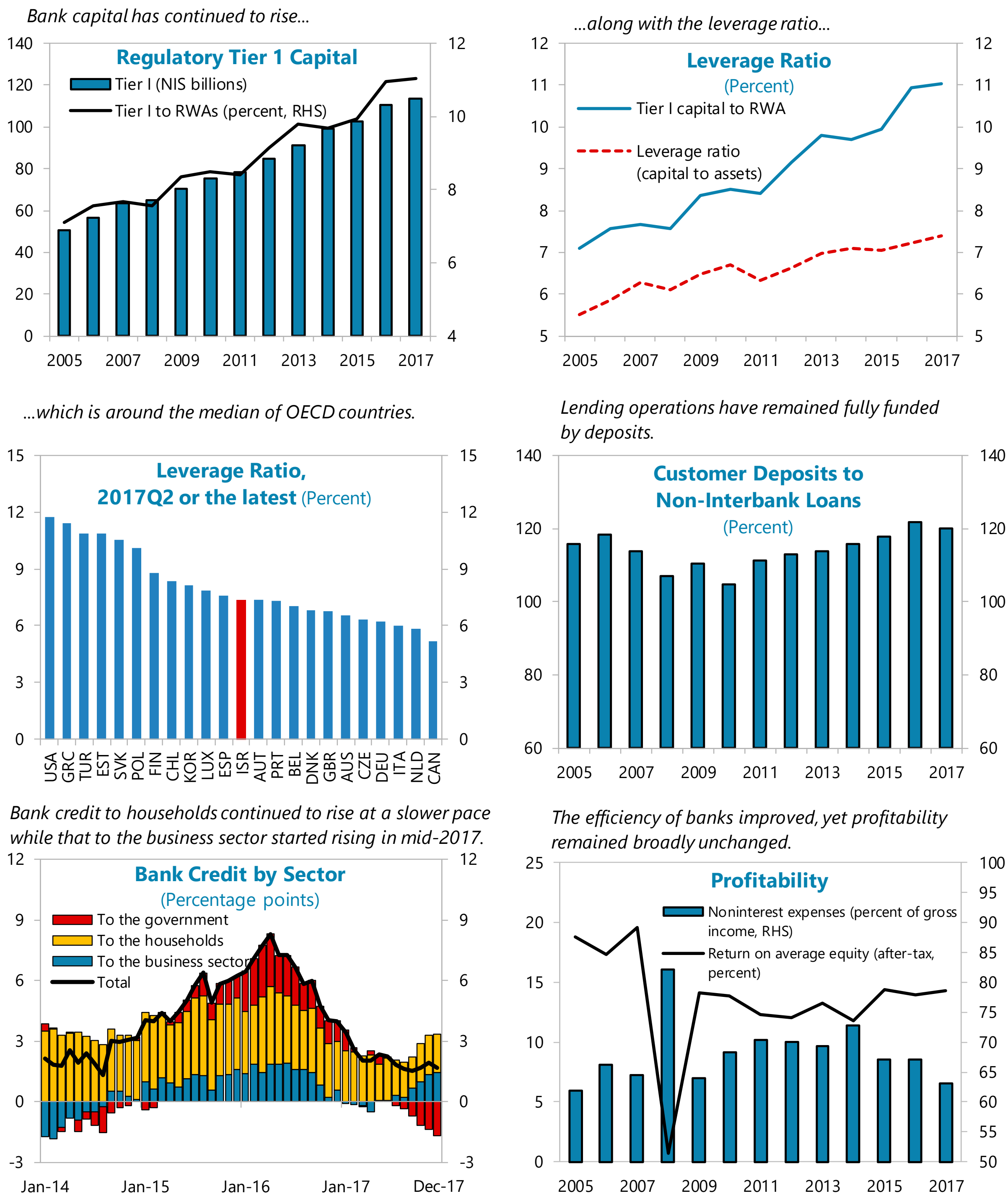
Sources: Bloomberg; Datastream; Haver; and Moody's Analytics, CreditEdge.

Figure 5. Israel: Exchange Rates and BOP



Sources: Bank of Israel; Central Bureau of Statistics; Haver Analytics; IMF; OECD; and IMF staff calculations.
1/ Includes telecom, computer and information; charges for use of intellectual property; and other business (R&D, consulting, technical, trade-related, and other).
2/ Transport, construction, insurance and services to governments.

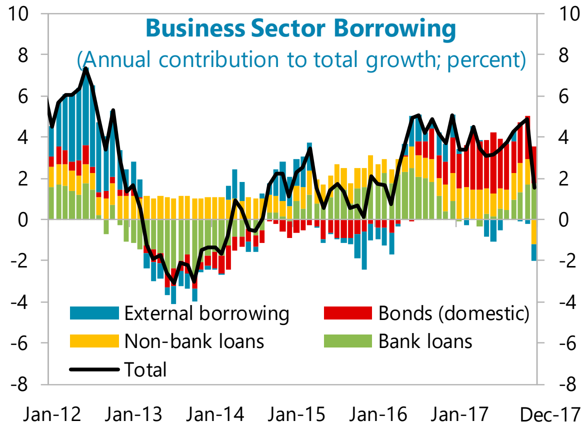
Figure 6. Israel: Performance of the Banking System



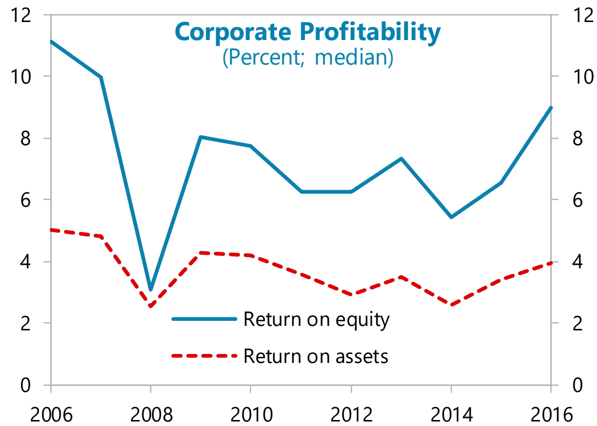
Sources: IMF Financial Soundness Indicator Database; and Haver; and IMF staff calculations.

Figure 7. Israel: Corporate and Household Sector

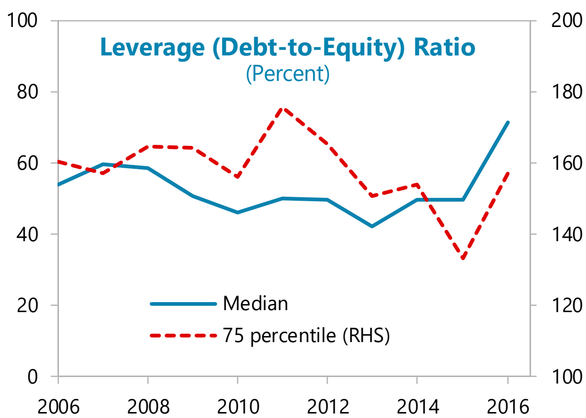
Business sector borrowing grew by 5 percent in 2017, aided by high bond issuance and gradual recovery in bank loans...



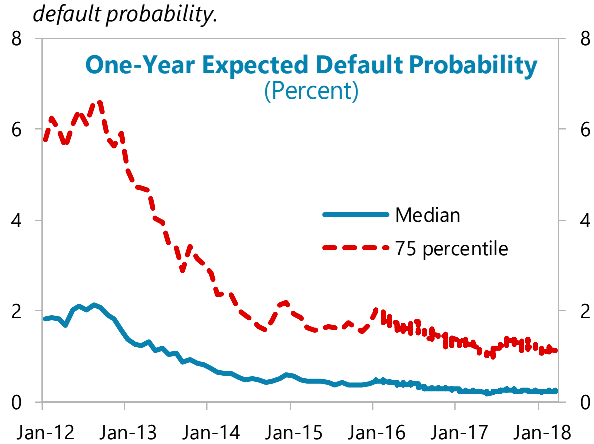
...with profitability picking up in recent years.



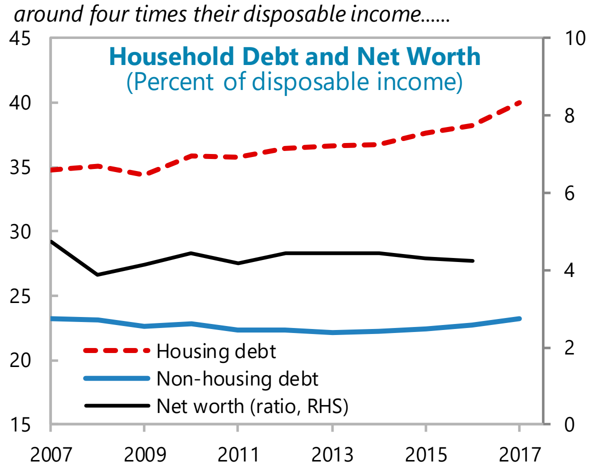
Corporate leverage ratios rose in 2016...



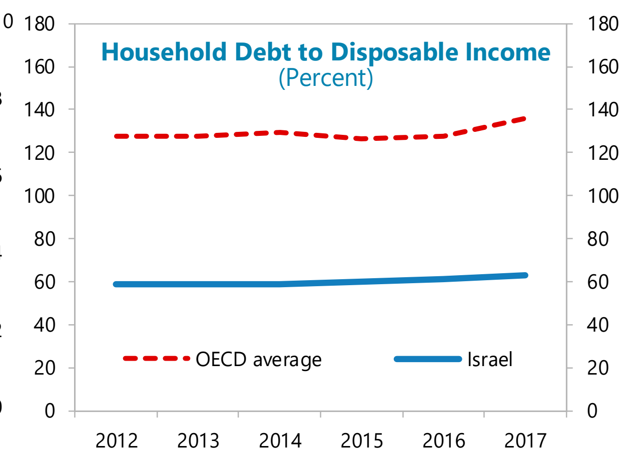
...yet market indicators point to a declining corporate default probability.



Household debt has been rising since 2010, driven by mortgage loans, yet household net worth has remained around four times their disposable income......



...and household debt remains low.



Sources: Haver Analytics; and IMF staff calculations.

Table 1. Israel: Selected Economic Indicators, 2014–23

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Prel.			Projections			
Real Economy (percent change)										
Real GDP	3.5	2.6	4.0	3.4	3.4	3.4	3.3	3.0	3.0	3.0
Domestic demand	4.2	3.4	6.0	3.5	3.4	3.5	3.0	3.0	3.0	3.0
Private consumption	4.5	3.9	6.1	3.3	3.4	2.9	3.0	3.0	3.0	3.0
Public consumption	3.5	3.2	3.9	3.2	3.0	3.0	3.0	3.0	3.0	3.0
Gross capital formation	4.2	2.4	8.1	4.5	3.9	5.6	3.0	3.0	3.0	3.0
Gross fixed investment	0.8	-0.8	11.9	2.8	3.4	5.6	3.0	3.0	3.0	3.0
Foreign demand (contribution to growth)	-0.5	-0.8	-1.9	-0.2	0.0	-0.1	0.3	0.0	0.0	0.0
Potential GDP	3.7	3.4	3.4	3.3	3.3	3.4	3.3	3.1	3.0	3.0
Output gap (percent of potential)	0.1	-0.6	0.0	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Unemployment rate (percent)	5.9	5.3	4.8	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Overall CPI (percent change, end of period)	-0.2	-1.0	-0.2	0.4	1.0	1.5	2.0	2.0	2.0	2.0
Overall CPI (percent change, average)	0.5	-0.6	-0.5	0.2	0.7	1.3	1.8	2.0	2.0	2.0
GDP Deflator (percent change, average)	1.0	2.7	1.0	0.1	0.2	1.5	1.9	2.1	2.1	2.1
Saving and investment balance										
Gross national saving (percent of GDP)	24.2	24.7	24.0	23.7	23.7	24.0	24.3	24.3	24.2	24.2
Foreign saving (percent of GDP)	-4.0	-4.9	-3.5	-3.0	-2.8	-2.7	-3.1	-3.0	-3.0	-3.0
Gross capital formation (percent of GDP)	20.2	19.8	20.5	20.7	20.9	21.3	21.2	21.2	21.2	21.2
Public Finance (percent of GDP)										
Central government										
Revenues and grants	25.7	25.8	26.4	26.9	25.9	25.7	25.7	25.7	25.7	25.7
Total expenditure	28.4	27.9	28.5	28.9	28.8	28.6	28.6	28.6	28.6	28.6
Overall balance	-2.7	-2.1	-2.1	-2.0	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Structural balance 1/	-2.8	-2.0	-2.6	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Cyclically adjusted primary balance 1/	0.7	0.5	0.3	0.3	-0.6	-0.7	-0.6	-0.6	-0.5	-0.5
General Government										
Overall balance	-3.3	-2.1	-2.1	-2.2	-3.2	-3.3	-3.4	-3.4	-3.4	-3.4
Structural balance 1/	-3.4	-1.9	-2.6	-3.4	-3.2	-3.4	-3.4	-3.4	-3.4	-3.4
Debt	66.1	64.2	62.3	60.9	61.5	61.4	61.3	61.1	61.1	61.0
Of which: Foreign currency external debt	14.9	13.6	13.1	12.8	12.8	12.8	12.8	12.8	12.8	12.8
Balance of Payments (percent of GDP)										
Current account balance	4.0	4.9	3.5	3.0	2.8	2.7	3.1	3.0	3.0	3.0
Goods and services balance	1.5	2.8	1.9	1.5	1.1	1.1	1.5	1.5	1.6	1.7
Exports of goods and services 2/	32.2	31.3	30.3	29.2	30.0	30.3	30.5	30.5	30.4	30.2
Real growth rate (percent)	1.9	-2.7	2.5	3.7	4.3	4.5	4.5	3.4	3.5	3.5
Export prices growth (percent)	0.1	-4.0	0.5	2.6	5.7	0.9	1.6	1.6	1.6	1.4
Imports of goods and services 2/	30.8	28.3	28.2	27.5	28.9	29.2	29.0	28.9	28.8	28.6
o/w Oil imports (billions of U.S. dollars)	12.8	7.4	5.8	7.4	9.1	8.8	8.6	8.7	8.8	9.1
Real growth rate (percent)	4.0	-0.3	9.4	4.3	4.4	5.0	3.6	3.6	3.6	3.6
Import prices growth (percent)	-0.7	-10.5	-2.9	2.9	7.5	0.3	1.1	1.3	1.2	1.1
Foreign reserves (eop, US$ billions)	86.1	90.6	98.4	113.0	120.6	125.8	132.7	139.7	147.5	155.4
Exchange Rate										
NIS per U.S. dollar (period average)	3.58	3.89	3.84	3.60	...	...	...	...	...	...
Nominal effective exchange rate (2005=100)	106.4	108.0	111.6	113.7	...	...	...	...	...	...
Real effective exchange rate (2005=100)	103.5	103.3	104.8	105.1	...	...	...	...	...	...
Terms of trade (2010 = 100)	96.5	106.7	108.2	104.5	102.2	102.8	103.3	103.7	103.9	103.9

Sources: Bank of Israel; Central Bureau of Statistics; Haver Analytics; and IMF staff estimates and projections.
1/ Percent of potential GDP.
2/ National Accounts data.

Table 2. Israel: Balance of Payments, 2014–23

(In billions of U.S. dollars; unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Est.			Projections			
Current account balance	12.3	14.7	11.2	10.4	10.5	10.7	12.7	13.2	13.7	14.3
Merchandise	-6.7	-4.2	-7.8	-9.5	-9.9	-11.5	-12.1	-13.5	-15.1	-16.8
Exports, f.o.b.	63.9	56.1	56.1	58.1	62.8	64.6	67.0	69.1	71.1	72.8
Imports, f.o.b.	70.6	60.3	63.9	67.5	72.7	76.0	79.1	82.7	86.2	89.6
Services	11.3	12.5	13.8	14.9	14.0	15.9	18.3	20.2	22.4	24.8
Exports	35.7	36.9	39.8	44.0	49.7	53.9	58.8	63.1	67.9	73.1
Imports	24.4	24.4	26.1	29.1	35.7	38.1	40.5	42.9	45.5	48.3
Primary income	-2.1	-2.7	-3.9	-2.9	-3.4	-3.9	-4.1	-4.8	-5.5	-6.3
Receipts	9.6	10.7	10.2	11.4	12.0	12.1	12.8	13.2	14.2	15.0
Payments	11.8	13.4	14.1	14.3	15.3	16.0	16.9	18.0	19.7	21.2
Secondary income	9.8	9.1	9.1	7.9	9.7	10.2	10.7	11.3	11.9	12.5
Receipts	12.4	11.9	12.2	11.5	13.9	14.5	15.2	16.1	16.9	17.9
Payments	2.6	2.8	3.1	3.6	4.1	4.3	4.5	4.8	5.0	5.3
Capital account	2.7	2.1	2.2	1.8	2.0	2.0	2.0	2.0	2.0	2.0
Financial account 1/	10.4	7.8	-0.3	-2.3	4.9	7.4	7.9	8.2	8.0	8.3
Direct investment, net	-1.5	-0.4	1.2	-12.7	-0.9	-0.8	-0.7	-0.6	-0.7	-0.9
Foreign direct investment abroad	4.5	11.0	13.1	6.3	9.7	10.0	10.3	10.6	10.9	11.2
Foreign direct investment in Israel	6.1	11.3	11.9	19.0	10.5	10.7	11.0	11.2	11.6	12.1
Portfolio investment, net	0.9	7.1	-1.6	1.7	3.6	5.7	6.4	7.1	7.8	8.4
Financial derivatives, net	-0.4	-0.3	-0.6	-1.4	-0.4	-0.4	-0.4	-0.5	-0.5	-0.6
Other investment, net	11.5	1.4	0.7	10.0	2.5	2.9	2.6	2.2	1.5	1.5
Change in reserves	7.4	7.3	8.5	8.1	7.6	5.3	6.9	7.0	7.7	8.0
Errors and omissions	2.8	-1.7	-5.2	-6.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Current account balance (percent of GDP)	4.0	4.9	3.5	3.0	2.8	2.7	3.1	3.0	3.0	3.0
Terms of trade (percent change)	-3.9	10.6	1.4	-3.4	-2.2	0.5	0.6	0.4	0.1	0.0
Gross external debt (percent of GDP)	30.5	28.7	27.6	25.4	24.6	24.3	23.9	23.7	23.6	23.6
Foreign reserves										
US$ billion	86.1	90.6	98.4	113.0	120.6	125.8	132.7	139.7	147.5	155.4
Percent of GDP	27.9	30.3	31.0	32.2	32.2	32.2	32.2	32.2	32.2	32.2
Months of G&S imports	12.2	12.1	12.2	12.5	12.7	12.6	12.7	12.7	12.7	12.8
GDP (billions of U.S. dollars)	308.4	299.1	317.7	350.9	374.4	390.7	412.0	433.9	457.8	482.6

Sources: Central Bureau of Statistics; Haver Analytics; and IMF staff estimates and projections.
1/ Excludes reserve assets.

Table 3. Israel: International Investment Position, 2008–17

(In percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Net Investment	9.1	7.1	11.7	17.6	21.5	22.3	21.9	22.8	34.3	40.6
Direct investment	2.9	0.6	3.3	2.8	-1.3	-3.0	-3.4	-4.9	-2.9	-7.1
Portfolio investment	-15.8	-20.7	-18.4	-9.7	-3.1	-1.5	-5.2	-5.8	2.5	8.7
Financial derivatives	0.0	0.0	0.0	-0.1	-0.1	0.0	-0.1	-0.2	-0.2	-0.1
Reserve assets	19.7	29.2	30.4	28.6	29.5	28.0	27.9	30.3	31.0	32.2
Other investment	2.4	-2.0	-3.7	-4.0	-3.5	-1.2	2.8	3.4	3.8	6.9
Total Assets	90.2	109.5	111.1	101.9	108.0	107.3	108.5	116.4	119.2	123.3
Direct investment	25.2	27.7	29.1	27.6	28.2	26.6	25.6	28.3	30.9	29.6
Portfolio investment	15.5	23.8	26.6	23.8	29.6	32.7	34.4	38.1	37.5	40.7
Reserve assets	19.7	29.2	30.4	28.6	29.5	28.0	27.9	30.3	31.0	32.2
Other assets	29.8	28.8	25.1	22.0	20.8	20.1	20.6	19.8	20.0	20.9
Total Liabilities	81.1	102.4	99.4	84.3	86.4	85.0	86.6	93.5	84.9	82.7
Direct investment	22.4	27.1	25.7	24.8	29.5	29.6	29.1	33.2	33.8	36.7
Portfolio investment	31.3	44.5	45.0	33.5	32.7	34.1	39.7	43.9	35.0	32.0
Other liabilities	27.5	30.8	28.7	26.0	24.3	21.3	17.9	16.4	16.2	14.0

Sources: Central Bureau of Statistics; and Haver Analytics.

Table 4. Israel: Summary of Central Government Operations, 2013–19 1/

(In percent of GDP; unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019
					Prel.	Proj.	
Revenue and grants	25.6	25.7	25.8	26.4	26.9	25.9	25.7
On income and profits	11.4	11.3	11.6	11.8	13.3	11.8	11.8
VAT and customs	10.8	11.2	10.9	10.9	10.5	10.9	10.7
Fees	0.6	0.5	0.6	0.6	0.5	0.6	0.6
VAT on defense imports	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Interest	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Loans from NII	1.3	1.3	1.4	1.9	1.7	1.8	1.8
Grants 2/	0.8	0.8	0.7	0.9	0.0	0.0	0.0
Other	0.4	0.3	0.3	0.3	0.5	0.6	0.6
Expenditure 3/	28.8	28.4	27.9	28.5	28.9	28.8	28.6
Administrative Departments	4.1	4.1	4.0	4.1	4.1	4.0	3.9
Social Departments	11.4	11.2	11.3	12.0	12.6	12.7	12.8
Economic Departments	2.5	2.2	2.0	2.1	2.3	2.3	2.3
Defense Expenditure 2/	6.1	6.2	6.1	6.0	5.3	5.3	5.3
Other Expenditures	0.2	0.3	0.3	0.3	0.6	0.4	0.4
Reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest	3.6	3.5	2.6	2.5	2.3	2.3	2.3
Repayment of Principal to NII	0.9	1.0	1.6	1.5	1.6	1.7	1.7
Budget deficit	-3.3	-2.7	-2.1	-2.1	-2.0	-2.9	-2.9
Unsettled Payment Orders 4/	0.6	-0.5	0.3	0.2	-0.5	0.0	0.0
Financing	3.9	2.2	2.5	2.3	1.4	2.9	2.9
Foreign (net)	0.0	0.1	-0.5	0.2	0.7	0.5	0.6
Loans	1.2	1.1	0.4	1.0	1.1	1.0	1.0
Repayment	-1.1	-1.0	-0.9	-0.7	-0.5	-0.4	-0.4
Domestic (net)	3.7	2.0	2.7	1.8	0.6	2.2	2.2
Loans	10.1	8.6	6.1	7.2	7.0	7.9	8.0
Repayment	-6.4	-6.6	-3.4	-5.3	-6.4	-5.6	-5.7
Sale of assets (net)	0.1	0.1	0.3	0.2	0.1	0.1	0.1
Memorandum items:							
Structural balance (percent of potential GDP)	-3.4	-2.8	-2.0	-2.6	-2.9	-2.9	-2.9
Primary balance (PB)	0.2	0.7	0.4	0.3	0.3	-0.6	-0.7
Cyclically adjusted PB (percent of potential GDP)	0.2	0.7	0.4	0.3	0.3	-0.6	-0.7
Deficit limit 3/	4.0	2.8	2.9	2.9	2.9	2.9	2.9
Real expenditure growth (in percent)	4.4	2.5	4.2	7.6	4.7	2.4	3.0
Public debt to GDP	67.1	66.1	64.2	62.3	60.9	61.5	61.4
Nominal GDP (in billions of NIS)	1,056	1,103	1,163	1,220	1,263	1,309	1,373

Sources: Israeli Ministry of Finance; and IMF staff estimates and projections.

1/ Data as per the MoF definition, on a cash basis, covering the budgetary sector and the National Insurance Institute.

2/ Starting from 2017, grants provded by the United States and associated spending are excluded from the MOF's budget presentation.

3/ Excludes state land sales.

4/ Registered spending but for which the equivalent cash has not yet been disbursed, hence it does not appear in financing.

Table 5. Israel: General Government Operations, 2013–19

(In percent of GDP; unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019
					Prel.	Proj.	
	(In billions of NIS, unless otherwise specified)						
Revenue	385.4	406.7	430.0	448.1	480.6	480.4	501.0
Taxes	269.1	284.9	301.2	315.3	341.3	336.0	349.6
Taxes on income, profits, and capital gains	104.4	107.8	117.5	124.6	147.4	133.4	140.2
Taxes on goods and services	128.6	138.3	143.3	148.8	148.4	157.9	162.9
Taxes on international trade and transactions	2.3	2.8	2.9	3.3	3.2	3.1	3.3
Taxes n.e.c.	33.8	36.1	37.4	38.7	42.2	41.6	43.2
Social contributions	62.5	65.3	68.7	72.3	74.9	77.6	81.4
Grants	10.9	11.1	12.9	13.5	13.9	14.4	15.1
Other revenue	42.9	45.4	47.2	47.0	50.5	52.4	54.9
Of which: Interest income	5.8	4.8	4.4	3.6	3.9	4.0	4.2
Expenditure	429.1	443.7	454.5	473.9	507.9	521.9	546.6
Expense	428.9	443.5	458.8	474.9	509.0	521.7	546.3
Compensation of employees	107.0	110.9	115.6	120.5	125.3	129.1	135.9
Purchases/use of goods and services	92.8	99.1	103.0	108.0	114.5	117.3	122.4
Interest expense	39.8	39.2	38.5	35.8	38.5	39.9	42.0
Social benefits	125.3	130.5	136.0	142.1	154.8	160.6	168.9
Expense n.e.c.	64.0	63.7	65.8	68.6	75.9	74.8	77.1
Net acquisition of nonfinancial assets	0.2	0.2	-4.3	-1.0	-1.1	0.2	0.2
Net lending/borrowing	-43.7	-36.9	-24.5	-25.8	-27.3	-41.5	-45.5
Net acquisition of financial assets	-3.8	-14.1	0.9	-0.6	-15.1	-5.1	-6.9
Net incurrence of liabilities	39.9	22.8	25.4	25.2	12.2	36.4	38.7
	(In percent of GDP)						
Revenue	36.5	36.9	37.0	36.7	38.1	36.7	36.5
Taxes	25.5	25.8	25.9	25.8	27.0	25.7	25.5
Taxes on income, profits, and capital gains	9.9	9.8	10.1	10.2	11.7	10.2	10.2
Taxes on goods and services	12.2	12.5	12.3	12.2	11.8	12.1	11.9
Taxes on international trade and transactions	0.2	0.3	0.2	0.3	0.3	0.2	0.2
Taxes n.e.c.	3.2	3.3	3.2	3.2	3.3	3.2	3.2
Social contributions	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Grants	1.0	1.0	1.1	1.1	1.1	1.1	1.1
Other revenue	4.1	4.1	4.1	3.9	4.0	4.0	4.0
Of which: Interest income	0.6	0.4	0.4	0.3	0.3	0.3	0.3
Expenditure	40.6	40.2	39.1	38.8	40.2	39.9	39.8
Expense	40.6	40.2	39.5	38.9	40.3	39.9	39.8
Compensation of employees	10.1	10.0	9.9	9.9	9.9	9.9	9.9
Purchases/use of goods and services	8.8	9.0	8.9	8.8	9.1	9.0	8.9
Interest expense	3.8	3.6	3.3	2.9	3.0	3.0	3.1
Social benefits	11.9	11.8	11.7	11.6	12.3	12.3	12.3
Expense n.e.c.	6.1	5.8	5.7	5.6	6.0	5.7	5.6
Net acquisition of nonfinancial assets	0.0	0.0	-0.4	-0.1	-0.1	0.0	0.0
Net lending/borrowing	-4.1	-3.3	-2.1	-2.1	-2.2	-3.2	-3.3
Net acquisition of financial assets	-0.4	-1.3	0.1	0.0	-1.2	-0.4	-0.5
Net incurrence of liabilities	3.8	2.1	2.2	2.1	1.0	2.8	2.8

Sources: Central Bureau of Statistics; IMF Government Financial Statistics; and IMF staff estimates and projections.

Table 6. Israel: Financial System Structure, 2008–16

	2008				2013				2016			
	Number of		Total assets		Number of		Total assets		Number of		Total assets	
	Branches	Employees	NIS billions	Percent of GDP	Branches	Employees	NIS billions	Percent of GDP	Branches	Employees	NIS billions	Percent of GDP
A. Banks												
Five major banks, consolidated	**1,191**	**46,790**	**1,013**	**130.8**	**1,235**	**47,287**	**1,246**	**118.0**	**1,059**	**43,775**	**1,465**	**120.0**
Bank Leumi	322	13,108	311	40.1	322	13,307	374	35.4	234	12,257	439	35.9
Bank Hapoalim	292	13,884	307	39.6	304	13,202	380	36.0	264	11,893	448	36.7
Israel Discount Bank	234	10,382	182	23.5	249	9,834	201	19.0	208	8,842	220	18.0
Mizrahi Tefahot Bank	168	4,627	114	14.7	177	5,767	180	17.0	187	6,103	230	18.9
First International Bank of Israel	175	4,789	99	12.8	183	5,177	111	10.5	166	4,680	128	10.5
Other Israeli banks (3)	**52**	**1,555**	**49**	**6.3**	**58**	**1,851**	**62**	**5.9**	**61**	**1,977**	**65**	**5.3**
Foreign bank branches (4)			...	...	**4**	...	**16**	**1.5**	**6**	...	**18**	**1.5**
B. Non-bank financial institutions 1/			**765**	**98.8**			**1,390**	**131.6**			**1,655**	**135.6**
Provident and severance pay funds	...	...	145	18.8	...	...	204	19.3	...	...	219	18.0
Advanced study funds	...	...	73	9.4	...	...	143	13.5	...	...	184	15.1
Old pension funds	...	...	237	30.6	...	...	348	32.9	...	...	395	32.4
New pension funds	...	...	71	9.2	...	...	186	17.6	...	...	286	23.5
New general pension funds	...	...	1	0.1	...	...	2	0.2	...	...	4	0.4
New comprehensive pension funds	...	...	70	9.1	...	...	183	17.3	...	...	282	23.1
Mutual funds	...	...	98	12.7	...	...	231	21.9	...	...	214	17.5
Assured yield life insurance plans	...	...	55	7.1	...	...	78	7.4	...	...	86	7.1
Profit sharing life insurance plans	...	...	86	11.1	...	...	202	19.1	...	...	270	22.1
Total financial system (A+B)	...	...	**1,827**	**235.9**	...	...	**2,714**	**257.0**	...	...	**3,202**	**262.4**
Memorandum items:												
GDP (NIS billions)	...	...	...	774.4	...	...	...	1,056.1	...	...	...	1,220.3

Sources: Bank of Israel; Ministry of Finance; Capital Market, Insurance, and Saving Authority; and Israel Securities Authority.

1/ The number of funds include management companies.

Table 7. Israel: Financial Soundness Indicators, Banks, 2011–17:Q3
(End-period, in percentage points)

	2011	2012	2013	2014	2015	2016	2017 Q3
Capital Adequacy							
Regulatory capital to risk-weighted assets 1/	14.0	14.9	14.8	14.3	14.0	14.7	14.5
Regulatory Tier I capital to risk-weighted assets 1/	8.4	9.2	9.8	9.7	9.9	10.9	11.1
Capital as percent of assets (leverage ratio)	6.3	6.6	7.0	7.1	7.1	7.2	7.4
Asset quality and exposure							
Nonperforming loans to total gross loans	3.4	3.5	2.9	2.2	1.8	1.6	1.4
Nonperforming loans net of loan-loss provisions to capital	12.3	12.3	8.9	6.1	3.4	2.2	1.1
Sectoral distribution of bank credit (percent) 2/							
Industry	9.6	8.9	8.5	8.0	7.1	6.4	...
Construction and real estate	16.6	16.4	16.2	16.1	16.4	16.5	...
Commerce	6.4	6.5	6.7	7.4	7.2	7.6	...
Finance services	8.0	7.5	7.4	7.1	6.3	6.0	...
Households	35.2	36.7	38.5	38.9	40.5	41.7	...
Of which: mortgages	17.7	19.0	20.4	20.8	22.0	22.8	...
Borrowers with activity abroad	13.0	12.6	11.7	11.9	11.8	10.9	...
Others	11.3	11.4	11.1	10.7	10.7	11.0	...
Large exposures as percent of regulatory capital	395.0	364.8	357.9	345.5	349.6	321.4	...
Earnings and profitability							
Return on average assets (before tax)	1.2	0.8	0.9	0.8	1.0	1.0	1.0
Return on average equity (before tax)	12.3	12.1	13.3	11.8	14.4	13.9	13.7
Interest margins to gross income	65.2	60.7	59.1	58.4	56.5	58.6	61.9
Trading and fee income to gross income	7.1	6.4	6.2	6.8	6.3	5.3	0.0
Noninterest expenses to gross income	70.3	70.0	69.3	72.7	67.1	67.1	64.9
Personnel expenses to noninterest expenses	59.0	58.6	59.6	59.1	59.3	58.0	58.5
Liquidity							
Liquid assets as percent of total assets	...	...	14.2	15.7	15.1	...	...
Liquid assets as percent of short-term liabilities	...	...	25.7	27.7	26.5	...	...
Customer deposits as a percent of total (non-interbank) loans	111.3	113.0	113.9	115.8	117.8	121.6	120.1
Foreign exchange risk							
Net foreign exchange open position to capital	-44.6	-43.7	-55.7	-55.2	-61.1	-65.6	-53.5
Foreign currency-denominated loans as percent of total loans	16.6	14.9	13.1	13.2	12.4	11.4	11.5
Foreign currency-denominated liabilities as percent of total liabilities	29.7	27.7	26.8	29.2	26.9	25.9	23.8

Sources: Bank of Israel; and IMF Financial Soundness Indicators Database.

1/ The calculation of capital base follows rules under Basel II.

2/ Include off-balance sheet data.

Table 8. Israel: Financial Soundness Indicators, Non-Banks, 2008–16
(End-period, in percentage points unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Insurance sector									
Return on equity	-19.0	35.9	19.3	-0.5	14.4	18.3	11.9	6.7	6.2
Net premiums as percent of capital	302.6	204.1	192.5	224.5	213.2	201.3	194.3	226.6	257.2
Capital as percent of technical reserves	6.0	7.3	7.4	6.4	6.4	6.5	5.7	5.5	5.4
Surplus capital as percent of required solvency 1 capital	1.5	25.5	28.8	16.6	32.7	40.4	44.8	42.2	47.3
Liquid assets as percent of total assets	41.4	49.5	52.4	51.2	51.9	53.4	57.0	57.3	55.8
Households									
Household assets as percent of disposable income	466.4	489.4	517.3	493.1	516.7	514.1	515.6	502.0	497.7
Of which: residential buildings	153.5	143.0	143.2	142.5	146.4	145.0	143.7	142.5	142.8
Household financial liabilities as percent of disposable income	78.9	75.4	74.2	75.4	72.3	70.9	72.2	73.1	73.6
Corporate sector									
Non-financial sector borrowing to GDP ratio	84.5	85.5	82.7	79.6	76.6	74.7	75.7	74.5	74.3
From residents	67.4	68.8	67.2	63.7	61.3	60.7	61.1	61.9	62.0
From non residents	17.1	16.7	15.5	15.8	15.3	14.1	14.7	12.6	12.4
Debt to equity ratio									
All nonfinancial corporate	2.6	2.2	2.2	2.3	2.2	2.0	1.9	1.7	1.9
Of which: Manufacturing sector	1.3	1.1	1.1	1.5	1.4	1.2	1.2	1.1	1.6
Construction corporate	4.1	3.8	3.0	2.9	2.5	2.3	2.1	2.0	1.8
Net income to equity ratio									
All nonfinancial corporate	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Of which: Manufacturing sector	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Construction corporate	-0.2	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Earning before interest and tax to equity ratio									
All nonfinancial corporate	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Of which: Manufacturing sector	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.0
Construction corporate	0.0	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1
Equity markets									
Tel Aviv Stock Exchange Index 75 (annual percent change)	-67.5	149.8	15.7	-25.9	4.8	24.7	-9.8	-5.4	17.3
Equity prices of financial institutions (annual percent change)	-55.7	126.9	9.3	-34.0	23.1	18.8	-7.7	4.0	19.2
Equity prices of real estate firms (annual percent change)	-80.0	125.2	15.4	-23.2	14.1	26.0	0.9	1.1	17.0
Equity prices of banks (annual percent change)	-55.5	114.0	6.8	-34.6	22.9	16.3	-5.6	7.3	17.8
Market capitalization in percent of GDP	52.4	87.7	92.3	64.1	60.9	66.8	70.7	81.8	67.4
Corporate bond markets									
Corporate bond yields over government bond yields (in percentage points)									
Real estate and construction	20.0	9.7	4.8	8.1	5.7	3.1	3.8	3.7	2.5
Manufacturing	7.5	3.6	3.1	4.8	4.2	4.9	4.4	3.8	3.4
Corporate bond outstanding (in billions of NIS)	185.6	217.3	240.1	238.7	260.8	271.4	263.7	251.6	272.7
Average daily turnover (in billons of NIS)	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.1	2.4
Real estate markets (prices; annual percent change)									
Average prices of owner occupied dwelling	6.5	22.4	17.0	0.0	5.8	7.4	7.2	6.0	0.9
Jerusalem	13.3	15.5	14.7	8.6	0.6	2.0	7.6	4.3	3.7
Tel Aviv	10.7	34.1	16.9	-4.8	-9.2	36.1	7.4	4.9	3.7
Memorandum items									
GDP (year on year percent change, constant prices)	3.0	1.5	5.5	5.2	2.2	4.2	3.5	2.6	4.0
Nominal GDP (in billions of NIS)	774	816	873	936	992	1,056	1,103	1,163	1,220
Total financial sector assets (in billions of NIS)	1,827	2,002	2,137	2,258	2,440	2,714	2,892	3,056	263
Of which: Five major banks (in percent of total financial assets)	55.4	52.1	50.0	52.1	50.0	45.9	45.9	45.4	557.2
Total financial sector assets (in percent of GDP)	235.9	245.5	244.6	241.2	245.9	257.0	262.0	262.8	21.5
of which: Five major banks (in percent of GDP)	130.8	127.8	122.4	125.7	123.1	118.0	120.3	119.4	120.0

Sources: Bank of Israel; and IMF staff estimates.

Table 9. Israel: Credit by Financial Sector and Nonresidents, 2008–17

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Financial Sector Credit										
Banks	88.4	84.0	84.7	85.2	82.3	79.0	78.0	78.6	77.9	76.5
Of which to:										
Business sector	49.1	43.5	43.1	42.2	39.2	35.4	34.0	33.4	32.3	32.3
Households	30.4	32.0	33.6	34.3	34.8	35.5	36.2	37.0	37.0	37.2
Government	8.9	8.5	8.1	8.7	8.3	8.1	7.9	8.3	8.6	7.0
Institutional investors	51.5	52.5	51.7	49.9	52.6	53.0	53.2	53.2	53.8	57.5
Of which to:										
Business sector	13.6	14.8	14.2	13.5	13.9	13.6	13.2	12.7	13.1	13.9
Households	0.6	0.6	0.6	0.6	0.7	0.7	0.8	1.0	1.4	1.9
Government	37.3	37.1	36.9	35.8	38.0	38.8	39.2	39.5	39.3	41.8
Credit card companies	0.8	0.9	1.1	1.1	1.1	1.1	1.2	1.3	1.5	1.7
Of which to:										
Business sector	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Households	0.6	0.8	0.9	0.9	0.9	0.9	1.0	1.2	1.3	1.4
Total financial sector credit	140.7	137.4	137.5	136.1	136.0	133.1	132.4	133.1	133.2	135.7
Nonresidents Credit to:										
Business sector	16.3	16.9	15.4	16.5	16.3	15.2	15.5	14.2	14.2	11.9
Households	-	-	-	-	-	-	-	-	-	-
Government	13.7	13.3	11.4	12.7	11.3	9.3	9.8	8.8	8.4	8.2
Total nonresidents credit	30.0	30.2	26.8	29.2	27.7	24.6	25.3	23.0	22.7	20.1
Government Credit to:										
Business sector	0.3	0.1	0.3	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Households	5.6	4.9	4.0	3.3	2.8	2.4	2.0	1.4	1.2	1.0
Total government credit	5.9	5.1	4.3	3.5	3.0	2.5	2.1	1.5	1.2	1.1
Households and Nonfinancial Corporations Credit to:										
Business sector	4.3	8.8	9.9	8.1	8.2	9.0	8.2	8.3	9.4	10.4
Government	15.8	19.8	18.7	15.5	16.3	15.9	15.6	14.2	11.9	10.2
Total HH and NFC credit	20.1	28.6	28.6	23.6	24.5	24.9	23.8	22.5	21.3	20.6
Total Credit	196.7	201.3	197.1	192.4	191.2	185.0	183.6	180.1	178.4	177.4

Source: Haver Analytics.

Table 10. Israel: Business and Household Sector Borrowing 2008–17
(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total business sector borrowing	93.2	87.2	84.0	83.3	79.6	73.8	71.4	69.2	69.3	68.0
Bank loans	49.8	44.2	43.6	42.3	39.1	35.4	33.9	33.4	32.4	32.5
Institutional investor loans	1.4	1.7	2.0	2.6	3.4	4.0	4.4	5.0	5.6	6.1
Bonds 1/	25.3	24.0	22.6	21.4	20.4	18.8	17.4	16.4	16.8	17.2
External borrowing	16.3	16.9	15.4	16.5	16.3	15.2	15.5	14.2	14.2	11.9
Others 2/	0.4	0.3	0.4	0.4	0.4	0.3	0.2	0.2	0.2	0.2
Total household sector borrowing	37.7	38.8	39.6	39.6	39.6	39.8	40.4	40.8	41.3	41.9
Mortgage	22.8	23.4	24.2	24.4	24.6	24.9	25.2	25.6	25.9	26.5
Others	15.0	15.4	15.4	15.2	15.0	15.0	15.2	15.2	15.4	15.4

Sources: Bank of Israel; Israel Central Bureau of Statistics; Haver Analytics; and IMF staff calculations.

1/ Includes bonds held by domestic investors only.

2/ Includes business sector borrowing from credit card companies and the government.

Annex I. Status of Key Recommendations from the 2017 Article IV Consultation and 2016 Technical Assistance on Bank Supervision

Recommendations	Status
Reduce general government fiscal deficits to around three percent of GDP over the business cycle, with temporary flexibility to facilitate structural reforms.	Excluding one-off revenues, the central government deficit for 2017 was in line with 2.9 percent of GDP budget target. The deficit ceiling for 2019 has been raised to 2.9 percent of GDP, from 2.5 percent of GDP. The implied deficit for the general government is 3.4 percent of GDP. The 2.5 percent target for the central government is deferred until 2020, but the track record of past adjustments indicates it will be revised up.
Increase public investments in human and physical capital while protecting fiscal space.	Several public transport projects are underway, including a high-speed rail between Jerusalem and Tel Aviv and light rail systems in the largest three cities (4.9 percent of GDP). In 2017, the government created a committee on scaling up public infrastructure investments ('Infrastructure 2030').
Boost the supply of housing by addressing municipal disincentives, ensuring adequate land supply for housing, reducing construction times and costs. Enhance also rental markets.	A series of Buyers' Price tenders took place in 2017 (40,000 apartments were successfully sold by end-2017). A new tax on owners of more than two properties aiming to promote a release of apartments by investors was overturned by the Supreme Court. An *Arnona* equalization fund was created in 2017 aiming to redistribute property tax fairly across municipalities. A Fair Rental Law was passed in 2017.
Establish a Financial Stability Council (FSC). Further strengthen the financial stability framework to fully realize the benefits of greater competition. For the insurance sector, adopt Solvency II.	A bill to establish the FSC was discussed by the Knesset Finance committee in May 2017, but it remains to be approved. An inter-governmental working group comprising the BoI, MoF, and Ministry of Justice was formed in 2017 to discuss (i) creation of a framework to provide temporary deposit security to new bank entrants and (ii) the bank resolution framework. The CMISA adopted a Solvency II framework in 2017, aiming to achieve a full compliance with the solvency capital requirements by end-2024.
Enhance risk-focused and forward-looking bank supervision strategy	In 2017, the BSD streamlined cases that require its prior approval from every new initiative to only major cases. The BSD is modifying risk cards to better capital a forward-looking dimension.
Raise productivity by boosting competition.	The government continued to implement various product and labor market reforms. For example, (i) the government and Israel Electric Corp (IEC) agreed to open up the power production market and transfer system management and planning to another state-owned company; (ii) import barriers for communications products were removed while those of personal imports were streamlined and clarified; (iii) the Knesset approved import procedure simplification for several items, including non-sensitive food, cosmetic products, and home appliances; (iv) the entry of high-tech foreign workers was substantially eased.
Reduce poverty by addressing structural problems hindering inclusion of Haredi and Israeli-Arab populations	The government (i) created a committee, Employment 2030, to form measures to enhance labor participation; (ii) decided to reform the technological education system to enhance its quality; (iii) raised the amount and expanded the coverage of the EITC; (iv) started providing subsidies for after-school extra curriculum

Annex II. Risk Assessment Matrix[1]

Source of Risk and Relative Likelihood	Impact if Realized
External Risks	
High/Medium Weaker-than-expected global growth, including lower medium-term growth in key advanced and emerging economies	**Medium** Weaker global growth would hamper the emerging recovery of exports and reduce foreign investments, leading to lower growth in Israel. A rise in inflation would likely be delayed.
Policy response:	Monetary policy should remain accommodative. Fiscal policy should allow automatic stabilizers to operate fully, but if the shock is prolonged, there would be a need to moderate spending growth over the medium term.
High Tighter global financial conditions owing to repricing of risk across asset classes	**Low/Medium** Experience indicates that investor flight to safety would modestly impact Israel's risk premia. If it relieved appreciation pressures on the shekel this would be supportive for exports.
Policy response:	Protect confidence in Israel through sound medium-term fiscal policy and strong financial sector supervision. Prolong accommodative monetary stance if the global growth outlook weakens notably. FX intervention could be used if needed to smooth excessive exchange rate volatility.
High Heightened regional security/geopolitical tensions	**Medium/High** Growth would be impacted by lower tourism receipts and more adverse developments could damage business confidence and investment. Increased defense spending could breach the multi-year defense budget and lead to fiscal slippages. The likely shekel depreciation would partly cushion the overall economic impact.
Policy response:	Fiscal policy should allow the automatic stabilizers to operate fully. Deviations from the medium-term defense budget should be temporary and corrected once the situation improves.
Domestic Risks	
Low A sharp decline in housing prices (after price rises slowed to 2.0 percent y/y in November 2017 from 6.7 percent a year earlier)	**Medium** Macroprudential policies have contained household debt risks, including through relatively low LTV ratios, and banks are further protected by capital buffers. But domestic demand, especially construction activity, could fall significantly, impacting growth and potentially having adverse effects on corporate loan quality.
Policy response:	Ease monetary policy as feasible and allow the automatic fiscal stabilizers to operate. If price levels reach significantly lower levels, some easing of macroprudential policies could be considered.
Medium Fiscal pressures running up to the 2019 election	**Medium** The early adoption of the 2019 budget has reduced the risk of election-related spending overruns, yet risks of tax cuts remain. A weakened fiscal position would reduce room for fiscal structural reforms, limiting potential progress in addressing participation and productivity gaps.
Policy response:	Adhere to the rule requiring new commitments to be financed. Maintain commitment to the multi-year deficit targets consistent with debt sustainability and preserving adequate fiscal buffers.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihoods of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff's views on the sources of risk and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex III. Steps to Promote Competition in the Financial Sector

The Israeli authorities are taking a range of actions to promote competition in the financial sector:

- **Instituting a bureau for banking computer services:** The government plans to create a new central computer office that any banks can use, aiming to reduce entry cost for new banks. The MoF has allocated NIS 200 million in the 2019 budget.

- **Creating an information sharing platform:** The online platform based on Application Program Interface (API) between banks and third parties acting on behalf of a customer will be created, allowing a customer to compare prices of personalized banking services. Banks will be obliged to share the customer's information, with his consent and in a secured manner.

- **Introducing "one-click" mobility between bank accounts:** The administrative requirements for switching an account between banks will be eliminated. The new framework employs a "follow-on" technological mechanism that links the customer's old bank account to new account and automatically transfers all the standing orders.

- **Operationalizing the Central Credit Register:** The credit register will narrow the information gaps between banks and customers, and is expected to be available to both parties in early 2019.

- **Separating two credit card companies from banks:** The BoI recently invited potential buyers from Israel and abroad to examine the opportunity to purchase these companies by January 2020.

- **Lowering minimum capital requirements for banks:** The government has reduced the minimum capital requirement for banks from NIS 400 million to NIS 50 million.

- **Lowering minimum capital requirements for insurance companies:** The CMISA cut the capital requirement for insurance in early 2018 with a view to enhancing competition in the insurance market. In response, two on line insurance companies are expected to start business in 2018.

Appendix I. External Sector Assessment

The external position of Israel in 2017 was broadly consistent with fundamentals and desirable policies, but this assessment is subject to significant uncertainty. The Israeli shekel has been on an appreciating trend for over a decade, supported by strong growth in high-tech services exports and favorable terms of trade developments. The real exchange rate has reached historically high levels, especially on a ULC basis, which appears to be weighing on goods exports, which are losing global market share. The still solid, although declining, surplus on the current account suggests that the shekel is undervalued. However, this surplus partly reflects persistent low investment due to structural issues while the full impact of the appreciation of the shekel may not yet be reflected in the external balance. In this context, it is appropriate to give significant weight to the real exchange rate analyses, which indicate that the shekel is either broadly in line with fundamentals or overvalued. Policies that address structural hurdles to investment are needed to promote external balance as well as sustained growth.

External Balance Sheets

1. **Israel's net international investment position (NIIP) increased significantly in 2017, and is expected to rise gradually going forward.** In 2017, the net IIP reached 41 percent of GDP, up from 34 percent of GDP in 2016, supported by gross assets rising from 119 to 123 percent of GDP and a small decrease in gross liabilities. Portfolio investments have increased since mandatory private pensions were introduced in 2008, reaching 33 percent of total assets in 2017. Liabilities are increasingly in the form of direct investment (44 percent of liabilities), followed by portfolio investment (39 percent), partly due to the attractiveness of Israel's high-tech sector.

Figure 1. External Position

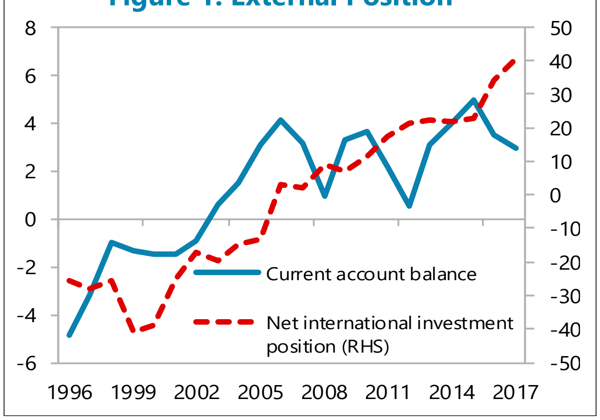
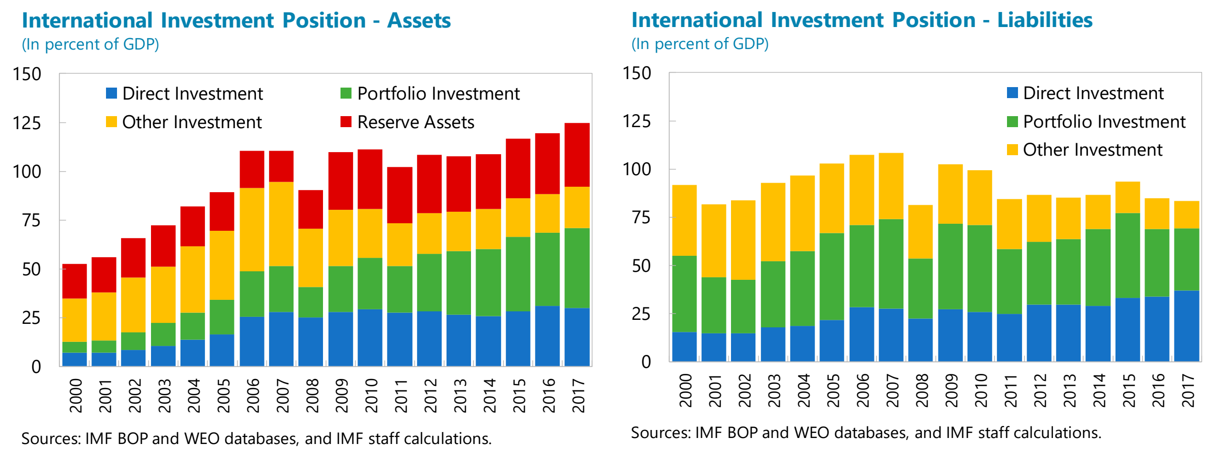


Figure 2. International Investment Position

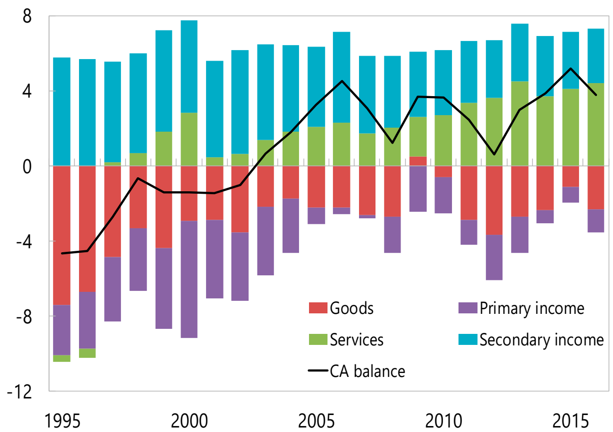


Current Account

2. Rising exports of high-tech services helped Israel maintain a current account surplus for over a decade. Israel's current account turned to surplus from 2003 (Figure 3, left panel), averaging three percent of GDP in the decade to 2017. A steady rise in the services balance, supported by a rapid increase in exports of high-tech services, was a key contributor (Figure 3, right panel).[1] These service sector gains have outweighed the impact of a substantial fall in secondary income as current transfers to both the government and private sector have declined relative to Israel's GDP.[2]

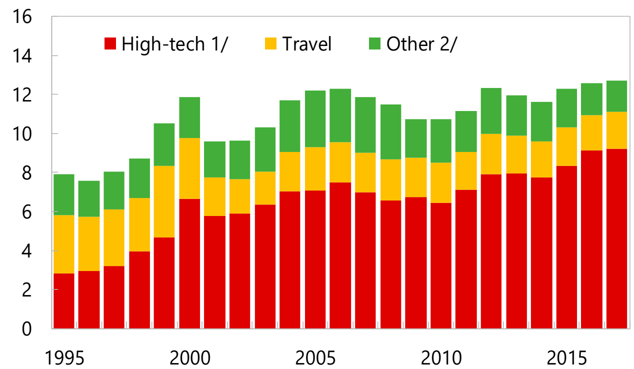
Figure 3. External Position and High-Tech Service Exports

Current Account Balance
(Percent of GDP)



Sources: Haver Analytics, Fund staff calculations.

Service Exports
(Percent of GDP)



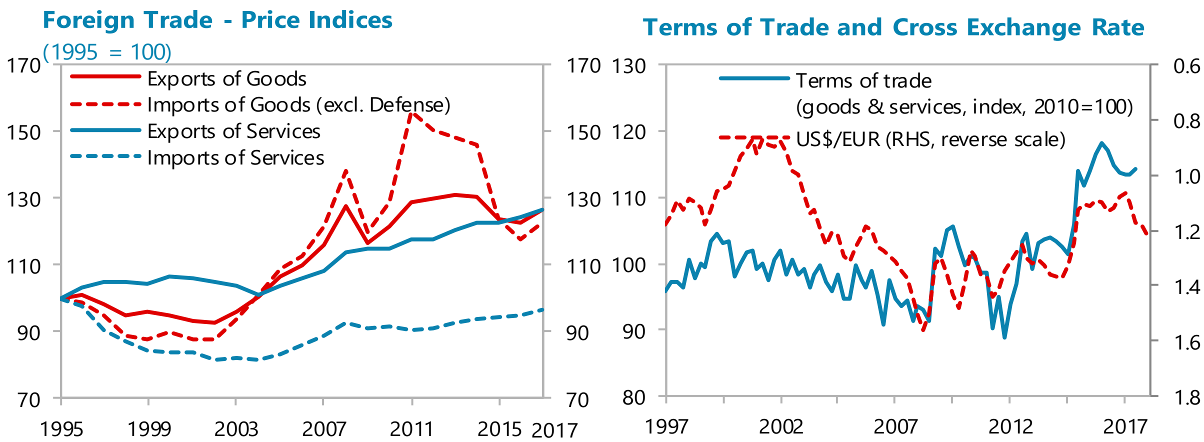
Sources: IMF BOP and WEO Databases, and IMF staff calculations.
1/ Includes telecom, computer and information; charges for use of intellectual property; and other business (R&D, consulting, technical, trade-related, and other).
2/ Transport, construction, insurance and services to governments.

3. Favorable terms of trade have also contributed to Israel's current account surpluses. Since 2012, Israel's terms of trade have risen by around 18 percent. This improvement was mostly driven by weakening goods import prices especially for fuels (Figure 4, left panel). With Israel exporting comparable amounts to Europe and to the U.S., but importing considerably more from Europe, the strengthening of the U.S. dollar against the euro has also contributed to terms of trade gains (BoI 2017) (Figure 4, right panel). Absent these declines in goods import prices, the goods balance would be roughly three percent of GDP lower in 2017. Service export prices have risen modestly relative to service import prices in recent years, but most of the increase in the services balance reflects the booming volume of exports of high-tech services.

[1] High-tech services include electronic components, electronic communications equipment, command and control equipment, scientific medical equipment, communications, computer services, and research and development.

[2] Israel has been receiving sizable grants from the U.S. (about one percent of GDP per year).

Figure 4. Terms of Trade



Sources: CBS, Haver, and IMF staff calculations.

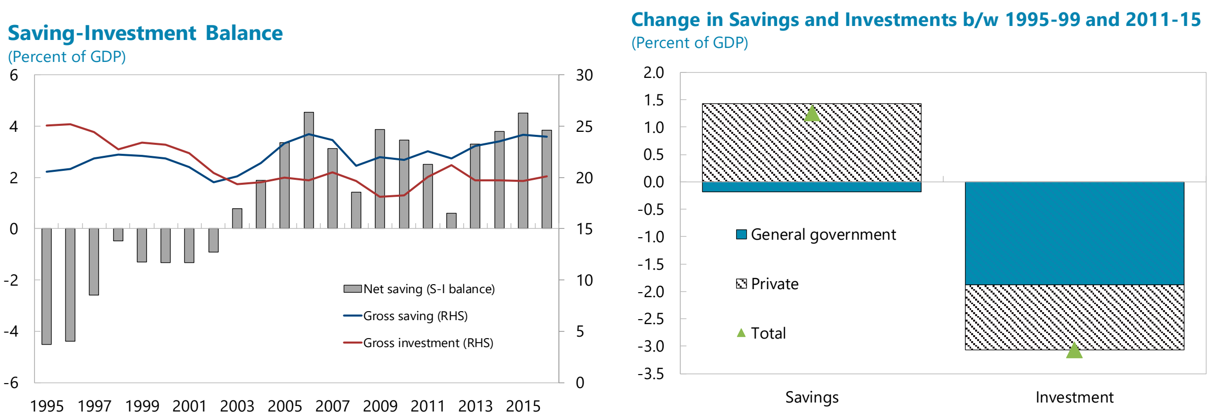
Sources: Haver Analytics; and IMF staff calculations.

4. **The shift of the current account balance into surplus reflected rising private savings and declining public and private investment** (Figure 5):

- **Savings.** The increase in savings was driven by the private sector, including households, partly due to the introduction of mandatory private pension saving in 2008. The current level of private net lending is higher than peers.[3] This could be motivated by precautionary concerns, such as uncertainties (e.g., geopolitical risks) and high old-age poverty, while the large wave of migrants from the former Soviet Union may be building their net wealth.

- **Investment.** Israel's investment—both public and private—has been declining since the early 1990s, following a surge in construction to absorb half a million immigrants from the former Soviet Union (Figure 4, left panel). The reduction in public investment drove fiscal consolidation; general government investment fell by two percentage points of GDP from the 1995–99 to 2011–15, exceeding the 1¼ percentage point deficit cut in that period (Figure 4, right panel).

Figure 5. Saving-Investment Balance

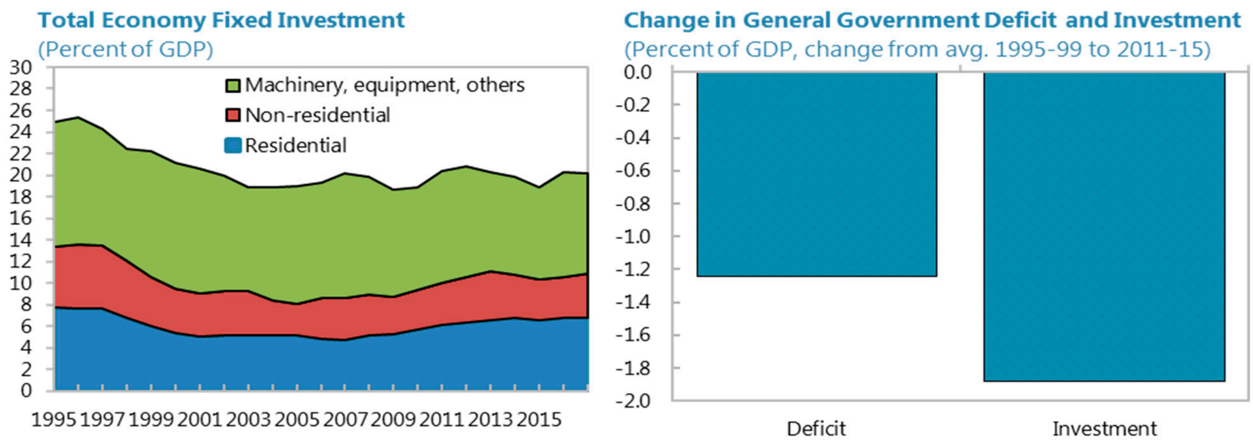


Sources: Bank of Israel

Sources: CBS, Fund staff calculations.

[3] Israel's private net lending (savings net of accumulation of non-financial assets and capital transfers) averaged 7.4 percent of GDP in 2008–15, compared with 3.7 percent and 5.1 percent in OECD and the euro-area, respectively.

Figure 6. Investment



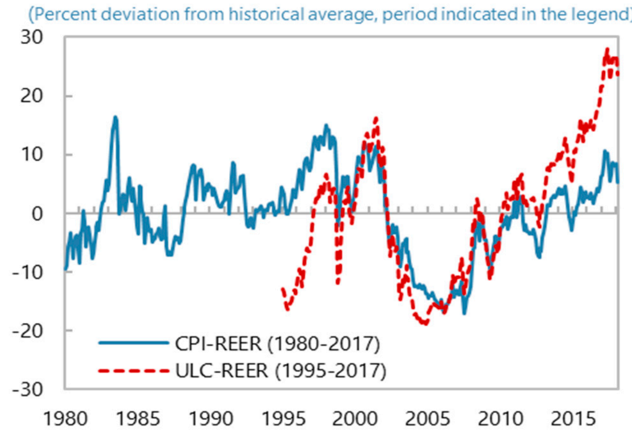
Sources: Central Bureau of Statistics, IMF staff calculations

Sources: Bank of Israel, OECD, and IMF staff calculations

Real Exchange Rate

5. Israel's real effective exchange rate (REER) has appreciated for a decade to be well above historical average (Figure 5). After reaching a bottom following the dot-com bust and second intifada, the REER has been appreciating since 2007, albeit with fluctuations. The rise was more prominent for the ULC-based REER, which recently stood at its historical high, some 25 percent above its historical average. The CPI-based REER—which is available for a longer period—is also above historical average, by almost 10 percent.

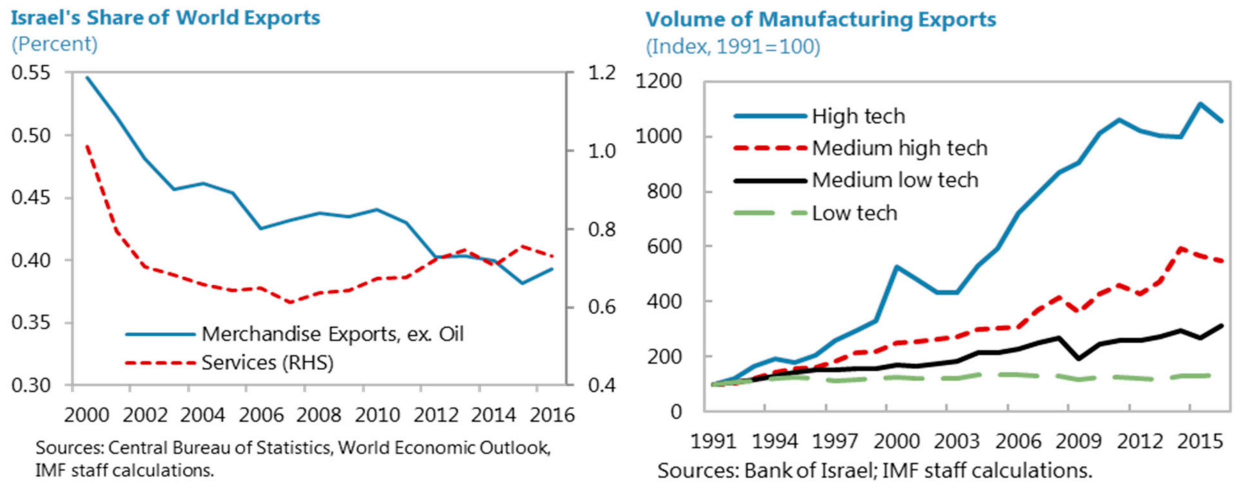
Figure 7. Real Effective Exchange Rate



Source: IMF INS Database

6. There is concern that the appreciation will undermine export growth and the external balance in coming years. Goods exports from Israel have shown a declining trend since the early 2000s, with global market share declining from 0.55 percent to below 0.40 percent (Figure 5, left panel). Weak performance persisted in recent years despite the global economic recovery, suggesting that the appreciation has weighed on competitiveness. Within manufacturing, exports of high-tech goods appear to have stalled in recent years, indicating that the impact on competitiveness is not limited to a natural decline in the share of lower technology production as Israel's income and wage levels rise (Figure 6, right panel).

Figure 8. Israel's Goods Exports Performance



7. Although this appreciation is dramatic by historical standards, it could be warranted to some extent by fundamentals. As discussed above, Israel has enjoyed a combination of favorable shocks from booming exports of high-tech services and rising terms of trade. Moreover, deep reforms after the dot-com bust have contributed to a major rise in labor force participation from the middle of the 1990s. Altogether, Israel's real per capita growth in the 2007–2017 period was 1.7 percent, well above the average of advanced economies (0.8 percent) or advanced Europe (1.0 percent). The question is whether these developments warrant the full extent of the real appreciation of the shekel, the effects of which may not yet be fully evident in the external balance.

8. Estimates of exchange rate misalignment vary across methodologies (Table 1), suggesting that the shekel is broadly in line with fundamentals, although subject to higher uncertainty:

- **Focusing on the external balance indicates significant undervaluation, although the 2017 current account gap may not yet fully reflect the appreciation of the shekel**. The 2017 CA balance (three percent of GDP) is affected by a one-off factor: vehicle imports were bought forward into 2016, raising the 2017 balance by about ⅓ percent of GDP, leaving an underlying balance of 2⅔ percent of GDP. The External Balance Assessment (EBA) current account (CA) analysis suggests that this underlying 2017 CA balance is above the level warranted by fundamentals and appropriate policies by 3⅔ percentage points of GDP,[4] translating into an REER undervaluation of 15 percent. However, even with the significant decline in the surplus in recent years, the full impact of the substantial appreciation of the REER-ULC may not yet be reflected in the data for 2017, widening the current account gap. Moreover, the EBA CA analysis does not factor in net official and private transfers, which have remained high for Israel, at two percent of GDP in 2017.

[4] About half of the CA gap (2.2 percent of GDP) is attributable to policy gaps. The main domestic driver to the policy gap is low public health expenditure compared to the desirable level (contribution of one percent of GDP), while the main external contributor to the policy gap is the fiscal underperformance of peer countries (one percent of GDP).

- **Analysis of the real exchange rate finds the shekel is either broadly in line with fundamentals (EBA-Lite REER) or significantly overvalued (REER Level Analysis).** The EBA Lite REER index analysis—which does consider aid and remittances—indicates that the CPI-REER is broadly in line with fundamentals, with an overvaluation of 0.8 percent. A more significant overvaluation (17 percent) is found when using REER Level Analysis.[5] Furthermore, the REER-ULC has appreciated substantially more than the REER-CPI, suggesting than the on ULC terms the shekel might be more overvalued than indicated by the REER models.

Table 1. External Balance Assessment (EBA) Methodologies

(In percent of GDP, unless otherwise indicated)

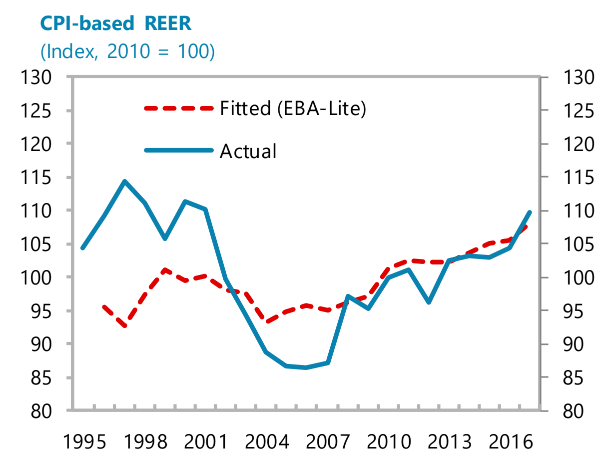
EBA Current Account Analysis	
Current Account (actual)	3.0
(-) Cyclical Contributions (from model)	0.1
(-) Adjustments to the CA (temporary factors)	0.3
(=) Cyclically-adjusted Underlying CA	**2.6**
(-) Cyclically-adjusted Current Account Norm	**-1.1**
(=) Current Account Gap	**3.7**
o/w Policy Gaps	2.2
Elasticity (percent of GDP / percent change in REER)	-0.25
REER Gap (percent)	**-14.8**

EBA External Sustainability Approach	
Adjusted Medium-term CA/GDP	3.3
(-) CA/GDP Stabizing NFA at Benchmark	1.7
(=) Current Account Gap	**1.7**
Elasticity (percent of GDP / percent change in REER)	-0.25
REER Gap (percent)	**-6.8**

EBA REER Level Analysis	
REER Gap (percent)	**16.9**
o/w Policy Gaps	-4.0

EBA-Lite Index REER Analysis	
REER Gap (percent)	**0.8**

Figure 9. Equilibrium REER Approach



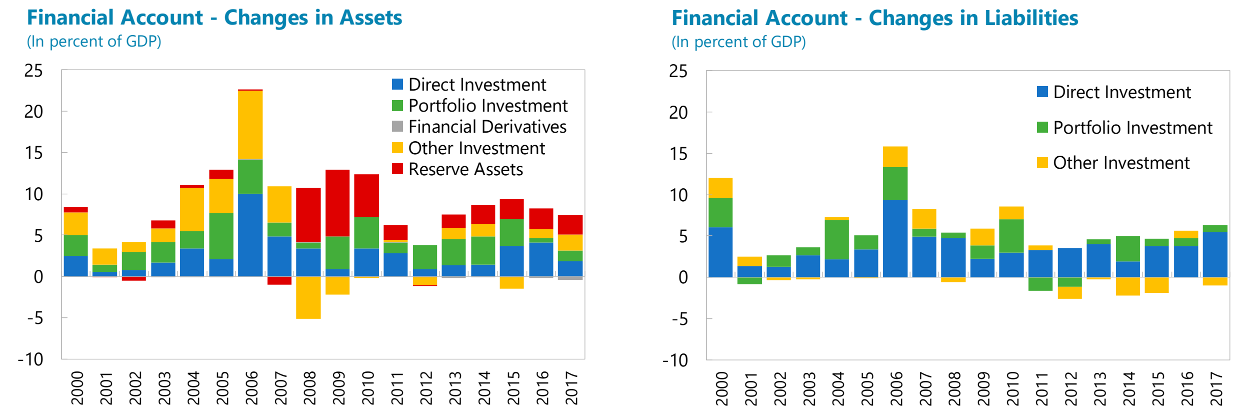
Sources: IMF, Haver, and IMF staff calculations.

[5] The REER Level model is estimated without Israel in the sample, but then the coefficients are applied using Israel data for 2017. This, however makes it difficult to assess the goodness of fit on Israeli data and weakens the robustness of the results.

Capital and Financial Flows

9. Israel generally maintains small net financial outflows, where net outflows of across a range of assets are partially offset by net direct and portfolio investment inflows. Israel maintains a regime with free capital mobility, with only a few sectoral restrictions on direct investment. FDI in Israel surged in 2017, increasing from 3.7 to 5.4 percent of GDP, owing to the acquisition of Israeli companies (i.e., Mobileye, Keter Plastics, and Tamar Petroleum) by foreign companies. The financial account would remain in deficit as long as current and capital account surplus continues.

Figure 10. Financial Flows from and to Israel



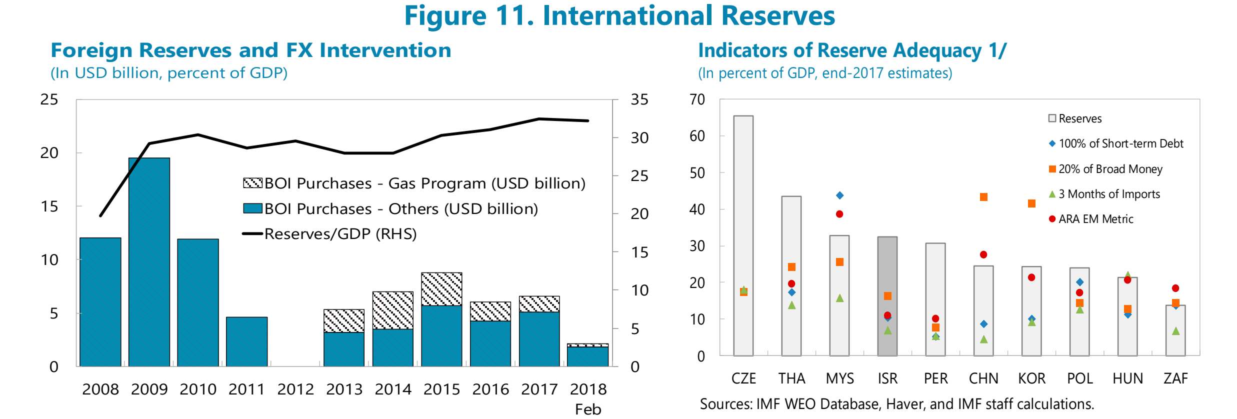
Sources: IMF BOP and WEO databases, and IMF staff calculations.

Sources: IMF BOP and WEO databases, and IMF staff calculations.

FX Intervention and Reserves

10. FX intervention continued in 2017 at a similar pace to 2016 with the level of foreign reserves remaining comfortable. Since August 2009, the Bank of Israel (BoI)'s policy provides for FX intervention in the event of shekel movements inconsistent with underlying economic conditions or when the foreign exchange market is disorderly. In 2013, the BoI started pre-announced interventions to offset lower imports owing to natural gas production. Intervention in 2017 amounted to US$6.6 billion, compared with US$6.0 billion in 2016. Reserves rose to US$113 billion by end 2017 (32 percent of GDP), with over half of the increase due to revaluation gains.

Figure 11. International Reserves



Sources: Bank of Israel, and IMF staff calculations.

Sources: IMF WEO Database, Haver, and IMF staff calculations.
1/ Comparator countries have similar tolerance for external risks based on indicators for economic flexibility, market maturity and market access.

Appendix II. Debt Sustainability Analysis 2018

Israel's debt-to-GDP ratio fell from 94 percent in 2003 to 61 percent in 2017. The structure of this debt is favorable, with a maturity averaging 7.8 years and nonresidents holding only around 13⅓ percent of the total, helping assure resilience to shocks.[1] Nevertheless, relatively high interest payments and elevated gross financing needs are a source of vulnerability. Although most indicators are below their early warning benchmarks, Israel's debt outlook appears to be most sensitive to growth shocks.

1. Under staff's baseline scenario, the government debt-to-GDP ratio is projected to remain around 61 percent of GDP (Figures A2.1–A2.2). The DSA covers debt of the general government.[2] Gross financing needs would increase from 8¼ percent of GDP in 2017 to above 10 percent in 2018 and then stay around 10 percent throughout the projection period. The baseline scenario assumes no fiscal consolidation measures would be taken:

- Real GDP growth is projected to remain near 3½ percent in the next few years, then return to around three percent in the medium term.
- CPI inflation is projected to rise to around two percent—the mid-point of the target range—by 2020 and stay at around two percent throughout the projection period.
- The central government deficit is expected to increase from 2.0 percent of GDP in 2017 to 2.9 percent of GDP in 2018 and stay at the level thereafter. The general government deficit is assumed to be larger than the budget deficit by 0.3 percentage points of GDP in 2018, 0.4 points in 2019, and 0.5 points annually from 2020 through 2023.[3]
- Non-debt creating financing is assumed to be ½ percent of GDP annually.
- Primary expenditure is projected to decline slightly to below 37 percent of GDP in 2018 and remains around that level throughout the projection period.
- From 5.1 percent in 2017, the effective interest rate is projected to rise moderately to 5½ percent in the medium term, reflecting gradual normalization of monetary policy.[4] Borrowing conditions—facilitated by solid sovereign ratings (A+) and the U.S. debt guarantee program (untapped amount of US$ 3.8 billion or one percent of GDP)—are assumed to remain favorable.

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[1] Around a third of debt held by nonresidents is guaranteed by the U.S. government.

[2] The analysis is for the general government, including both tradable and non-tradable debt.

[3] The difference between general and central government deficits was 0.5 percent of GDP annually during the past five years, but was close to zero in recent years.

[4] The high interest rates reflect a long-standing arrangement between the government and institutional investors, guaranteeing a stable return of approximately four percent in real terms to benefit contributors to mandatory private pension schemes. About 30 percent of domestic debt falls into this category and is held by institutional investors (mostly pension and insurance funds) as non-tradable bonds.

Shocks and Stress Tests

2. A range of stress tests indicate that debt sustainability is reasonably resilient to growth, interest rate, and combined macro-fiscal shocks (Figures A2.3–A2.4).

- **Growth shock**. Lower real GDP growth rates (by one standard deviation for two years starting in 2019) would lead to a larger deficit as revenues fall while expenditure remains unchanged in nominal terms. The debt-to-GDP ratio would rise to about 64¾ percent by 2020 and would stay around that level through 2023. Financing needs would increase to 11¼ percent of GDP by 2020 and then decline to around 10½ percent of GDP.

- **Interest rate shock**. A geopolitical shock or tighter global financial conditions could push up borrowing costs by 200 basis points. Government debt would rise moderately to around 62½ percent of GDP by 2023, only 1½ percentage point above the baseline, with a moderate increase in financing needs to around 10½ percent of GDP over the same period.

- **Combined macro-fiscal shock**. A shock that combines exchange rate depreciation, an expansion of the primary deficit, and a decline in real GDP, would raise debt to around 66 percent of GDP by 2020 and financing needs to 11½ percent of GDP. Debt is projected to keep rising to around 67 percent by 2023 and financing to remain around 11½ percent of GDP.

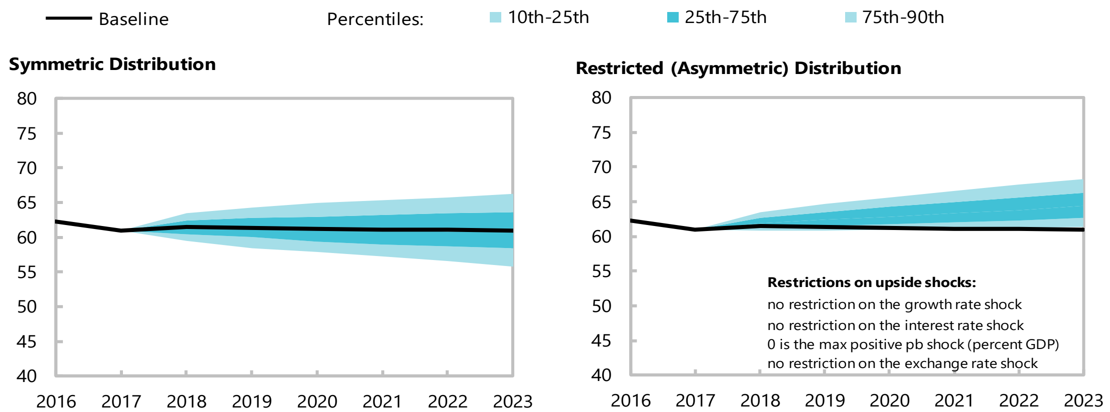
Figure 1. Israel: Public DSA—Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

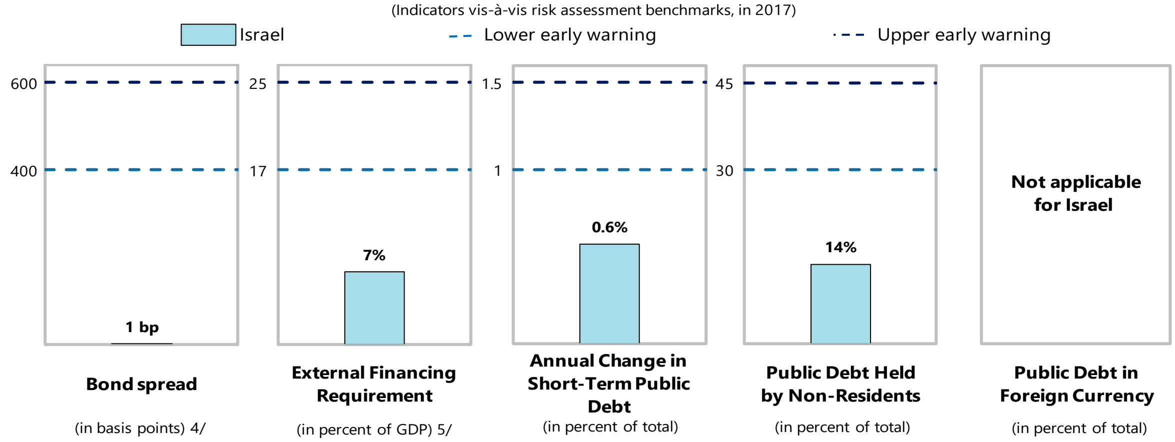
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 22-Dec-17 through 22-Mar-18.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Israel: Public DSA—Baseline Scenario

(In percent of GDP unless otherwise indicated)

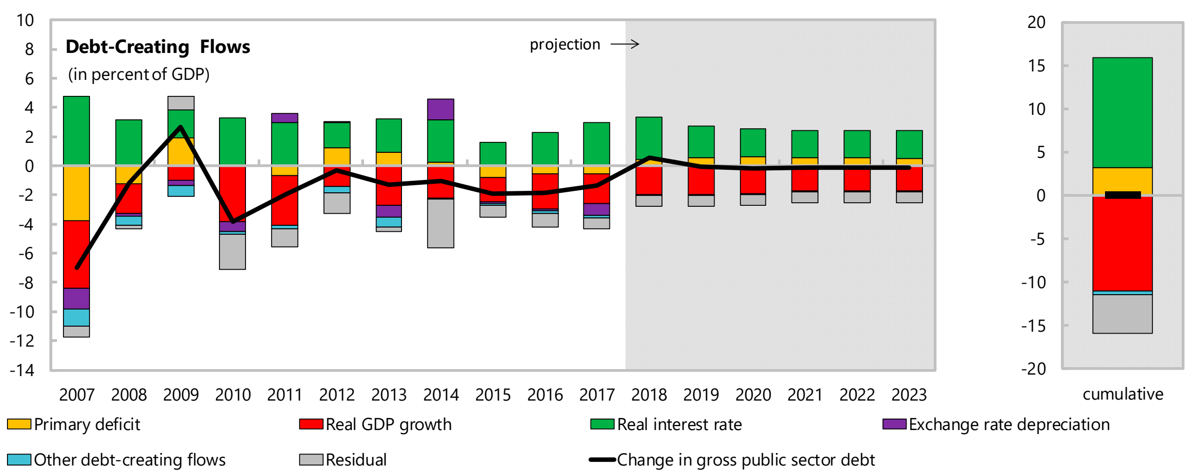
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	69.4	62.3	60.9	61.5	61.4	61.3	61.1	61.1	61.0
Public gross financing needs	10.4	6.5	8.2	10.0	9.5	9.7	9.8	9.8	9.8
Real GDP growth (in percent)	3.8	4.0	3.4	3.4	3.4	3.3	3.0	3.0	3.0
Inflation (GDP deflator, in percent)	2.2	1.0	0.1	0.2	1.5	1.9	2.1	2.1	2.1
Nominal GDP growth (in percent)	6.0	5.0	3.5	3.6	4.9	5.2	5.2	5.1	5.1
Effective interest rate (in percent) [4/]	6.3	4.8	5.1	5.2	5.2	5.3	5.3	5.4	5.5

As of March 22, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		1
5Y CDS (bp)		51
Ratings	Foreign	Local
Moody's	A1	A1
S&Ps	A+	A+
Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.8	-1.9	-1.4	0.5	-0.1	-0.2	-0.1	-0.1	-0.1	0.0	
Identified debt-creating flows	-0.7	-0.9	-0.6	1.3	0.7	0.6	0.6	0.6	0.7	4.5	
Primary deficit	-0.2	-0.5	-0.6	0.4	0.6	0.6	0.6	0.5	0.5	3.2	0.2
Primary (noninterest) revenue and grants	36.7	36.4	37.7	36.4	36.2	36.2	36.2	36.2	36.2	217.4	
Primary (noninterest) expenditure	36.5	35.9	37.2	36.8	36.8	36.8	36.8	36.7	36.7	220.6	
Automatic debt dynamics [5/]	0.0	-0.2	0.1	0.9	0.2	0.0	0.1	0.2	0.2	1.6	
Interest rate/growth differential [6/]	0.2	-0.1	0.9	0.9	0.2	0.0	0.1	0.2	0.2	1.6	
Of which: real interest rate	2.7	2.3	3.0	2.9	2.2	1.9	1.9	1.9	1.9	12.7	
Of which: real GDP growth	-2.5	-2.4	-2.0	-2.0	-2.0	-1.9	-1.7	-1.7	-1.7	-11.1	
Exchange rate depreciation [7/]	-0.2	-0.1	-0.8	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.5	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.4	
Privatization (negative)	-0.5	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-1.1	-0.9	-0.8	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-4.4	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

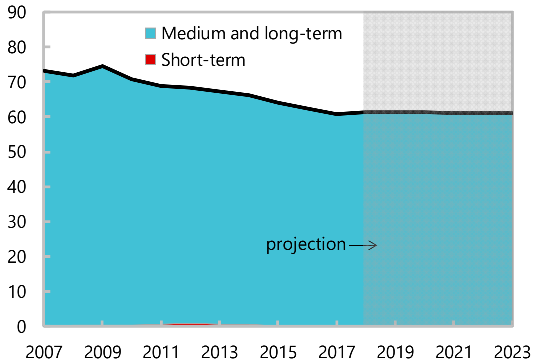
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

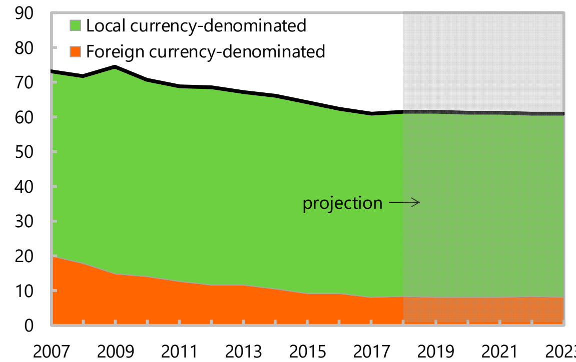
Figure 3. Israel: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



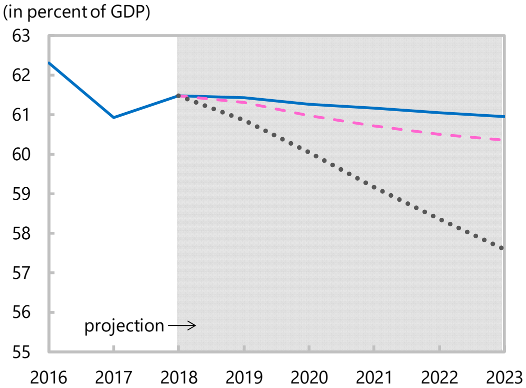
By Currency
(in percent of GDP)



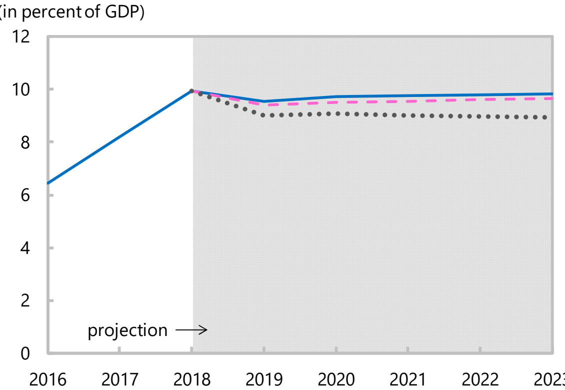
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

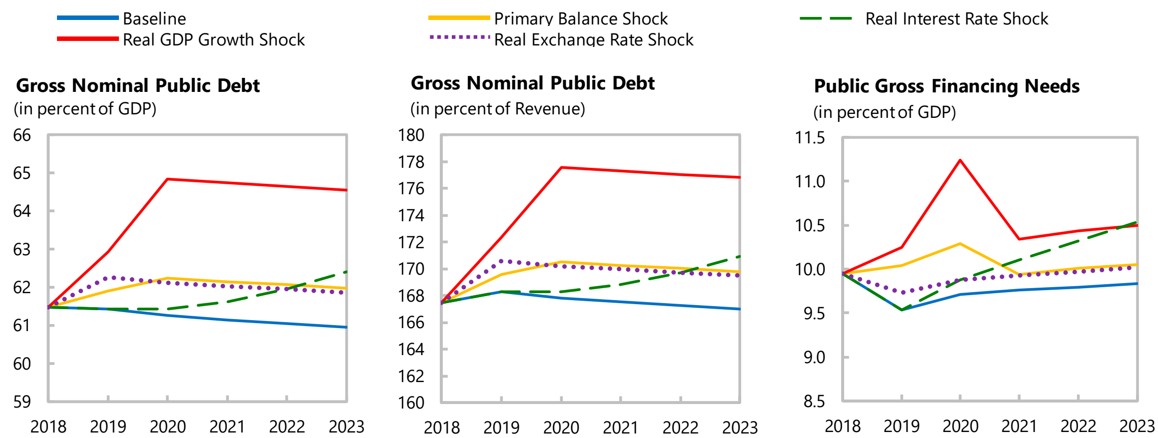
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.4	3.4	3.3	3.0	3.0	3.0
Inflation	0.2	1.5	1.9	2.1	2.1	2.1
Primary Balance	-0.4	-0.6	-0.6	-0.6	-0.5	-0.5
Effective interest rate	5.2	5.2	5.3	5.3	5.4	5.5
Constant Primary Balance Scenario						
Real GDP growth	3.4	3.4	3.3	3.0	3.0	3.0
Inflation	0.2	1.5	1.9	2.1	2.1	2.1
Primary Balance	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Effective interest rate	5.2	5.2	5.3	5.3	5.4	5.5

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.4	3.5	3.5	3.5	3.5	3.5
Inflation	0.2	1.5	1.9	2.1	2.1	2.1
Primary Balance	-0.4	-0.1	-0.1	-0.1	-0.1	-0.1
Effective interest rate	5.2	5.2	5.3	5.4	5.5	5.6

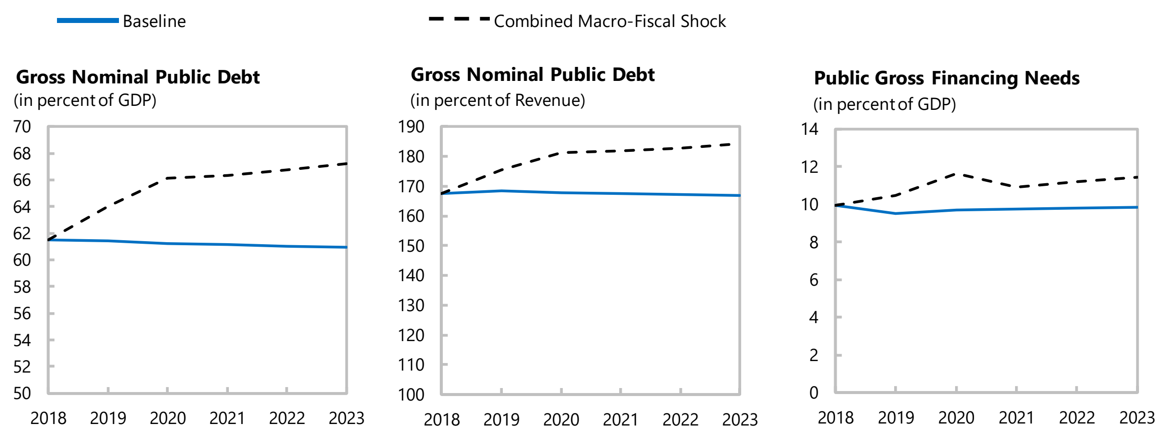
Source: IMF staff.

Figure 4. Israel: Public DSA—Stress Test

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2018	2019	2020	2021	2022	2023
Primary Balance Shock						
Real GDP growth	3.4	3.4	3.3	3.0	3.0	3.0
Inflation	0.2	1.5	1.9	2.1	2.1	2.1
Primary balance	-0.4	-1.1	-1.1	-0.6	-0.5	-0.5
Effective interest rate	5.2	5.2	5.3	5.4	5.4	5.5
Real Interest Rate Shock						
Real GDP growth	3.4	3.4	3.3	3.0	3.0	3.0
Inflation	0.2	1.5	1.9	2.1	2.1	2.1
Primary balance	-0.4	-0.6	-0.6	-0.6	-0.5	-0.5
Effective interest rate	5.2	5.2	5.6	5.9	6.2	6.5
Combined Shock						
Real GDP growth	3.4	2.1	2.0	3.0	3.0	3.0
Inflation	0.2	1.2	1.6	2.1	2.1	2.1
Primary balance	-0.4	-1.1	-1.8	-0.6	-0.5	-0.5
Effective interest rate	5.2	5.4	5.6	6.0	6.3	6.5

	2018	2019	2020	2021	2022	2023
Real GDP Growth Shock						
Real GDP growth	3.4	2.1	2.0	3.0	3.0	3.0
Inflation	0.2	1.2	1.6	2.1	2.1	2.1
Primary balance	-0.4	-1.1	-1.8	-0.6	-0.5	-0.5
Effective interest rate	5.2	5.2	5.3	5.4	5.5	5.5
Real Exchange Rate Shock						
Real GDP growth	3.4	3.4	3.3	3.0	3.0	3.0
Inflation	0.2	1.9	1.9	2.1	2.1	2.1
Primary balance	-0.4	-0.6	-0.6	-0.6	-0.5	-0.5
Effective interest rate	5.2	5.4	5.3	5.4	5.4	5.5

Source: IMF staff.

INTERNATIONAL MONETARY FUND

ISRAEL

April 12, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By European Department

CONTENTS

FUND RELATIONS

(As of March 31, 2018)

Membership Status: Israel became a member of the Fund on July 12, 1954.[1]

General Resources Account:

	SDR Million	Percent Quota
Quota	1,920.90	100.00
Fund Holdings of Currency (Holdings Rate)	1,763.77	91.82
Reserve Tranche Position	157.19	8.18
Lending to the Fund		
New Arrangements to Borrow	36.33	…

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	883.39	100.00
Holdings	850.93	96.33

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Oct 20, 1976	Oct 19, 1977	29.25	12.00
Stand-By	Feb 14, 1975	Feb 13, 1976	32.50	32.50
Stand-By	Nov 08, 1974	Feb 14, 1975	32.50	32.50

Overdue Obligations and Projected Payments to Fund[2]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2018	2019	2020	2021	2022
Principal					
Charges/Interest	0.23	0.30	0.30	0.30	0.30
Total	0.23	0.30	0.30	0.30	0.30

[1] For purposes of Fund relations, the West Bank and Gaza (WBG) fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement.

[2] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement:

The *de jure* exchange rate arrangement is classified as "free floating." The *de facto* exchange rate arrangement, however, is classified as "floating" as the BOI has intervened more than three times over the last six months.

Israel accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 21, 1993. Israel maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, with the exception of measures introduced for security reasons pursuant to Decision No. 144-(52/51). Israel subscribes to the SDDS and is in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars.

Article IV Consultation:

The last Article IV consultation was concluded on March 24, 2017. Israel is on the standard 12-month consultation cycle.

ROSCs:

- Financial System Stability Assessment was conducted in 2000 issued in August 2001.
- Fiscal Transparency ROSC was conducted in 2003, issued in April 2004.
- Monetary and Financial Policy Transparency was conducted in 2003, issued as IMF Country Report No. 03/76 in March 2003.
- AML/CFT ROSC was conducted in 2003, issued in June 2005.
- Data Module ROSC was conducted in 2005, and issued as IMF Country Report No. 06/125 in March 2006.
- Financial System Stability Assessment Update was conducted in 2011, issued in April 2012.

Technical Assistance:

Conforming the commitments under the Oslo Accords, the Fund has been providing policy advice and technical assistance (TA) to the Palestinian Authority (PA) since 1994, and presently has a resident representative based in Jerusalem. Staff missions to the West Bank and Gaza (WBG) have been assisting the PA in designing and implementing its macroeconomic and fiscal framework, and reforms aimed to strengthen economic institutions. The most recent progress report was presented at the Ad-Hoc Liaison Committee (AHLC) meeting of donors held in Brussel on March 20, 2018. The Fund has also provided TA for capacity development, particularly in the areas of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), banking supervision and regulation, public financial management, revenue administration, and macroeconomic statistics.

Recent technical assistance to Israel covered issues on systemic risk assessment and stress testing, fiscal regime for mining, a medium-term budget framework, and the effectiveness and efficiency of the Banking Supervision Department.

Resident Representative:

The office of the IMF Resident Representative for the WBG was established in July 1995.

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance	
General: Macroeconomic statistics are of generally high quality and broadly adequate for surveillance, although there are few shortcomings particularly in monetary and government finance statistics. A Report on the Observance of Standards and Codes—Data Module, a Detailed Assessments Using the Data Quality Assessment Framework (DQAF), and a Response by the Authorities were published on the IMF website on March 24, 2006 (*IMF Country Report No. 06/125*).	
National Accounts: No issues to report.	
Price Statistics: No issues to report.	
Government Finance Statistics: The methodology underlying the reported overall annual fiscal balance is not in conformity with internationally accepted best practice, as interest expenditure excludes the inflation component. The authorities are gradually moving toward implementation of the methodology that is standard in other countries, so that the discrepancy will decline over time. Quarterly data submitted by the Central Bureau of Statistics broadly follows the GFSM 2001 format. However, for financial assets and liabilities, only transaction data are currently submitted, although a financial balance sheet (stocks of financial assets and liabilities) is under preparation. Within-year monthly reports on central government operations—compiled by the MOF—cover only the main aggregates of budgetary accounts, not broken down by components.	
Monetary Statistics: Since 2015, Israel has reporting in monetary data in IMF's Standardized Reporting Format (SRF) for the central bank and other deposit takers. Going forward, coverage should be expanding to other financial corporations as they play an important part in the financial system.	
Balance of Payments: Balance of payments and international investment position data are compiled on a quarterly basis and follow the sixth edition of the *Balance of Payments Manual*. External sector data were not examined in the Report on the Observance of Standards and Codes. Country participates in Coordinated Direct Investment Survey and in Coordinated Portfolio Investment Survey.	
II. Data Standards and Quality	
Participant in the Special Data Dissemination System (SDDS) since April 1996, and in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars.	Data ROSC published on March 24, 2006.
III. Reporting to STA (Optional)	
Data are regularly reported for publication in the *Government Finance Statistics Yearbook* and in the *IFS*.	

Table of Common Indicators Required for Surveillance

(As March 30, 2018)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	Same day	Same day	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb-18	Mar-18	M	M	M		
Reserve/Base Money	Feb-18	Mar-18	M	M	M	LNO, LO, NO, LO	O, O, O, NA, NA
Broad Money	Feb-18	Mar-18	M	M	M		
Central Bank Balance Sheet	Feb-18	Mar-18	M	M	M		
Consolidated Balance Sheet of the Banking System	Jan-18	Mar-18	M	M	M		
Interest Rates[2]	Same day	Same day	D	D	D		
Consumer Price Index	Feb-18	Mar-18	M	M	M	O, O, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2016	Nov-17	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Feb-18	Mar-18	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4-17	Mar-18	Q	Q	Q		
External Current Account Balance	Q4-17	Mar-18	Q	Q	Q	NA	NA
Exports and Imports of Goods and Services	Q4-17	Mar-18	Q	Q	Q		
GDP/GNP	Q4-17	Mar-18	Q	Q	Q	O, O, O, LO	LO, O, LO, O, LO
Gross External Debt	Q4-17	Mar-18	Q	Q	Q		
International Investment Position[6]	Q4-17	Mar-18	Q	Q	Q		

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary, extra budgetary, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects the assessment provided in the data ROSC for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[9] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.