

Israel: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Israel

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 2002 Article IV consultation with Israel, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 10, 2002**, 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 February 13, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **March 7, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 7, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Israel.

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

Report on Observance of Standards and Codes Update

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ISRAEL

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Article IV Consultation with Israel

Approved by Carlo Cottarelli and Martin Fetherston

February 13, 2003

- Consultation discussions were held in Jerusalem and Tel Aviv during November 26–December 10, 2002. For purposes of Fund relations, the West Bank and Gaza Strip continue to fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement. However, the mission focused on the Israeli economy and did not meet with representatives of the Palestinian Authority, as the Middle Eastern Department is undertaking the Fund's work on the West Bank and Gaza Strip.
- The staff team comprised Messrs. Takeda (head), Mehrez (both EU1) and Ms. Schumacher (MAE). Mr. Litman (OED) participated in the meetings.
- The team met with Minister of Finance Shalom, Bank of Israel Governor Klein, and other senior officials of the government and the Bank of Israel. It also met with representatives of private sector organizations, including financial institutions and a labor union organization.
- Israel maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions (Appendix I).
- Israel has subscribed to the Special Data Dissemination Standard, and has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix II).

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I. INTRODUCTION

1. **The last Article IV consultation was concluded on July 30, 2001.** On that occasion, Directors observed that security problems since end-September 2000, together with the global high-tech slump, led to a sharp contraction of the economy. They agreed that the authorities' central task was to maintain macroeconomic stability while minimizing the economic costs of the slowdown—through a gradual monetary easing and cuts in government expenditure—and to strengthen the structural foundations of the economy for future growth. Directors were encouraged by the favorable findings of the FSAP, but urged the authorities to address a number of problems, including an inadequate anti-money laundering regime.
2. **Since then, the economy and the security situation deteriorated further.** The authorities' attempt in December 2001 to rebalance the macroeconomic policy mix did not yield intended results (Box 1), although its direction was consistent with staff's recommendation to reduce fiscal deficits and to loosen monetary policy. Too large an interest rate cut in one shot and the subsequent failure of the government to deliver the promised fiscal deficit cut, combined with a worsening of the security situation, resulted in a loss of market confidence, a sharp depreciation of the sheqel, a surge in inflation, and the need to substantially tighten monetary policy once again.
3. **Likud leader Sharon won the prime ministerial elections in February 2001, and formed a coalition government including the Labor party.** However, the Labor party left the coalition in October 2002, and the Knesset was dissolved. Likud won the elections held in late-January 2003, and Mr. Sharon has been asked to form a new government.

II. ECONOMIC BACKGROUND

4. **The economy is in the midst of a deep recession.** Waning exports and investment, combined with stagnant private consumption, led to an estimated 1 percent contraction in real GDP in 2002, following a negative 0.9 percent growth in 2001 (Figure 1, Table 1).¹ The stagnation can be attributed to the burst of the technology bubble, the global slowdown, and the deterioration in the security situation. The Bank of Israel (BoI) estimates the direct negative effect of security-related events on tourism, construction, agriculture, and export to the Palestinian Authority to be about 3 percent of GDP in 2001 (Box 2). The global slowdown and the high-tech slump each contributed a negative 1 and 2¾ percent. A similar magnitude of GDP continued to be lost in 2002. Recently, some indicators suggest that economic activity is stabilizing (Figure 2, Table 2), but there are no signs of recovery in sight.

¹ Excluding public spending, GDP contracted by 2.5 percent in 2001 and an estimated 3.7 percent in 2002.

Box 1. The December 2001 Policy Package

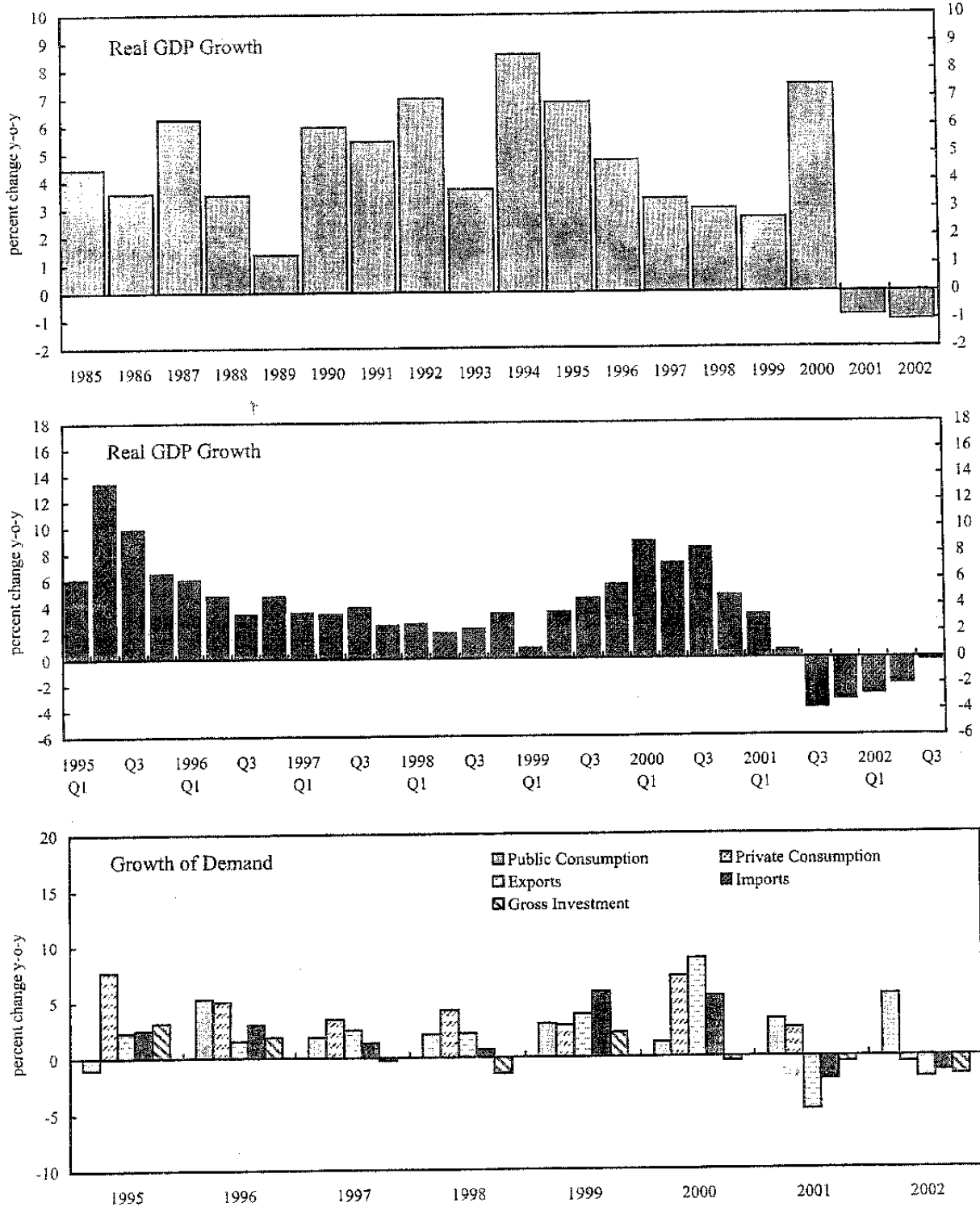
The macroeconomic policy mix toward the end of 2001 was characterized increasingly by accommodative fiscal and tight monetary policy. The central government budget recorded an operational deficit of 4.6 percent of GDP in 2001, well above the targeted 1.75 percent as well as the 2000 deficit outturn of 0.7 percent, and there was a major concern that the 2002 fiscal deficit would substantially exceed the target at that time of 2.4 percent of GDP. Although the BoI continued its gradual easing throughout 2001 reducing the policy interest rate by 20–30 basis points at most of its monthly policy meetings, real interest rates rose sharply in the last quarter of 2001 as expected inflation declined. As a result, the sheqel appreciated, actual inflation fell below the target range, and the concern about public finances intensified. To avoid adverse consequences on exports and investment, a policy rebalancing was necessary.

The December 2001 policy package had the following main ingredients: (a) NIS 6.15 billion (1¼ percent of GDP) deficit cut to 3 percent of GDP from the proposed budget for 2002; (b) a 2 percentage point interest rate cut to 3.8 percent; (c) a modification of the exchange rate band, whereby the lower (most appreciated) boundary became flat at NIS 4.10/basket;¹ (d) the abolition of the ceiling on the issuance of treasury bills (Makam) used by the BoI for market operations; and (e) relaxing the limit on the share of investment abroad in the total asset of institutional investors (provident funds, pension funds, and life insurance companies) from 5 percent to 20 percent, and abolishing it altogether by the end of 2002—making the sheqel a fully convertible currency.

The implementation of the package was mixed. Measures (c), (d), and (e) were fully implemented without any reversal. However, the government failed to cut its deficit promptly, and the interest rate cut was partially reversed in February 2002 when the BoI raised its policy rate by 60 basis points in response to a weakening of the sheqel and its inflation implications. The rate hike temporarily stopped the sheqel depreciation, but soon after, serious concerns over the government's stance re-emerged. These concerns and an escalation in the violence led to a renewed depreciation of the sheqel, a surge in inflation, and a rise in long-term interest rates. In June, the BoI responded by raising its policy rate by 4.5 percentage points in several steps, and the government passed an emergency economic package designed to reduce the budget deficit by about NIS 12 billion (2½ percent of GDP), and increased the deficit target to 3.9 percent of GDP.

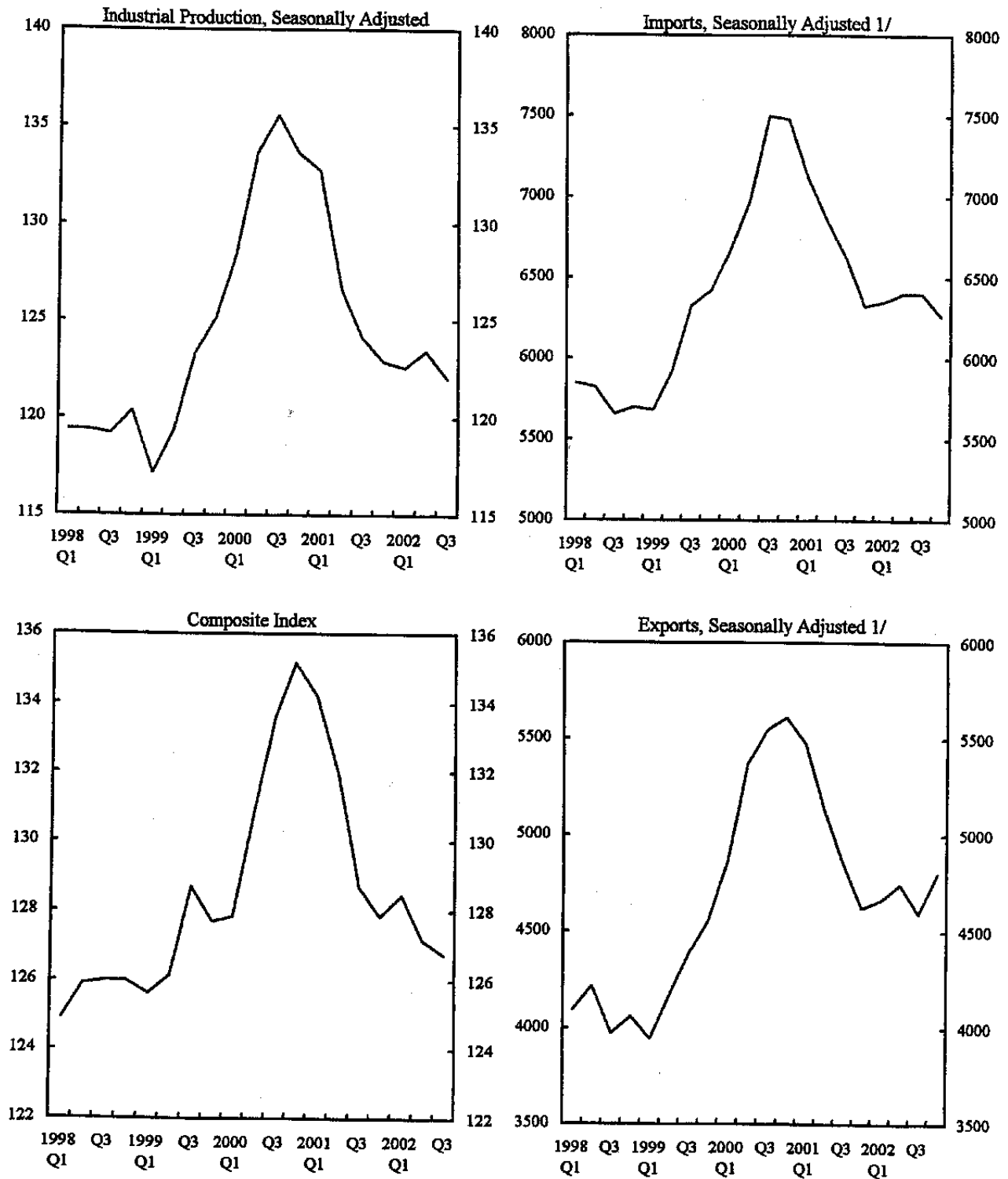
¹The lower boundary had been depreciating at 2 percent per annum. The new lower boundary implied an initial downward shift of about 1 percent. The upper boundary continued depreciating at 6 percent per annum (see Figure 3)

Figure 1. Israel: Demand and Output, 1985-2002



Sources: Central Bureau of Statistics; Bank of Israel; and Fund staff projections.

Figure 2. Israel: Recent Developments, 1998-2002



Sources: Bank of Israel; Ministry of Finance; and Central Bureau of Statistics.

1/ In millions of U.S. dollars, excluding ships, aircrafts, and diamonds.

Box 2. The Economic Effect of the Intifada

The Intifada that started in September 2000 has affected economic activity through five channels: a fall in tourism, a reduction in trade with the Palestinian Authorities (PA), a fall in Palestinian labor supply, an increase in defense expenditures, and a rise in the level of uncertainty. Tourism and exports to the PA were the two sectors that have been hurt the most—their value added has fallen by 55 and 66 percent respectively, and there is no hope of recovery in sight. The hotel industry is in a serious difficulty, and the government's support is being provided, including through special loan guarantees and worker retraining programs. The absence of Palestinian workers hurt mainly the construction and agriculture sectors where Palestinians' share in employment used to be about 25 and 15 percent, respectively. The construction sector lost 10 percent, while the agriculture sector lost 7 percent, of its value added. The impact, however, dissipated gradually in the course of 2001 as foreign workers replaced Palestinians. Defense expenditures rose from 9.5 percent of GDP (23.6 percent of government expenditures) in 2000 to 10.5 percent of GDP (24.3 percent of the government expenditures) in 2002.

Estimating the impact of the Intifada-related uncertainty is very hard since the economy has been affected simultaneously by many shocks. However, there is no doubt that uncertainty has had an adverse influence on investment and consumption. The service sector, such as restaurants and shopping malls, is directly exposed to the risk of attacks, which should discourage the sector's investment. The sharp fall in foreign direct investment is also related to uncertainty, though its main cause is the burst of a high-tech bubble. Finally, increased uncertainty should also reduce consumption, as households increase their precautionary saving.

5. **Despite the recession, the sheqel had been remarkably stable until December 2001, when the BoI slashed its policy rate by 2 percentage points as part of a policy package.** During the following six months, the sheqel depreciated by more than 20 percent vis-à-vis the currency basket (Figure 3), a fall comparable to the one experienced during the Russia/LTCM crisis in 1998.

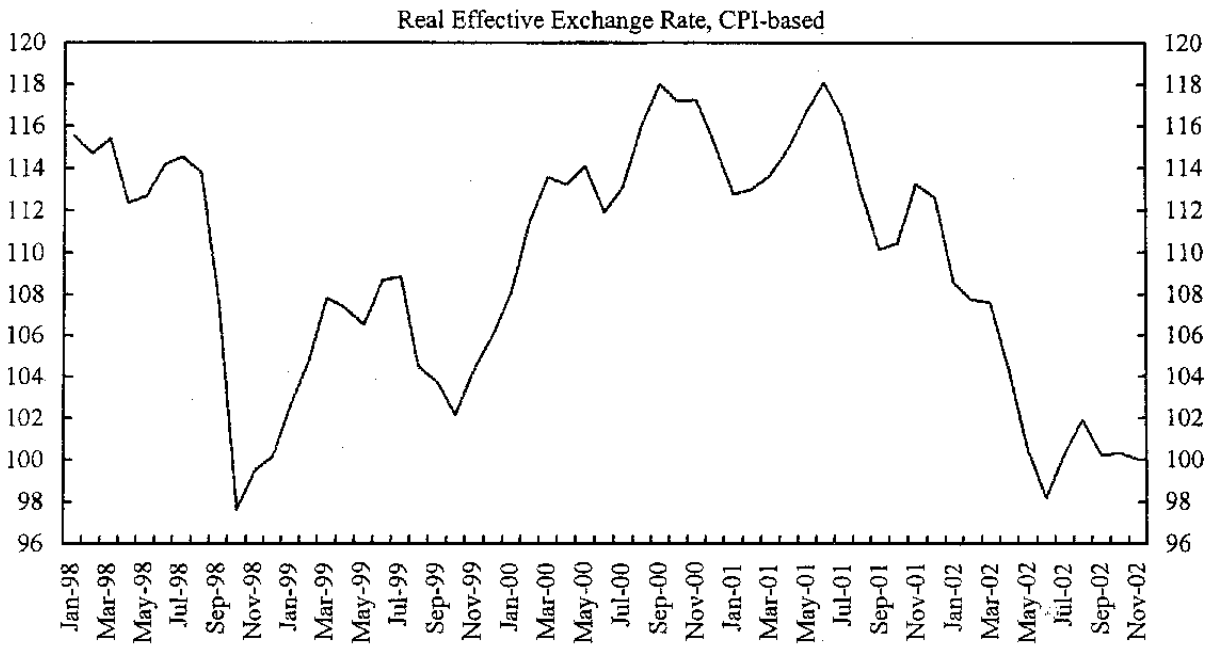
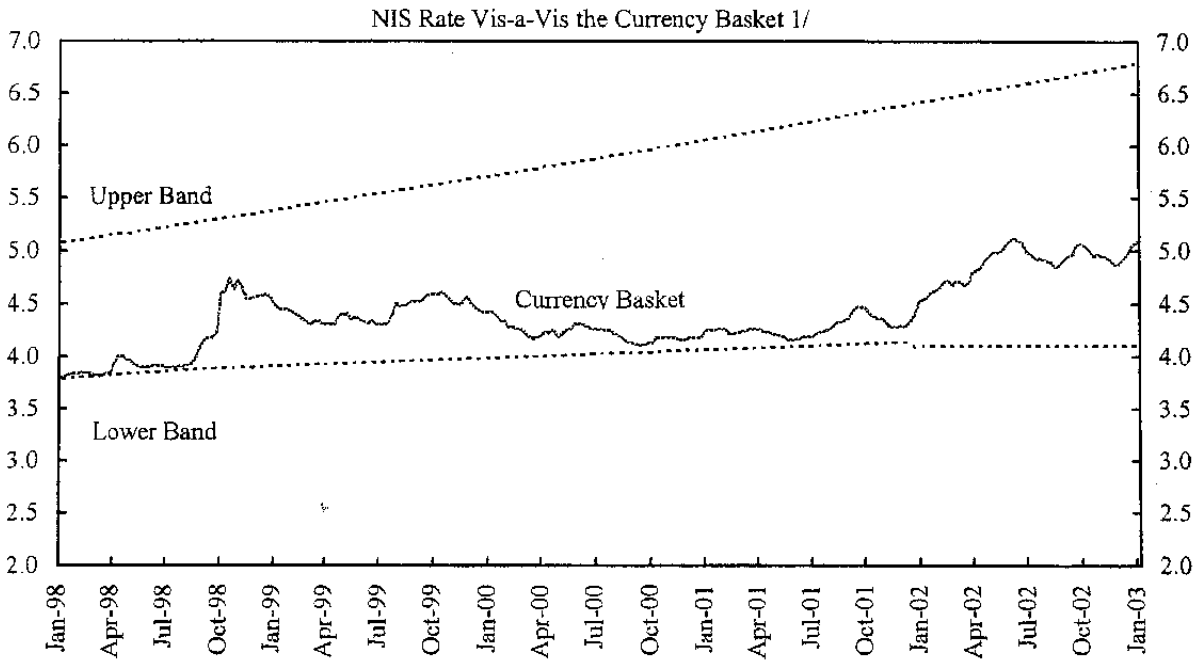
6. **The sheqel's slide, aided by the remnants of past high inflation in the form of indexation and dollar-denominated prices, led to a surge in inflation (Figure 4, top panel).** The CPI rose by 6.3 percent during the first half of 2002 alone, well above the upper end of the inflation target.² Furthermore, inflationary expectations, both short-term and long-term, soared toward June (Figure 4, bottom panel).³

7. **In an effort to halt the sheqel's depreciation and the surge in inflation, the BoI raised its policy rate in June by 4.5 percentage points to 9.1 percent (Figure 5).** This rate hike partially reversed the sheqel's slide, and reduced inflation expectations. However,

² The target was 2–3 percent at end-2002, and is permanently 1–3 percent from 2003 onward.

³ Market-based inflationary expectations are derived by comparing yields on CPI-indexed and nonindexed government bonds.

Figure 3. Israel: Exchange Rates, 1998–2003



Sources: Bank of Israel; and IMF, *Information Notice System*.

1/ Weekly average of daily rates. Updated to February 3, 2003.

Figure 4. Israel: Inflation, 1991–2002

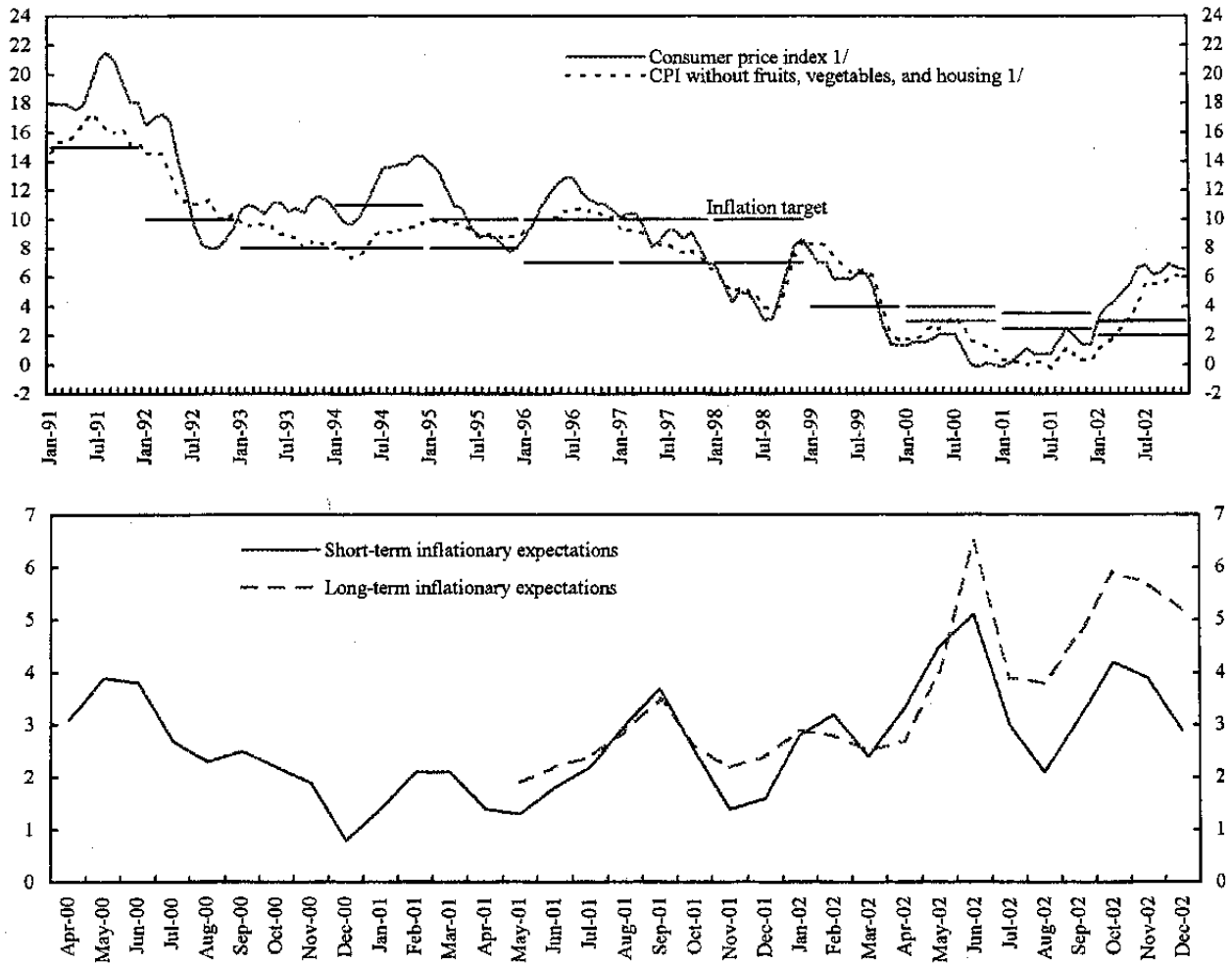
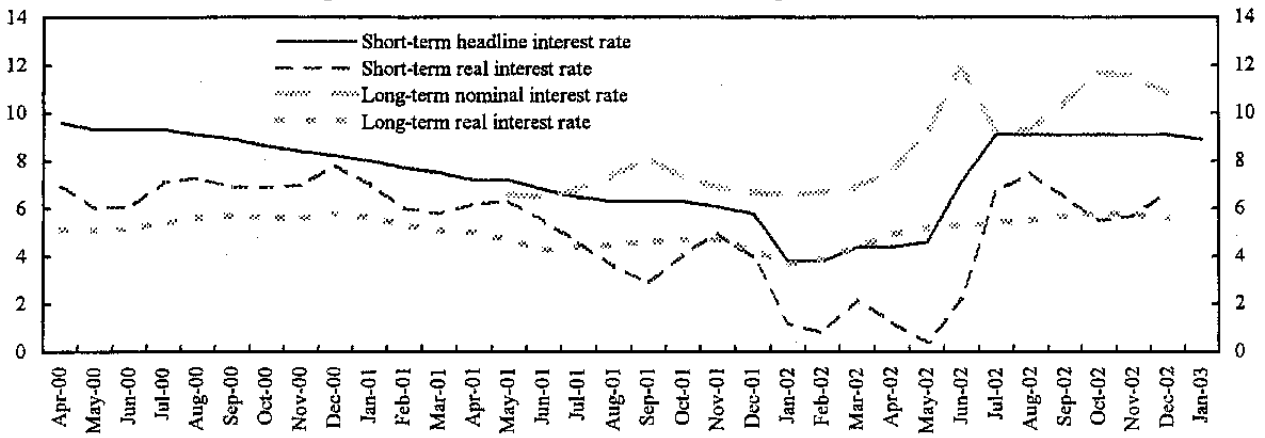


Figure 5. Israel: Interest Rate Developments, 2000–03



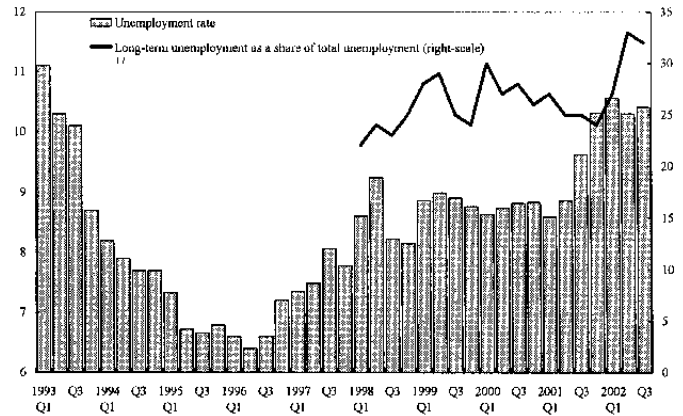
Sources: Central Bureau of Statistics; and Bank of Israel.

1/ Percentage change from the corresponding period one year earlier.

exchange rate volatility remains high, and substantial risks to exchange rate stability loom ahead, such as further economic deterioration, a loss of fiscal credibility, and a war in Iraq.

8. **Labor market conditions are worrisome (Box 3).** Unemployment is high, at about 10.4 percent, and the share of the long-term unemployed (jobless for more than six months) is a troubling 32 percent (see figure). The participation rate is only 54 percent, partially because of disincentives to work and inefficient employment services. At the same time, the number of foreign workers is estimated at 11 percent of the labor force, a share second only to Switzerland among industrial countries. Real wages fell by 5.7 percent in 2002, in part thanks to the hike in inflation.

Israel: Unemployment and Long-term Unemployment, 1993–2002



Source: Central Bureau of Statistics.

1/ Unemployed persons who sought work for over 27 weeks.

Box 3. Labor Market Problems

The slump in economic activity has brought to the fore three disturbing elements in the labor market—the high and rising unemployment rate, the low participation rate, and a steady increase in income maintenance recipients. The unemployment rate has been rising since 1995, and even in 2000, a year of rapid growth, it was 8.8 percent. The slowdown pushed the rate to 10.4 percent by the end of 2002. The participation rates of men and women 25–54 years old are 84 and 69 percent, respectively, among the lowest in the industrial world. The rate is traditionally low among the ultra orthodox population and non-Jewish women for cultural reasons. However, particularly worrying from a policy point of view is the low participation among people with low skills and with 3 or more children (see table). The number of income maintenance recipients has been rising since the early 1990s from about 30,000 in 1990 to about 150,000 in 2002.

Labor Force Participation Rates in Israel
Between ages 24–54, 2000

	Men	Women
Average participation rate	84.0	69.0
Education		
0–8	66.6	23.5
9–10	82.9	48.9
11–12	87.9	66.8
13+	85.4	84.2
Number of children		
None	79.7	73.9
1–2	90.4	73.6
3 or more	81.8	48.1
Ultra-orthodox	43.0	n.a.
Non-Jewish	80.0	30.0

These elements have three common explanations: relatively generous welfare benefits, inefficient employment services, and a rise in foreign workers. Not only are welfare payments high relative to the minimum wage, but also many supplementary benefits, such as discounts on the use of public facilities, are linked to being on welfare, rather than to the level of income. Entering the labor force, therefore, leads to a loss of supplementary benefits and often to a fall in total effective income. Employment services are seriously understaffed, against the swell in the number of the unemployed. As a result, their effectiveness has declined, and they have often become a rubber stamp for receiving unemployment benefits. Finally, the number of foreign workers soared in the last decade from 3,000 in 1990 to above 250,000 in 2002. The foreign workers, while important to the economy, have replaced many Israeli workers, lowered unskilled workers' wages, and deprived employers in the labor-intensive sectors of incentives to modernize their production.

9. **External indicators are mixed.** Despite the deterioration in the trade balance, the current account deficit is estimated to have increased only moderately in 2002 to around 2 percent of GDP, as payments to factors—mostly a decline in investment income earned by foreign investors—offset the fall in tourism (Table 3). Capital inflows, especially foreign direct investment, have declined substantially. Gross external debt has risen above 60 percent of GDP, although net external debt remains negligible, and foreign reserves fully cover short-term foreign liabilities (Table 4).

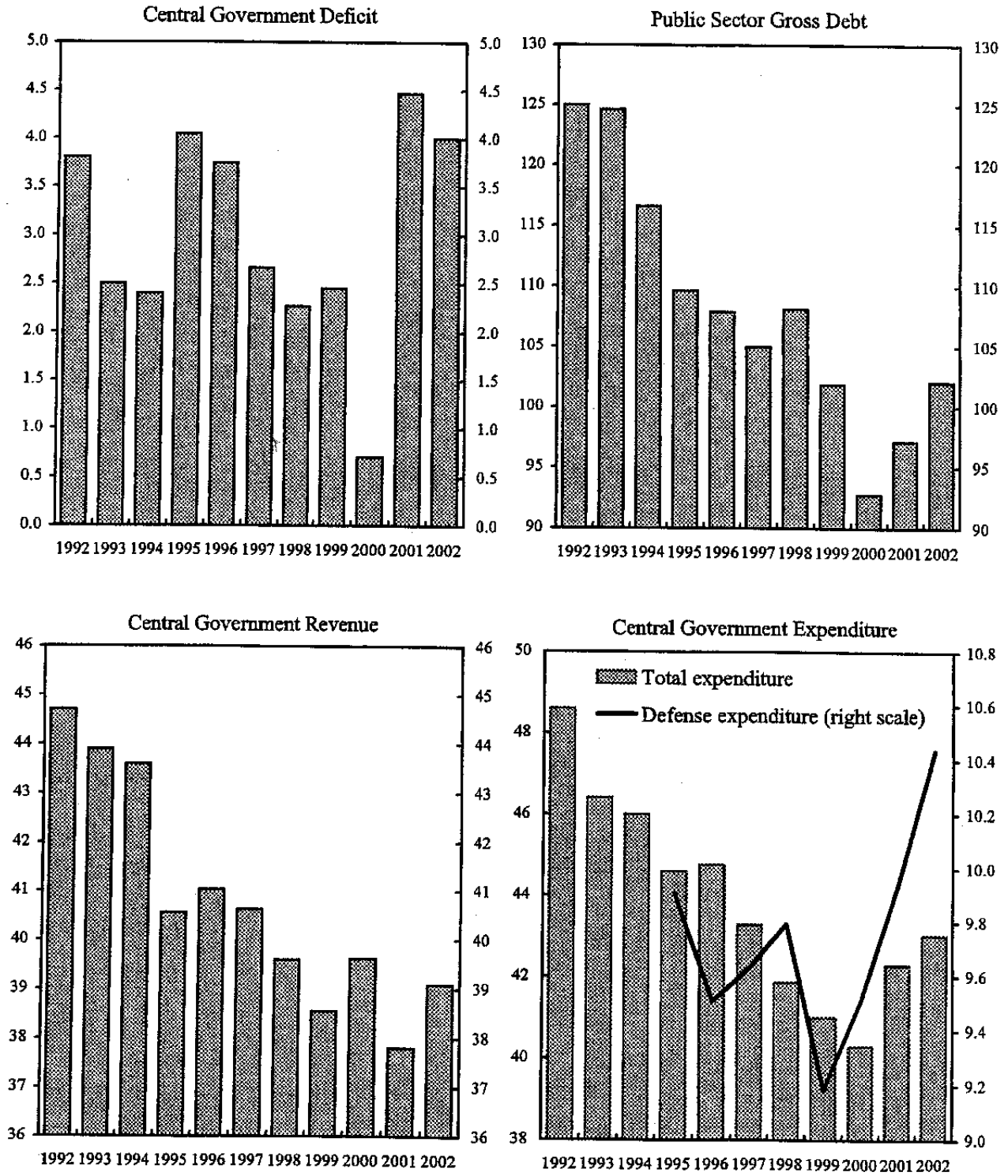
10. **The government has struggled to retain control over the fiscal deficit in the face of falling revenues and security-related expenditure increases (Figure 6, Table 5).** The repeated budget adjustments shook markets' confidence in the government's ability to reduce debt and deficit over the medium term. The 2002 budget was adjusted twice during the year with measures equivalent to a total of 3 percent of GDP, but these measures were not sufficient to prevent an increase in the deficit target on each occasion. The target rose from an original level of 1.75 percent to 3.9 percent of GDP in the end.⁴ Preliminary estimates indicate that the authorities were able to achieve this target with only a minor deviation. The debt/GDP ratio, which reversed its declining trend in 2001, continued to rise, reaching 104 percent by end-2002. The higher level of debt, combined with weaker fiscal credibility and the economic uncertainty, led to a rise in long-term real interest rates on ten-year indexed bonds from 3.7 percent in January 2002 to 5.6 percent in December 2002 (Figure 7).

11. **The 2003 budget aims at a deficit of 3 percent of GDP.**⁵ The budget's stated goal is to create conditions for stability by returning to a declining trend in the deficit, expenditure, and debt to GDP ratios, while stimulating business sector activity and employment by enhancing competition and cutting social benefits. Tax revenue is expected to increase by 7 percent under the assumption of 1 percent economic growth and 3 percent inflation, and a higher VAT rate. On the expenditure side, the major changes include a cutback on transfer payments and defense expenditures. The budget was passed by the Knesset prior to the elections with modifications amounting to a minimal deficit expansion. However, many analysts believe that a further significant expenditure cut will be needed in order to meet the 3 percent deficit target, primarily due to revenue overestimation.

⁴ The government excludes that part of interest on its debt that compensates for inflation when calculating fiscal deficits. Thus, the published deficits are smaller than conventionally-measured deficits. Staff estimates the difference to be about 1–2 percent of GDP in recent years.

⁵ The U.S. aid (debt guarantees and military aid) the government is requesting is not included in the 2003 budget.

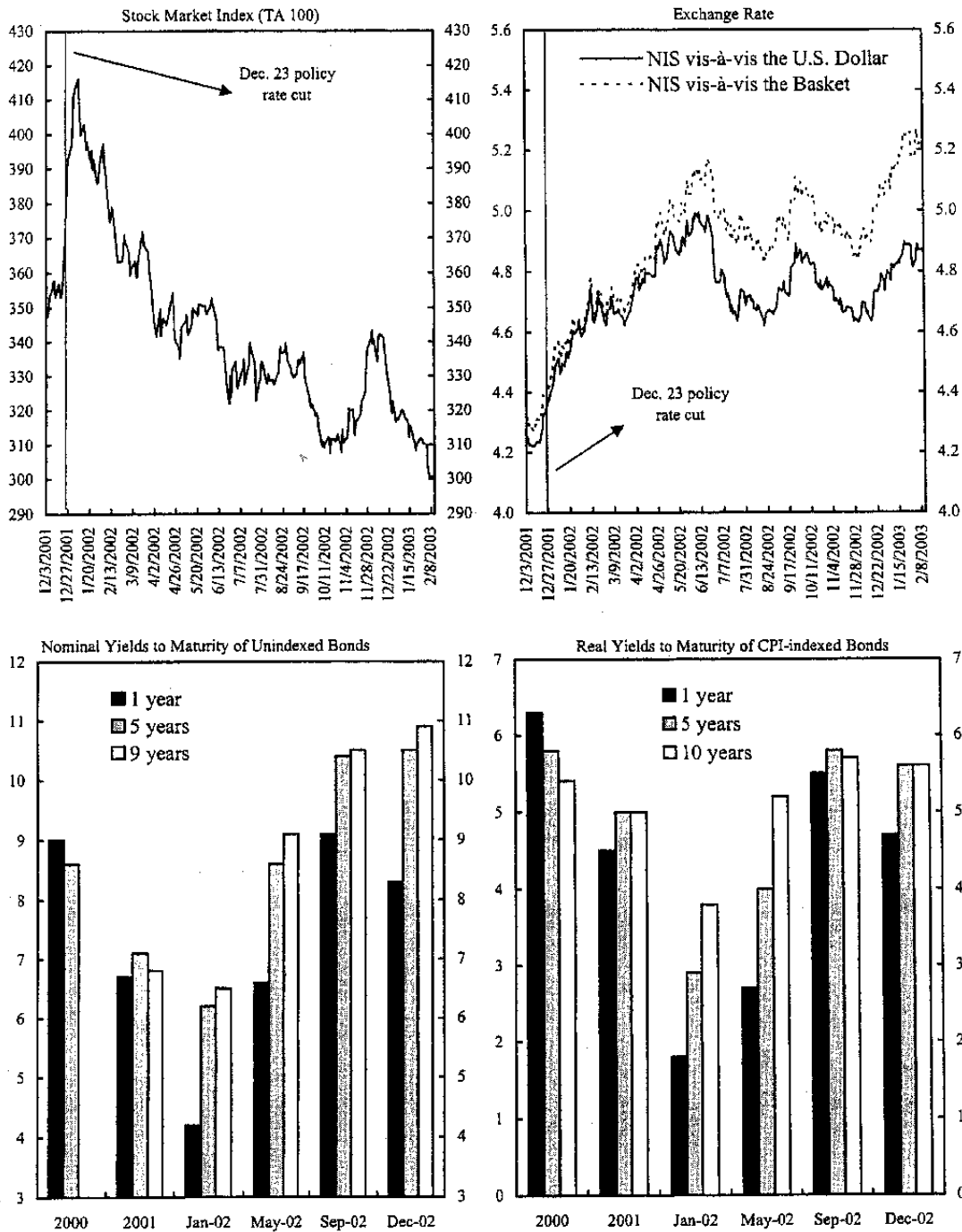
Figure 6. Israel: Selected Fiscal Indicators, 1992-2002 1/
(In percent of GDP)



Sources: Israeli authorities; and Fund staff estimates.

1/ Includes only the "real" component of interest payments.

Figure 7. Israel: Financial Indicators, 2001-03



Sources: Bank of Israel; and data from the authorities.

12. **On the structural front, the government pushed forward a broad-based tax reform and introduced some labor market reform measures.** The tax reform included a gradual lowering of the marginal tax rate on labor income and the introduction of a 10 percent capital gains tax. The labor market reform consisted of lowering disincentives to work by reducing transfer payments and increasing incentives to hire. In addition, the fees imposed on hiring foreign workers were raised, albeit less than envisioned. The government sold an additional 6 percent of Bank Leumi, but no progress has been made in the privatization of other banks, the former telecommunications monopolist, Bezeq, the flagship airline, El Al, and the remaining public controlled companies.

13. **Bank profits have suffered as a consequence of the deteriorated macroeconomic environment (Table 6).** The credit quality of the corporate sector has declined, and problem loans—excluding loans in the special mention category—rose by 26 percent from December 2000 to June 2002.⁶ Bank supervisors reacted promptly by requiring banks to increase supplementary provisions in the fourth quarter of 2001. They have also conducted focused on-site examinations of major banks to assess their credit classification and to require higher specific provisions so that banks' loan assessments better reflect underlying risks. The aggressive provisioning policy enabled banks to maintain the problem loans to total credit ratio—excluding special mention loans and net of provisions—at around 3.5 percent during 2000–02.⁷ However, such policy inevitably reduced bank profits substantially from the high levels that had prevailed before 2001; indeed, profits turned negative in the case of some banks. Bank profits were also adversely affected by capital losses from the fall in tradable securities prices due to the sharp increase in interest rates.⁸

14. **The economic outlook is exceptionally uncertain.** Although the plunge in high-tech exports appears to be stabilizing, it is unclear whether the economy has indeed reached bottom. Furthermore, the prolonged recession is likely to hold down consumption and investment as many firms and households are still adapting to the low level of activity. Fiscal policy has used all its headroom, and monetary policy is constrained by the sheqel's weakness. Taking these negative factors into account and assuming no further deterioration in the security situation and a mild global recovery, the economy is expected to enter only a

⁶ Special mention loans are those loans over which bank management sees fit to increase control and supervision, although it does not expect credit losses on them. Including these loans, problem loans have risen by 46 percent.

⁷ Including special mention loans, the ratio rose from 6.7 percent as of end-2000 to 8.7 percent as of June 2002.

⁸ Reflecting banks' declining profitability, Standard and Poor's cut the long-term rating of the two largest Israeli banks in September 2002 from A- to BBB+. Fitch downgraded the fifth largest bank from BBB+ to BBB in December 2002.

frail recovery period with GDP growing at ½ percent in 2003 led by external demand. However, political and economic risks abound. On the political side, the security situation may worsen or a regional war may spill over to Israel.⁹ On the economic side, continued weakness in the global technology sector may hinder exports, a rise in unemployment and poverty may threaten social stability, while a loss of confidence may disrupt foreign exchange and capital markets. If these risks materialize, economic activity may shrink further.

III. REPORT ON THE DISCUSSIONS

15. **The authorities and staff shared an understanding that foreign exchange and financial market stability was of utmost importance.** With a memory of the major market disruption in the first half of 2002 still fresh, and given the continuing, unusually high degree of uncertainty and the risk of downgrading by credit-rating agencies, all agreed that there was a strong need for macroeconomic policies to be geared toward bolstering market confidence and maintaining stability. The mission's discussions with the authorities focused on how to achieve this goal, while minimizing the economy's adjustment burden.

16. **The mission also focused on banking sector issues.** The banking sector was suffering from the cumulative negative effect of recession, and close monitoring was needed to evaluate the extent to which the sector's soundness might have been jeopardized. In addition, the mission followed up on the 2000/2001 FSAP findings to review the authorities' efforts to improve Israel's observance of financial sector standards and codes.¹⁰ A separate mission team led by MAE looked into Israel's anti-money laundering and combating financing of terrorism (AML/CFT) regime.¹¹

A. Monetary and Exchange Rate Policy

17. **The market disruption in the first half of 2002 naturally made the authorities cautious.** The BoI argued that there was evidence that market sentiment was not yet stabilized, and that extra care was therefore needed in restarting monetary easing. Although the slide of the sheqel stopped and then reversed in July, concern over the regional security situation led to a renewed weakening in September. Implied exchange rate volatility remained high, even when the sheqel strengthened toward end-November. Market-based

⁹ The extent of economic spillover is difficult to predict, but the experience of the Gulf War suggests that it may be small even if Israel is attacked, as long as the attack is conventional and limited.

¹⁰ *Israel: Report on the Observance of Standards and Codes—An Update* (forthcoming) for details of the mission's findings.

¹¹ *Israel: Report on the Observance of Standards and Codes—FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism* (forthcoming).

inflationary expectations—an important forward-looking indicator for the BoI's policy decision making—came down from the peak reached in June, but subsequently rebounded (Figure 4, bottom panel). In particular, long-term (ten year) expectations exceeded 5 percent, much higher than the government's inflation target of 1–3 percent. The BoI interpreted these pieces of evidence as suggesting that more time was needed before embarking on monetary easing, and also argued that there was no major cost in delaying easing for several months.¹²

18. **Staff agreed that caution was necessary not to disturb market stability, but also emphasized the risk of waiting too long.** Real interest rates of 6 percent were clearly too high for an economy in a deep recession. In staff's view, the only upside risk to inflation stemmed from exchange rate instability, and hence, if this risk did not materialize, inflation would likely fall to, or even below, the lower end of the target range in the course of 2003. The government was particularly concerned about a chain of events that could be triggered by the BoI's policy if it was too tight, namely, a negative impact on the economy, lower government tax revenues and a larger fiscal deficit, loss of market confidence in fiscal discipline, a weakening of the sheqel, and eventually, the need to tighten monetary policy further. Staff argued that in order to minimize the risk of inflation undershooting, the BoI should probe room for easing, seizing the opportunities provided by improvements in financial market conditions and a reduction in expected inflation as various uncertainties were resolved. Staff noted a number of events in the near future that would reduce uncertainty and, if their outcomes were favorable, would hopefully improve market conditions, including the approval of the 2003 budget by the Knesset, the January 2003 elections, and a resolution of the regional security situation.

19. **The BoI pointed out that high real interest rates were not entirely due to monetary policy.** The real yield curve was remarkably flat, and long-term real interest rates up to 19 years of maturity were around 6 percent. The BoI argued that a considerable part of the high real yield curve must be explained by the market's concern about fiscal policy. Staff agreed, and noted that the fiscal authorities' concerted efforts toward consolidation were essential for lowering real interest rates across the whole maturity spectrum.

20. **A number of contentious institutional issues related to monetary and exchange rate policies were still pending, but they had been largely defused or de facto frozen at the time of the mission.** The flattening of the lower (most appreciated) boundary of the exchange rate band in December 2001 has reduced—though not eliminated—inconsistency between the band and inflation targeting. The sheqel's subsequent depreciation, which had put the exchange rate closer to the center of the very wide band, also decreased the relevance of the issue. The government drafted an amendment to the Bank of Israel Law in spring

¹² Interestingly, the mission's discussion with the private sector also revealed that, although most thought that real interest rates were too high, they preferred stable markets over monetary easing.

2002 amid a heated public debate, including the publication by the BoI of the European Central Bank's negative assessment of the proposed amendment with respect to the BoI's policy objective, operational independence, and the selection of the members of the policy-making body. This feud was not well-received by the market, and was cited as one reason for the sheqel's depreciation. Although the amendment was sent to the Knesset, the government chose not to bring it to the first reading so as to avoid aggravating market concerns.

B. Fiscal Policy

21. **The authorities stressed their commitment to declining deficit and public debt ratios.** They pointed out that, despite the sharp recession and the additional defense expenditure due to the ongoing conflict, the budget was adjusted during 2002 to contain the deficit to 3.9 percent of GDP, or 0.7 percentage points below the 2001 level. The deficit-cutting measures were socially unpopular and politically difficult, but were necessary to maintain stability, the authorities' first goal. Particularly notable was the cut on transfer payments that had been hampering employment, as they had given rise to strong disincentives to join the labor force.

22. **The 2003 budget reinforced the government's stance toward fiscal consolidation, at least on paper.** The budget framework centered around three pillars: reducing the budget deficit; trimming government expenditures; and lessening the tax burden. Starting from 3 percent of GDP in 2003, the authorities intended to reduce the deficit by 0.5 percentage points every year, reaching a level of one percent of GDP by 2007. The government expenditure as a share of GDP, which expanded in 2001 and 2002, would decline from 46.3 percent in 2002 to 45.1 percent in 2003. The marginal tax burden on labor income would fall gradually until 2007. Furthermore, transfer payments, which have been growing steadily during the last decade, would decline, and defense expenditures would be kept at their 2002 budgeted level of 9.5 percent of GDP (22 percent of total government expenditures) despite the demanding security situation.¹³

23. **However, many observers, including the BoI, expressed serious concerns that the 2003 budget deficit would exceed its target by about 2-3 percent of GDP (NIS 9-14 billion), primarily due to revenue overestimation.** They noted, first of all, that revenues from the National Security Institution were overestimated by about NIS 3-4 billion. Second, various optimistic assumptions regarding revenues from land sales, VAT tax refunds, and other small items added up to a revenue overestimation of about NIS 1-2 billion. Third, tax revenues might be lower than predicted by NIS 2-3 billion even under the presumed 1 percent GDP growth, and in addition, some thought that the growth

¹³ The actual defense outlays in 2002 exceeded the originally budgeted amount by about 1 percent of GDP.

assumption itself might be too high. Fourth, on the expenditure side, the Ministry of Defense demanded additional NIS 3–5 billion, which was left to be resolved after the Knesset's approval of the budget.

24. **Staff shared these concerns, but nevertheless supported the government's effort to pass the budget without a change.** Reopening the budget could give rise to the risk of expanding, rather than shrinking, the deficit due to potential populist demands. Staff emphasized, however, that the next government should take necessary steps expeditiously to contain deficit expansion if it became clear that revenue was not coming in as expected. Ministry of Finance officials expressed their determination to introduce additional expenditure cuts, if necessary to adhere to the 3 percent of GDP target. Staff welcomed this assurance, since it would signal the government's resolve to maintain fiscal discipline. However, staff thought that, to avoid unduly aggravating the recession, the government should not attempt to go beyond the target, unless growth this year turned out to be better than expected, giving rise to extra revenues. At the same time, given the high debt ratio staff saw no room for the automatic stabilizers to operate, should growth fall short of the budget projections.

25. **According to the MoF calculations, public debt would rise slightly in 2003 before resuming its declining trend in 2004, based on the deficit target path toward 2007 and after, and assuming that the growth rate would return to about 4 percent by 2004.** Under these assumptions, the level of debt to GDP would fall below 60 percent in about 20 years, and the dynamics was robust to small deviations in the deficit and growth. Staff supported the gradual decline in the targeted deficit over the next six years. Staff noted, however, that certain deficit-cutting measures were one-off in nature, which implied that achieving the declining target path would continue to be a challenging task in years ahead. In this context, staff welcomed the Ministry's plan to formulate a medium-term fiscal program that would flesh out the target path. Staff also pointed out that even if the deficit targets were met, the debt to GDP ratio would not fall if growth did not pick up quickly or real interest rate rates continued to be high relative to growth.¹⁴

26. **The Ministry of Finance explained that despite their efforts to cut expenditures, they were able to maintain the level of spending on infrastructure.** The Ministry noted that utilizing private sector investment in infrastructure in the forms of Build Operate and Transfer (BOT) and Private Financing Initiative (PFI) projects, infrastructure investment was maintained, or even enhanced, in 2002 and 2003.¹⁵ Staff commended the authorities'

¹⁴ See Table 8, especially the simulated debt ratio paths under stress scenarios.

¹⁵ Planned investments in transport infrastructure projects total NIS 7 billion in 2003 compared to NIS 6 billion in 2002. Out of NIS 7 billion, about NIS 2.5 billion are privately financed.

determination to strengthen infrastructure, but cautioned that the use of BOT/PFI could decrease transparency of fiscal policy unless the government's future commitment to private firms was fully disclosed.

27. **The government has introduced a broad-based tax reform.** The reform, effective on January 1, 2003, aims at improving the efficiency and fairness of the tax system by widening the tax base and lowering the high taxes on labor income. It centers around the following three pillars. First, the direct tax burden on labor income has been reduced, particularly on middle-income earners whose marginal tax rate reached 55 percent at a relatively low wage level—about 1.4 times the average wage. During 2003–08, marginal tax rates will be lowered gradually, on average by 11 percentage points for middle-income earners. Second, capital gains from domestic traded securities and interest income, which used to be mostly tax exempt, are now subject to a tax of 15 percent (CPI-indexed instruments) or 10 percent (nonindexed instruments). Third, income of Israeli residents originating outside of Israel is taxed. Staff asked if the new capital gains and interest taxation could lead to capital outflows in order to avoid detection of taxable gains and incomes by the authorities. They replied that the low tax rates implied that the risk was minimal.

C. Financial Sector Issues

28. **Against the backdrop of declining bank profitability due to the recession, staff met bank managers and supervisors to examine banking sector soundness.** They reassured staff that the additional provisions made in 2001 and 2002 had brought the net book value of bank loans close to their true economic value. They also explained that, in order to prepare against a further deterioration of economic conditions, banks were making efforts to strengthen their capital base and cut operational costs.¹⁶ Some banks with a very concentrated exposure to the corporate sector were also increasing their exposure to the household sector in order to diversify risk.

29. **These efforts notwithstanding, the authorities did not expect banks to perform better in 2003 as long as the recession continued.** They thought that provisions would remain high—around 1 percent of total credit—and profits would be low. Although the authorities did not foresee any major banking sector problem in the near future, they

¹⁶ The four largest banks increased their Tier 1 capital in 2002, reversing the previous declining trend, and one bank successfully issued a new instrument—subordinated debt that gives the issuing bank and the supervisors the right to convert it into equity whenever the bank capital falls below the regulatory minimum—that counts under a new bank regulation as an upper Tier 2 capital in line with the Basle Accord. Banks were planning to cut operational costs by gradually reducing staff, closing branches, and restructuring their operations through mergers and acquisitions.

emphasized the need to monitor bank loan classification and capital adequacy closely, and also noted that they would support mergers of medium-size banks and acquisitions of small banks by large banks, which, in their view, would strengthen the banking sector's ability to withstand a recession. Staff agreed with the authorities that there did not seem to be imminent vulnerabilities in the banking sector that could pose a threat to financial stability. However, staff cautioned that if economic conditions were to deteriorate further in 2003, or even remained stagnant, banks would become more vulnerable as more provisions became necessary and the capital base, which was fairly close to the regulatory minimum for some banks, might be eroded further. Staff therefore supported the authorities' vigilant and proactive policy stance.

30. Staff followed up on the findings of the Financial Sector Stability Assessment (FSAP) conducted in 2000–01. Staff welcomed the removal of controls on institutional investors' investment abroad, the BoI's efforts to introduce a Real-Time Gross Settlement System by 2005,¹⁷ and the progress made in the implementation of recommendations in all the areas assessed by the FSAP. However, a number of recommendations were yet to be implemented. The most important ones are; legislation that allows an adequate exchange of information among domestic supervisory agencies; a more adequate bank exit policy framework; the introduction of deposit insurance; agreements for cooperation and information exchange between foreign and domestic insurance supervisors; and enabling insurance supervisors to set, and implement, rules on corporate governance and internal controls in insurance companies.

31. In June 2002, Israel was removed from the Financial Action Task Force's list of "noncooperative" countries and territories in the fight against money laundering. Israel's progress in strengthening its AML/CFT regime has been confirmed by the MAE-led mission. The Prohibition on Money Laundering Law was enacted in August 2000 as comprehensive legislation for AML. In January 2002, the Israel Money Laundering Prohibition Authority (IMPA) became operational as a financial intelligence unit at the Ministry of Justice, and started to receive unusual transaction reports from financial institutions in February 2002. Nevertheless, the mission identified a number of areas for further improvement, including the need to ensure more consistency among the relevant supervisory authorities in addressing AML/CFT problems as well as an enhanced information exchange among domestic and overseas supervisors. Staff urged the authorities to work on these areas to strengthen Israel's AML/CFT regime further.

¹⁷ In this respect, the BoI requested technical assistance from the IMF in order to continue the reform of the Payment Systems in Israel along the lines suggested by the FSAP.

D. Other Policy Issues

32. **A badly needed labor market reform has been implemented.** The reform combines a decline in the amount of and eligibility for income support, incentives to hire new employees, and a reduction in the number of foreign workers. The authorities expressed their hope that this reform would stop the increase in transfer payments and the rise in income support recipients. To assist the absorption of welfare recipients into the labor market, firms that hire new employees who were on welfare or unemployed for more than 50 days will receive NIS 1,000 a month for up to one year. Furthermore, the authorities plan to establish an immigration authority to deal with the swelling number of foreign workers, stop issuing new work permits, and raise the fees for employing foreign workers to partially offset distortions that favor the employment of foreigners, such as the exemption from social security contributions and a typically lax observance of labor regulations among those firms employing foreign workers. Through all these measures the authorities envision a reduction in the number of foreign workers by 50,000 (20 percent of the total foreign workers) by the end of 2003.

33. **The government has also initiated a pilot project for improving its employment and welfare services, based on the Wisconsin model for welfare reform.** One key idea of the project is to combine employment services and welfare; welfare recipients are directed toward work, including community services if suitable private-sector work is not available, and earn income from the work, rather than being given welfare benefits. Although promising, the scale of the project is very limited, and its contribution to reducing the unemployed with an ability to work but being trapped in welfare remains to be seen.

34. **There have been no major developments recently in the area of trade policy.** The tariffication of agricultural products was completed in 2000 (the only remaining nontariff barrier is that related to Kosher food), and product standards are well-harmonized with international ones. More than 80 percent of Israel's trade is covered by free trade agreements (FTAs). The policy focus had been to strengthen ties with the EU accession countries, primarily through bilateral FTAs, but this had largely been completed by 2001.

IV. STAFF APPRAISAL

35. **The Israeli economy is facing a number of major difficulties, which are caused largely by shocks that are either external or non-economic in origin.** As long as these difficulties continue, even the very best of macro policies would not allow the economy to achieve its full potential, and hence growth will remain subdued at best. At the same time, the economic and geopolitical uncertainties impose a heavy toll on any policy mistakes, as was the case in the first half of 2002. This means that the authorities should aim, first and foremost, at credible, transparent, and consistent policies that would maintain market confidence and stability.

36. **Of particular importance is the ongoing security problem.** Its economic impact was initially limited to certain sectors, but has gradually spread to the whole economy by aggravating investor and consumer sentiment. What is especially damaging is the uncertainty regarding when the violence will ever end. Looking ahead, the restoration of peace would yield substantial economic gains to the region as a whole.

37. **Against this background, the main task of the government is to strengthen market confidence in fiscal consolidation by re-establishing a declining path of debt, deficit, and expenditure.** The 2003 budget is a step in the right direction, especially because it contains important fiscal reform measures, including social benefit cuts and the tax reform. However, a major concern is that revenues may not come in as budgeted, making it difficult to achieve the 3 percent of GDP deficit target. The new government that has emerged from the January elections should address this problem expeditiously by introducing additional expenditure-cutting measures to signal its commitment to fiscal consolidation. Given the high public debt ratio, there is no room to let the automatic stabilizers operate, and should growth, and hence revenue, fall short of the projected level, additional measures would be needed to reassure markets that public finances are under control and the 2003 deficit will be kept close to its target. Over the medium term, the public debt ratios should decline if economic growth returns to its potential quickly and the government achieves its deficit targets. However, the high debt to GDP ratio implies that if growth fails to pick up, the ratio can easily continue to rise. The government should be mindful of this risk, and aim to achieve a declining path of the debt to GDP ratio, if necessary by cutting deficits faster than currently envisaged in years ahead.

38. **In order to maintain fiscal discipline and make deficit cuts sustainable, the government needs to take additional structural steps.** Social benefit cuts force welfare recipients to look for jobs, at a time when job opportunities are scarce. Therefore, in order to cushion the impact on the poor, it is essential to reduce foreign workers by strictly enforcing regulations, to introduce measures that reduce distortions favoring the employment of foreigners, and to improve efficiency of employment services. The freeze on private member bills with budgetary implications should be extended so as to maintain the government's control on expenditures. The government should formulate a medium-term fiscal program, in which future spending plans and commitments—including those stemming from public projects financed by private firms—and the expiration of any one-off deficit cutting measures are presented in a transparent way. Such a program will help ease the market's concern about sustainability of public finances over the medium term, and tend to attenuate market reaction to temporary shocks.

39. **Monetary policy is facing a difficult trade-off.** Maintaining market stability in the short run clearly requires the BoI to be cautious in cutting interest rates. However, it is also clear that interest rates are very high for an economy undergoing a deep recession. In particular, undershooting the inflation target would unduly exacerbate the economy's

adjustment burden. The BoI's task therefore is to strike the right balance between easing its policy too fast and waiting too long, which is achieved by cutting interest rates gradually whenever market conditions and inflationary prospects improve. The BoI's 20 basis point rate cut in late-December is consistent with this strategy and is a good start. However, the sheqel's recent weakening out of concern over the Iraqi situation is a reminder that the BoI's room for maneuver may be limited for the time being.

40. **The BoI's role as bank supervisor will become increasingly important for maintaining market stability.** Given the declining profitability of banks, priority should be given to proactive measures to strengthen banks' ability to withstand a continuing, or even deepening, recession, such as tougher provisioning requirements. Improving supervisors' crisis management capabilities is also needed, such as introducing a better bank exit policy framework and a deposit insurance scheme.

41. **The authorities should make further progress in improving Israel's compliance with financial sector standards and codes.** In particular, efforts should be made to enhance information exchange among supervisors and strengthen insurance supervisory powers and skills to assure an orderly adaptation of the insurance sector to a more entrepreneurial and competitive market environment. Although Israel has made significant progress in improving its AML/CFT regime, further improvements and refinements are needed, and are expected to be made, along the recommendations made by the ROSC mission.

42. **Data provision is generally adequate for surveillance purposes.** Israel is prepared to meet the SDDS benchmark for external debt data by the end of the transitional period, end-March 2003.

43. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Israel: Selected Economic and Financial Indicators, 1996-2003

	1996	1997	1998	1999	2000	2001	2002 1/2003 1/	
	(Percent change unless otherwise indicated)							
National account indicators (constant prices)								
Domestic demand	5.8	2.0	1.4	4.4	3.5	1.7	-0.4	0.0
Private consumption	5.1	3.4	4.2	2.8	7.2	2.5	-0.6	0.8
Public consumption	5.3	1.8	2.0	3.0	1.3	3.3	5.5	1.2
Gross capital formation	8.0	-1.0	-5.8	10.2	-2.8	-2.6	-8.0	-4.5
Fixed capital formation	9.2	-1.0	-3.0	-2.9	3.9	-8.1	-8.8	0.8
External sector (net contribution to growth)	-1.5	1.2	1.4	-2.0	3.4	-2.7	-0.6	0.6
Exports of goods and services	5.1	8.4	6.9	12.0	25.3	-11.7	-5.4	3.4
Imports of goods and services	7.7	3.3	1.7	14.9	12.3	-4.5	-3.0	1.3
Real GDP	4.7	3.3	3.0	2.6	7.4	-0.9	-1.0	0.5
Labor market indicators								
Unemployment rate (in percent)	6.7	7.7	8.6	8.9	8.8	9.3	10.5	10.9
Real wages								
Total economy	1.6	2.4	2.2	2.6	6.2	3.0	-5.7	...
Business sector	1.5	3.5	2.9	3.7	6.6	3.2	-6.5	...
Public sector	1.9	0.0	0.4	0.1	5.3	2.7	-3.7	...
Prices								
Overall CPI (end period)	10.6	7.0	8.6	1.3	0.0	1.4	6.5	1.6
Overall CPI (period average)	11.3	9.0	5.4	5.2	1.1	1.1	5.7	1.8
Underlying CPI (excluding housing, fruit and vegetables, end period)	10.1	6.7	8.5	1.7	0.9	0.2	6.3	1.6
Interest rates (average, in percent)								
Self-renewing overnight deposits	13.8	12.2	10.3	10.9	8.0	5.6	5.6	...
BOI policy rate	15.1	13.6	11.7	12.1	9.3	6.8	6.8	...
Money and credit (period average)								
Non direct domestic credit	24.6	19.1	16.1	16.7	13.1	10.8	10.5	...
Narrow money (M1)	9.4	13.2	12.1	9.6	11.0	14.2	15.6	...
Broad money (M3)	22.5	21.4	15.9	21.2	16.9	15.5	6.0	...
Public finance (percent of GDP)								
Central government revenue	41.0	40.6	39.6	38.5	39.6	37.8	39.3	40.6
Central government expenditure	44.8	43.3	41.9	41.0	40.3	42.3	43.2	43.6
Central government balance	-3.7	-2.7	-2.3	-2.5	-0.7	-4.5	-4.0	-3.0
General government balance	-5.8	-4.3	-3.8	-4.8	-2.2	-3.8	-4.2	-3.9
Gross public debt	107.9	105.0	108.1	101.9	92.8	98.1	103.8	106.0
Balance of payments								
Trade balance (percent of GDP)	-7.2	-5.1	-3.2	-4.3	-2.7	-2.9	-3.4	-2.5
Current account (percent of GDP)	-5.5	-3.9	-1.3	-3.2	-1.7	-1.7	-2.1	-1.5
Foreign reserves (e.o.p., in US\$ billion)	11.6	20.3	22.7	22.5	23.2	23.2	23.6	23.6
Reserve cover (in months of imports)	3.7	6.6	7.6	6.7	6.0	6.4	6.7	6.5
Exchange rate and terms of trade indices								
NEER appreciation (period average) 2/	-2.7	0.2	-6.4	-7.7	9.1	0.7	-13.5	...
REER appreciation (period average) 2/	5.9	7.0	-3.0	-3.8	8.0	-0.3	-9.9	...
Terms of trade (1990=100; index level)	103.6	107.3	111.5	117.9	119.9	116.8	116.7	...

Sources: Bank of Israel, *Annual Report*; Central Bureau of Statistics; IMF, *International Financial Statistics*; and Fund staff estimates and projections.

1/ Fund staff estimates and projections.

2/ As of November 2002.

3/ As of October 2002.

Table 2. Israel: Current Indicators, 1998-2002

	1998	1999	2000	2001	2002	2001												2002											
						Qrt 1	Qrt 2	Qrt 3	Qrt 4	Qrt 1	Qrt 2	Qrt 3	Qrt 4	Qrt 1	Qrt 2	Qrt 3	Qrt 4	Dec-01	Jan-02	Feb-02	Mar-02	Apr-02	May-02	Jun-02	Jul-02	Aug-02	Sep-02	Oct-02	Nov-02	Dec-02
Activity and Employment 1/																													
Private consumption	3.4	4.2	2.8	7.2	...	0.7	0.1	-0.1	-0.6	0.1	-0.7	0.0	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Public consumption	2.0	3.0	1.3	3.3	...	0.0	1.1	-4.2	8.3	1.6	1.4	1.1	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Gross capital formation	-5.8	10.2	-2.8	-2.6	...	1.3	-9.8	3.6	-17.4	6.8	0.0	3.5	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Fixed capital formation	-3.0	-2.9	3.9	-8.1	...	-3.5	-2.6	-0.5	-3.6	-0.9	-1.3	-3.7	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Exports of goods and services	6.9	12.0	25.3	-11.7	...	-3.1	-6.1	-4.1	0.0	-1.2	0.9	-3.5	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Imports of goods and services	1.7	14.9	12.3	-4.5	...	-3.8	-4.1	-3.7	-1.5	1.6	2.7	-3.2	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real GDP	3.0	2.6	7.4	-0.9	...	0.0	-0.8	-1.6	-0.8	0.4	-0.2	0.0	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Business sector gross product																													
Industrial production index	2.7	1.4	9.6	-4.7	...	-0.7	-4.6	-1.7	-1.6	0.1	0.7	-0.7	...	1.0	-0.5	-0.5	1.0	0.9	-0.8	-0.5	-0.4	-0.3	1.6	0.2	...	...	...	...
State-of-Economy index	3.7	1.1	3.8	-0.9	...	-0.7	-1.7	-2.5	-0.7	0.5	-1.0	-0.3	...	0.5	0.5	0.0	-0.5	-0.9	0.2	0.2	-0.2	-0.5	-0.2	-0.2	-0.3	...	...	...
Business sector employee posts	5.5	6.0	2.1	0.3	4.1	0.0	0.6	-1.6	-0.3	-0.4	-0.6	0.0	...	-0.1	0.1	-0.3	-0.3	-0.4	0.2	-0.1	0.2	-0.2	-0.1	0.1	...	...	...	...
Unemployment rate (in percent) 2/	8.6	8.9	8.8	9.3	...	8.6	8.9	9.6	10.3	10.6	10.3	10.4	...	10.4	10.5	10.6	10.5	10.5	10.5	10.4	10.4	10.4	10.4	10.4	...	...	...	...
Prices and Wages																													
Overall CPI	5.4	5.2	1.1	1.1	5.7	-0.7	1.4	1.0	-0.1	1.5	3.2	1.7	0.1	-0.1	1.1	0.8	0.5	1.5	0.9	1.3	0.6	-0.4	0.4	0.6	-0.8	-0.3	...	...
Percent change (Y/Y) 3/	8.6	1.3	0.0	1.4	6.5	0.3	0.9	1.7	1.6	3.8	5.7	6.5	6.7	1.4	3.1	4.0	4.3	5.0	5.5	6.6	6.9	6.2	6.4	6.9	6.7	6.5	...	...
Underlying CPI	5.5	6.0	2.1	0.3	4.1	-0.8	1.1	0.4	-0.3	0.3	2.9	2.6	0.3	-0.2	0.3	0.2	0.3	1.5	1.0	1.4	1.2	0.1	0.1	0.4	-0.3	0.0	...	...
Percent change (Y/Y) 3/	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real wage index (1994=100) 4/	2.2	2.6	6.2	3.0	-5.7	...	...	...	-0.9	-1.1	-1.7	-1.9	...	-0.5	0.7	-2.7	-0.9	-0.8	-0.3	1.8	-2.8	-3.0	0.3	-3.6	...	...	...	...
Percent change (Y/Y) 3/	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Financial Indicators (period average)																													
Narrow money (M1)	12.1	9.6	11.0	14.2	15.6	2.7	5.0	6.4	1.1	10.8	2.5	-3.4	...	4.1	5.3	3.0	3.5	-1.8	1.3	0.5	-3.1	-1.3	-0.5	-3.2	-1.1	...	...	...
Broad money (M3)	15.9	21.2	16.9	15.5	6.0	5.1	2.9	6.4	4.7	-0.1	1.8	0.1	...	1.0	0.3	-1.5	-0.1	1.6	0.8	0.7	-0.9	-0.2	1.2	0.1	-0.6	...	...	...
Nondirected credit (including foreign currency)	16.1	16.7	13.1	10.8	10.5	2.8	2.3	3.0	2.0	2.3	3.6	2.3	...	-0.1	1.6	0.7	0.8	1.7	1.3	0.9	0.2	1.1	0.9	0.7	-0.4	...	...	...
Interest rates (in percent)																													
BOI policy rate 5/	11.7	12.1	9.3	6.8	6.8	7.7	7.1	6.4	6.1	4.0	5.2	9.1	9.1	5.8	3.8	3.8	4.4	4.4	4.6	6.5	9.1	9.1	9.1	9.1	9.1	9.1	9.1	9.1	9.1
External Sector (period average)																													
Current account balance (in US\$ billions)	-1.4	-3.3	-2.0	-1.9	...	-0.2	-0.9	-1.4	0.7	-0.5	-0.9	-1.2	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Trade balance (in US\$ billions) 6/	-3.2	-4.4	-3.1	-3.3	...	-1.1	-0.9	-0.8	-0.5	-0.8	-1.1	-0.9	...	-0.6	-0.4	-0.6	-0.3	-0.5	-0.5	-0.7	-0.5	-0.6	-0.4	-0.5	-0.4	-1.1	...	...
Foreign reserves (in US\$ billions, end of period)	22.7	22.5	23.2	23.2	23.6	23.8	23.1	24.5	23.2	23.9	24.8	24.2	23.6	23.2	22.9	24.0	23.9	24.1	24.1	24.8	24.8	24.3	24.2	23.8	23.3	23.6	...	...
In months of imports (goods and services, projected)	7.6	6.6	6.0	6.4	...	6.1	5.9	6.3	6.0	6.2	6.4	6.2	...	6.0	5.9	6.2	6.2	6.2	6.2	6.4	6.4	...	...	...	...	...	...	...
Ratio of foreign reserves to M1	3.7	3.3	3.4	3.0	...	3.7	3.4	3.6	3.1	3.3	3.5	3.8	...	3.1	3.3	3.4	3.3	3.5	3.5	3.5	3.7	3.7	3.7	3.7	...	...	...	...
Ratio of foreign reserves to gross short-term debt	0.88	0.80	0.86	0.82	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
NEER (1990=100) 7/	-6.4	-7.7	9.1	0.7	...	-2.8	2.9	-3.4	-0.6	-5.6	-8.4	-1.3	...	-0.5	-4.9	-1.8	-0.6	-3.7	-4.3	-3.2	1.8	2.0	-2.2	-0.2	-0.8	...	...
REER (1990=100) 7/	-3.0	-3.8	8.0	-0.3	...	-2.9	3.0	-2.9	-1.0	-3.7	-6.4	-0.2	...	-0.6	-3.6	-0.8	-0.1	-3.2	-3.8	-2.2	2.1	1.7	-1.7	0.1	-0.3	...	...
NIS / currency basket (in NIS, average rate)	4.09	4.43	4.22	4.28	4.89	4.24	4.20	4.32	4.35	4.66	4.99	4.94	4.96	4.34	4.58	4.69	4.70	4.86	5.00	5.11	4.95	4.88	4.99	5.01	4.9	5.0	...	...
NIS / US\$ (in NIS, average rate)	3.86	4.14	4.08	4.21	4.74	4.13	4.16	4.25	4.28	4.62	4.88	4.73	4.73	4.28	4.54	4.66	4.66	4.81	4.89	4.94	4.72	4.68	4.78	4.80	4.69	4.69	...	...
NIS / US\$ (in NIS, end of period rate)	4.18	4.19	4.08	4.28	4.69	4.19	4.17	4.36	4.42	4.67	4.77	4.87	4.74	4.42	4.60	4.62	4.67	4.89	4.92	4.77	4.69	4.66	4.87	4.77	4.64	4.74	...	...
Fiscal Sector (domestic, excluding net credit)																													
Revenues (growth year-on-year)	6.1	8.6	15.1	-1.6	3.3	-5.0	1.4	4.3	-7.0	3.2	2.4	0.2	8.0	11.9	-7.4	4.8	12.7	0.1	4.3	3.2	5.2	-6.2	0.8	10.6	-5.0	18.1	...	...
Expenditures (growth year-on-year)	6.0	6.8	7.3	7.1	2.4	-5.5	18.4	11.1	5.0	4.6	-1.2	0.9	5.4	18.7	-10.1	9.7	13.0	-8.5	5.8	0.2	4.4	3.7	-4.6	17.0	7.0	-3.2	...	...
Accumulated deficit as percent of annual budgeted amount	131.0	117.1	19.5	131.9	131.6	-15.2	32.0	49.3	131.9	-7.2	15.1	27.8	78.7	131.9	-11.9	-22.0	-6.9	6.8	15.2	42.8	39.6	60.7	65.7	85.1	109.4	131.6	...	...

Sources: Bank of Israel; Central Bureau of Statistics; and IMF, *International Financial Statistics*

1/ Seasonally adjusted data; percentage change over previous period.

2/ Unemployment statistics are released quarterly; the monthly figures are trend data.

3/ (Y/Y) refers to percentage change from the corresponding period one year earlier.

4/ Gross wages, including taxes levied on employees. Seasonally adjusted.

5/ The Bank of Israel set the policy rate at 8.9 percent in January 2003.

6/ Unlike annual and quarterly data, monthly data are drawn from customs data and exclude ships and aircraft.

7/ IMF convention; an increase indicates appreciation and vice versa.

Table 3. Israel: Balance of Payments, 1996-2002
(In billions of U.S. dollars)

	1996	1997	1998	1999	2000	2001	2002 1/
Current account balance	-5.4	-4.0	-1.3	-3.3	-2.0	-1.9	-2.2
Merchandise	-7.1	-5.2	-3.3	-4.5	-3.1	-3.3	-3.5
Exports, f.o.b.	21.3	22.7	23.0	25.6	30.9	27.7	27.1
Imports, f.o.b.	28.4	27.9	26.2	30.0	34.0	30.9	30.6
Civilian imports	26.8	26.2	24.4	28.0	32.1	28.8	28.4
Military imports	1.7	1.8	1.9	2.1	1.9	2.1	2.1
Services	-1.1	-0.9	-0.2	0.7	2.7	-0.6	-1.5
Exports	8.0	8.4	9.4	11.4	15.2	12.0	10.0
Imports	-9.1	-9.2	-9.6	-10.7	-12.5	-12.6	-11.5
Factor Income	-3.3	-3.9	-3.9	-5.9	-8.0	-4.4	-3.5
Exports	1.8	2.1	2.8	2.6	3.4	3.5	3.0
Imports	-5.2	-6.1	-6.7	-8.4	-11.4	-8.0	-6.5
Net transfers	6.1	6.0	6.1	6.3	6.5	6.4	6.3
Capital and financial account balance 3/	4.2	0.7	0.0	2.7	3.6	0.5	0.9
Capital account	1.9	0.7	0.6	0.6	0.5	0.7	0.2
Financial account	2.2	0.0	-0.6	2.1	3.1	-0.2	0.7
Direct investment	0.3	0.8	0.6	1.9	1.7	2.1	0.4
Portfolio investment	4.1	4.1	2.5	1.8	2.9	-0.9	-1.6
Other investment	1.2	4.5	-1.8	-0.6	-0.9	-1.7	2.0
Errors and omissions	4.6	12.6	3.2	1.6	-1.1	1.1	1.4
Change in reserves 4/	-3.4	-9.4	-1.9	-1.0	-0.6	0.3	-0.1
Memorandum items (percentage of GDP):							
Current account balance	-5.5	-3.9	-1.3	-3.2	-1.7	-1.7	-2.1
Civilian trade balance	-5.5	-3.4	-1.4	-2.3	-1.0	-1.0	-1.3
Gross external debt	51.6	53.6	56.4	59.8	55.8	57.6	63.6
Net external debt 5/	19.1	14.3	10.8	9.3	5.3	2.7	3.4
Gross external debt (in US\$ billions)	51.0	55.2	58.0	61.6	63.5	64.4	66.1
Net external debt (in US\$ billions)	18.9	14.7	11.1	9.6	6.1	3.0	3.5
GDP (in US\$ billions)	98.9	102.9	102.8	103.1	113.9	111.8	103.8

Sources: Central Bureau of Statistics, *Monthly Bulletin of Statistics*; and Fund staff estimates.

1/ Fund staff projection.

2/ Revised: tourism expenditures excludes outlays by Israeli citizens that reside overseas.

3/ Excludes reserve assets.

4/ Negative (positive) sign denotes increase (decrease) in reserves.

5/ Net external debt subtract out of gross external debt the foreign reserve asset holdings of the Bank of Israel, the commercial banks, and other monetary institutions.

Table 4. Israel: Indicators of External and Banking Sector Vulnerability, 1996-2002
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	Latest Data	
							2002	Date
Financial indicators								
Public debt	107.9	105.0	108.1	101.9	92.8	98.1	...	July 2002
Broad money (percent change, 12-month basis)	24.1	22.7	21.4	22.0	7.9	5.9	2.4	Nov. 2002
Private sector credit (percent change, 12 month basis)	18.1	18.4	5.9	7.8	15.6	12.5	9.7	Nov. 2002
One month T-bill yield (Makam; nominal)	15.5	13.4	11.3	11.4	8.8	6.5	8.0	Dec. 2002
One month T-bill yield (Makam; deflated by 12-mth CPI, e.o.p.)	4.4	6.0	2.5	9.9	8.8	5.0	1.4	Dec. 2002
External Indicators								
Exports of G&NFS (percent change)	8.0	5.8	4.4	14.2	24.6	-14.0	-2.0	Sept. 2002
Imports of G&NFS(percent change)	6.7	-1.1	-3.5	13.6	14.3	-6.6	0.1	Sept. 2002
Terms of trade (percent change, average) 1/	-2.9	-7.0	-6.7	-1.4	-2.8	-4.0	2.4	
Current account surplus	-5.5	-3.9	-1.3	-3.2	-1.7	-1.7	-2.6	Sept. 2002
Capital and financial account balance	4.2	0.7	0.0	2.6	3.2	0.4	-1.1	Sept. 2002
<i>Of which:</i>								
Inward portfolio investment (debt securities etc.)	4.2	4.0	2.4	1.7	2.6	-0.8	3.1	Sept. 2002
Other investment (loans, trade credits etc.)	1.2	4.4	-1.7	-0.6	-0.8	-1.5	-8.5	Sept. 2002
Inward foreign direct investment	0.3	0.8	0.6	1.9	1.5	1.9	-0.5	Sept. 2002
Gross official reserves (in billions of US\$; e.o.p.)	11.6	20.3	22.7	22.5	23.2	23.2	23.6	Dec. 2002
Central Bank short-term foreign liabilities (in billions of US\$)	0.1	0.1	0.1	0.0	0.1	0.0	0.2	Sept. 2002
Short-term foreign assets of the financial sector (in billions of US\$)	13.3	11.1	13.2	14.3	15.7	15.6	14.6	Sept. 2002
Short-term foreign liabilities of the financial sector (in billions of US\$)	15.5	17.5	19.2	21.2	22.7	24.2	24.8	Sept. 2002
Official reserves in months of imports GNFS	3.7	6.6	7.6	6.6	6.0	6.4	6.6	Sept. 2002
Ratio of foreign reserves to broad money	0.3	0.4	0.5	0.4	0.4	0.4	0.3	Nov. 2002
Ratio of foreign reserves to short-term debt	0.5	0.8	0.9	0.8	0.9	0.8	0.8	Sept. 2002
Total net external debt/GDP (in percent)	19.1	14.3	10.8	9.3	5.3	2.7	2.1	Sept. 2002
Total gross external debt/GDP (in percent)	51.6	53.6	56.4	59.8	55.8	57.6	63.2	Sept. 2002
<i>Of which:</i>								
Government debt/GDP (in percent)	25.5	25.4	26.6	26.6	24.1	24.2	26.3	Sept. 2002
Total gross external debt to exports GNFS (in percent)	173.9	177.8	178.8	166.4	137.7	162.3	179.8	Sept. 2002
External amortization payments to exports GNFS (in percent) 3/	...	...	21.6	19.8	16.6	17.8	...	June 2002
Ratio of short-term debt to total debt (in percent)	45.0	45.1	44.4	45.8	45.1	47.2	47.5	Sept. 2002
Country risk ratings (S. & P. / Moody's) 4/	A- / A3	A- / A3	A- / A3	A- / A3	A- / A2	A- / A2	A- / A2	Dec. 2002
Spread of foreign bonds relative to U.S. Bonds (in basis points)	30	40	100	50	120	110	200	Oct. 2002
Exchange rate (per US\$, period average)	3.58	3.73	4.09	4.43	4.22	4.28	4.69	Dec. 2002
REER appreciation (+) (period average)	107.5	114.3	100.2	106.1	115.2	112.6	100.4	Oct. 2002
Change in stock market index (in percent)	-2.1	37.0	2.9	65.7	-2.6	-6.6	-19.9	Dec. 2002

Sources: Bank of Israel; Central Bureau of Statistics; International Monetary Fund; Fund staff estimates and projections.

1/ According to WEO GEE trade deflators.

2/ Exposure of the business sector, measured by the difference between the capitalized flow of foreign currency receipts and payments (including all receipts and payments in or formally indexed to foreign currency at the time of measurement. Data for 2000 refer to end-July.

3/ Public sector and non-financial private sector.

4/ Moody's upgrade in July 2000.

Table 5. Israel: State Budget, 1995-2003
(In percent of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002 Budget	2002 Est.	2003 Budget
Revenue	40.5	41.0	40.6	39.6	38.5	39.6	37.8	40.5	39.3	40.6
Domestic	37.7	36.1	36.3	35.0	34.7	36.8	35.3	36.8	35.7	36.5
Tax	31.2	30.4	30.8	29.9	30.0	31.6	31.4	31.9	30.1	31.2
<i>Of which:</i>										
On income and profits	16.9	16.1	16.7	16.4	16.3	18.3	18.1	18.1	16.4	16.8
On domestic goods and services	13.9	14.0	13.8	13.2	13.3	13.0	13.0	13.4	13.3	13.5
Nontax domestic	6.5	5.6	5.5	5.2	4.8	5.2	3.9	5.0	5.6	5.3
<i>Of which:</i>										
Loans from the National Insurance Institute	1.8	1.7	1.6	1.4	1.4	1.5	0.9	2.0		2.5
Foreign	2.8	5.0	4.3	4.5	3.8	2.8	2.5	3.7	3.6	4.1
<i>Of which:</i>										
Grants	1.9	4.1	3.2	3.2	2.6	2.5	2.1	2.5		2.7
Expenditure	44.6	44.8	43.3	41.9	41.0	40.3	42.3	43.5	43.2	43.6
Domestic	40.9	40.5	39.4	37.9	37.6	37.3	38.9	39.5	39.7	38.8
Current domestic	37.2	36.7	36.4	35.2	35.0	34.9	36.4	36.3		35.7
<i>Of which:</i>										
Wages	9.4	9.4	9.2	8.4	5.9	8.9	8.7	8.8		8.8
Interest	4.7	4.7	4.8	4.8	4.5	4.7	4.7	4.6		4.9
Subsidies and transfers	14.9	15.7	15.0	14.8	15.1	14.2	15.1	15.4		14.6
Repayment	8.6	10.2	9.4	9.8	8.9	8.3	9.5	9.1		10.9
Capital	3.6	3.8	2.9	2.7	2.5	2.5	2.5	3.2		3.1
Foreign	3.7	4.3	3.9	4.0	3.4	3.0	3.4	4.1	3.6	4.8
<i>Of which:</i>										
Interest	1.8	1.9	1.5	1.5	1.4	1.3	1.3	1.3		1.7
Budget balance	-4.0	-3.7	-2.7	-2.3	-2.5	-0.7	-4.5	-3.0	-4.0	-3.0
Domestic	-3.2	-4.5	-3.0	-2.9	-2.8	-0.6	-3.6	-2.7	-3.9	-2.3
Foreign	-0.9	0.7	0.4	0.6	0.4	-0.1	-0.8	-0.3	0.0	-0.7
Financing	4.0	3.7	2.7	2.3	2.5	0.7	4.5	3.0	4.0	3.0
Domestic	2.6	2.6	3.1	2.6	2.5	0.9	5.1	3.2		3.0
Bank of Israel (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0
Nonbank (net)	2.4	2.5	0.2	1.0	1.7	-0.1	3.6	2.7		2.7
Sale of assets	0.7	0.1	2.4	1.3	0.5	0.6	0.0	0.3		0.3
Other (net)	-0.5	0.0	0.5	0.3	0.3	0.3	1.5	0.2		0.0
Foreign (net)	1.4	1.1	-0.4	-0.4	-0.1	-0.2	-0.6	-0.2		0.0
Memorandum items:										
Defense expenditure	9.9	9.5	9.6	9.8	9.2	9.5	9.9	9.5	10.5	9.4
Primary balance	2.4	2.8	3.7	4.0	3.4	5.3	1.5	2.9	2.0	3.6

Sources: Data provided by the Israeli authorities; and Fund staff estimates.

Table 6. Israel: Financial Soundness Indicators—Five Largest Banking Groups, 1997–2002

	1997	1998	1999	2000	2001	<u>2002</u> 1st half
Asset growth (in percent)	6.1	8.5	10.9	7.9	7.5	-2.3
Credit growth (in percent)	7.3	10.5	12.0	13.7	12.7	0.0
Credit to GDP ratio	0.9	0.9	1.0	1.0	1.1	
Capital to risk-weighted assets ratio (in percent)	10.0	9.2	9.4	9.2	9.4	9.9
Tier 1 capital to risk-weighted assets ratio (in percent)	8.9	7.4	7.3	6.7	6.2	6.6
Tier 2 capital to risk-weighted assets ratio (in percent)	1.1	1.8	2.4	2.6	3.2	3.5
After-tax return on equity (in percent)	12.0	9.9	11.3	11.7	5.9	3.2 1/
After-tax return on assets (in percent)	0.6	0.5	0.5	0.5	0.3	0.2 1/
Problem loans, net (of specific provisions) to total net loans ratio (in percent) 2/	10.5	9.9	9.0	6.7	8.1	8.7
Problem loans (excluding loans in the special mention category), net of provisions to total net loans ratio (in percent)	5.3	4.6	4.7	3.5	3.2	3.6
Loan-loss provisions (stock) to total gross problem loans ratio (excluding loans in the special mention category) (in percent)	48.9	49.5	45.7	55.8	57.1	54.7
Share of foreign currency credit in total credit to the public 3/	32.1	35.3	35.9	34.0	36.0	38.1
Share of foreign currency deposits in total deposits of the public 3/	28.9	31.5	31.0	30.8	31.1	33.0
Share of foreign currency liabilities in total liabilities 3/	25.8	28.3	27.7	27.8	28.1	30.3

Sources: Data provided by the Bank of Israel; and Fund staff estimates.

1/ Annualized on the basis of the first six months.

2/ Problem loans include nonaccrual debt, restructured debt, temporary arrears and loans in the special mention category.

3/ As of September 2002.

Table 7. Israel: Medium Term Scenario, 1998-2006

	1998	1999	2000	2001	2002	2003	2004	2005	2006
(In percent unless indicated otherwise)									
GDP growth rate	3.0	2.6	7.4	-0.9	-1.0	0.5	2.3	4.5	4.4
Inflation (average)	5.4	5.2	1.1	1.1	5.7	1.8	1.6	2.2	2.0
Fiscal deficit/GDP									
Official definition	-2.3	-2.5	-0.7	-4.5	-4.0	-3.0	-2.5	-2.0	-1.5
Public debt/GDP (end of period)	108.1	101.9	92.8	98.1	103.8	106.0	106.1	103.5	100.8
Current account/GDP	-1.3	-3.2	-1.7	-1.7	-2.1	-1.5	-0.6	0.1	0.3
Foreign reserves in months of imports of goods and nonfactor services ^x	7.6	6.7	6.0	6.4	6.7	6.5	6.6	6.6	6.6
Foreign debt as percent of GDP	56.4	59.8	55.8	57.6	63.6	65.8	64.9	62.2	59.7
Memorandum items (growth rates):									
Aggregate domestic demand	1.4	4.3	3.7	1.7	-0.4	0.0	2.3	4.7	4.6
Private consumption	4.2	2.8	7.2	2.5	-0.6	0.8	2.0	5.0	5.0
Public consumption	2.0	3.0	1.3	3.3	5.5	1.2	2.0	3.0	3.0
Gross capital formation	-6.0	10.1	-1.7	-2.6	-8.0	-4.5	3.5	6.3	6.0
Exports of goods and services	6.9	12.0	25.3	-11.7	-5.4	3.4	5.3	6.4	6.2
Imports of goods and services	1.7	14.9	12.3	-4.5	-3.0	1.3	4.7	6.4	6.3

Source: Fund staff estimates and projections.

1/ Nominal effective discount rate of the Bank of Israel deflated by current CPI inflation.

2/ Official definition plus the inflation component of domestic interest payments.

Table 8. Israel: Public Sector Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
Public sector debt 1/	105.0	108.1	101.9	92.8	98.1	103.8	105.9	106.1	103.5	100.9	98.0
<i>Of which:</i>											
Foreign-currency denominated	36.7	37.8	35.6	30.6	32.4	34.2	32.8	32.9	32.1	31.3	30.4
Change in public sector debt	-2.9	3.1	-6.3	-9.1	5.3	5.7	2.2	0.2	-2.6	-2.7	-2.9
Identified debt-creating flows (4+7+12)	-7.0	-1.0	-5.2	-7.6	5.6	1.2	0.0	-0.9	-4.2	-4.2	-4.4
Primary deficit	-1.9	-2.8	-1.9	-4.5	-2.4	-2.9	-4.0	-4.7	-5.2	-5.7	-6.2
Revenue and grants	49.1	49.4	48.0	49.3	49.8	51.3	52.6	52.6	52.6	52.6	52.6
Primary (noninterest) expenditure	47.2	46.5	46.1	44.8	47.4	48.4	48.6	47.9	47.4	46.9	46.4
Automatic debt dynamics 2/	-2.7	3.1	-2.8	-2.3	8.0	4.1	4.1	3.8	1.0	1.5	1.8
Contribution from interest rate/growth differential 3/	-5.8	-3.2	-2.7	-1.6	5.0	1.8	3.9	2.5	-0.3	0.2	0.5
<i>Of which:</i>											
Contribution from real interest rate	-2.6	-0.4	-0.1	5.4	4.2	0.8	4.5	4.8	4.2	4.4	4.5
Contribution from real GDP growth	-3.2	-2.8	-2.6	-7.0	0.8	0.9	-0.6	-2.3	-4.5	-4.3	-4.0
Contribution from exchange rate depreciation 4/	3.1	6.3	4.1	-0.9	3.0	2.4	0.2	1.3	1.3	1.3	1.3
Denominator = $1+g+\pi+gr$	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0	1.1	1.1	1.1
Other identified debt-creating flows	-2.4	-1.3	-0.5	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	-2.4	-1.3	-0.5	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	4.1	4.2	-1.1	-1.5	-0.3	4.4	2.2	1.1	1.6	1.6	1.5
Public sector debt-to-revenue ratio 1/	213.8	219.1	212.0	188.1	196.9	202.2	201.4	201.7	196.8	191.7	186.2
Gross financing need 5/	13.7	13.9	13.4	10.4	13.3	12.3	13.2	11.9	12.0	10.9	9.8
in billions of U.S. dollars	14.1	14.3	13.9	11.9	14.8	12.7	14.0	12.6	13.1	12.1	11.1
Key macroeconomic and fiscal assumptions											
Real GDP growth (in percent)	3.3	3.0	2.6	7.4	-0.9	-1.0	0.5	2.3	4.5	4.4	4.2
Average nominal interest rate on public debt (in percent) 6/	6.5	6.7	6.5	7.1	6.7	6.6	6.2	6.3	6.5	6.6	6.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-2.5	-0.2	0.1	5.8	4.6	0.8	4.4	4.8	4.3	4.6	4.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.1	-15.0	0.2	2.8	-8.5	-6.7	-0.5	-3.7	-3.9	-3.8	-3.8
Inflation rate (GDP deflator, in percent)	9.0	6.9	6.4	1.3	2.1	5.7	1.8	1.6	2.2	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	0.3	1.5	1.8	4.3	4.9	1.0	1.0	0.9	3.4	3.3	3.1
II. Stress Tests for Public Debt Ratio											
1. Real interest rate is at historical average plus two standard deviations in 2003 and 2007						103.8	108.4	110.8	108.2	105.6	102.8
2. Real interest rate is at historical average plus two standard deviations between 2003 and 2007						103.8	108.4	110.8	110.9	110.6	109.9
3. Real GDP growth is at historical average minus two standard deviations between 2003 and 2004						103.8	107.6	111.4	108.6	105.7	102.6
4. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004 and 1 percent in 2005-2007						103.8	107.6	111.4	112.3	112.9	112.8
5. Primary balance is at historical average minus two standard deviations in 2003 and 2004						103.8	109.6	114.2	111.7	109.1	106.4
6. Primary balance is one percent above baseline between 2003 and 2007						103.8	106.9	108.1	106.6	105.0	103.1
7. Combination of 2-6 using one standard deviation shocks						103.8	105.4	107.0	104.8	102.5	100.1
8. One time 30 percent real depreciation in 2003 7/						103.8	121.4	122.1	119.6	117.2	114.6
9. 10 percent of GDP increase in other debt-creating flows in 2003						103.8	115.9	116.5	114.0	111.5	108.8
10. Combination of 2,4 and 6.						103.8	111.1	118.4	119.4	120.1	120.5
Historical statistics for key variables (past ten years)											
		<u>Historical</u>	<u>Standard</u>					<u>Average</u>			
		<u>Average</u>	<u>Deviation</u>					<u>2002-07</u>			
Primary deficit		-2.5	1.1					-4.8			
Real GDP growth (in percent)		4.6	2.8					2.5			
Nominal interest rate (in percent) 6/		6.7	0.2					6.5			
Real interest rate (in percent)		-1.7	4.2					4.0			
Inflation rate (GDP deflator, in percent)		8.4	4.2					2.5			
Revenue to GDP ratio		50.1	1.4					52.4			

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha e(1+\pi)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 9. Israel: External Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 External debt	53.6	56.4	59.8	55.7	57.6	63.6	63.9	65.4	65.2	65.1	65.1
2 Change in external debt	2.0	2.7	3.4	-4.0	1.8	6.0	0.3	1.5	-0.2	-0.1	0.0
3 Identified external debt-creating flows (4+8+11)	-0.7	0.3	-0.3	-9.3	0.2	5.6	-1.5	-1.0	-3.0	-2.8	-2.5
4 Current account deficit, excluding interest payments	0.7	-2.1	-0.4	-1.6	-1.8	-1.7	-2.3	-3.3	-4.0	-4.2	-4.4
5 Deficit in balance of goods and services	5.9	3.4	3.6	0.4	3.4	4.9	3.9	3.0	3.0	3.2	3.5
6 Exports	30.2	31.5	35.9	40.5	35.5	37.2	40.0	43.5	45.7	47.8	50.3
7 Imports	36.1	34.9	39.5	40.9	38.9	42.2	44.0	46.5	48.7	51.0	53.8
8 Net non-debt creating capital inflows (negative)	-2.5	-1.1	-3.3	-5.3	-2.5	-0.9	-1.8	-1.5	-1.2	-0.9	-0.6
9 Net foreign direct investment, equity	0.8	0.6	1.9	1.5	1.9	0.4	1.4	1.2	1.0	0.8	0.6
10 Net portfolio investment, equity	1.7	0.5	1.5	3.9	0.6	0.5	0.4	0.3	0.2	0.1	0.0
11 Automatic debt dynamics 1/	1.1	3.4	3.4	-2.3	4.5	8.2	2.7	3.9	2.2	2.4	2.5
12 Contribution from nominal interest rate	3.2	3.4	3.6	3.3	3.5	3.8	3.8	3.9	3.9	3.9	3.9
13 Contribution from real GDP growth	-1.7	-1.6	-1.5	-4.0	0.5	0.6	-0.3	-1.4	-2.9	-2.8	-2.7
14 Contribution from price and exchange rate changes 2/	-0.4	1.6	1.3	-1.6	0.6	3.7	-0.8	1.4	1.2	1.3	1.3
14 Residual, incl. change in gross foreign assets (2-3)	2.7	2.5	3.7	5.2	1.6	0.4	1.8	2.4	2.8	2.7	2.5
External debt-to-exports ratio (in percent)	177.8	178.8	166.4	137.7	162.3	170.6	159.6	150.4	142.7	136.0	129.5
Gross external financing need (in billions of US dollars) 3/	26.9	26.2	29.0	30.2	30.5	32.6	33.0	32.8	32.9	33.4	33.9
in percent of GDP	26.2	25.5	28.1	26.5	27.3	31.3	31.2	31.0	30.2	30.0	29.8
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	3.3	3.0	2.6	7.4	-0.9	-1.0	0.5	2.3	4.5	4.4	4.2
Exchange rate appreciation (US dollar value of local currency, change in percent)	-7.5	-9.2	-8.2	1.5	-3.1	-11.2	-0.5	-3.7	-3.9	-3.8	-3.8
GDP deflator in US dollars (change in percent)	0.8	-3.0	-2.3	2.8	-1.0	-6.1	1.3	-2.1	-1.8	-1.9	-1.9
Nominal external interest rate (in percent)	6.5	6.3	6.4	6.2	6.1	6.2	6.1	6.1	6.1	6.1	6.1
Growth of exports (US dollar terms, in percent)	5.8	4.4	14.2	24.6	-14.0	-2.4	9.5	8.6	7.8	7.3	7.4
Growth of imports (US dollar terms, in percent)	-1.1	-3.5	13.6	14.3	-6.6	0.7	6.3	5.8	7.5	7.2	7.8
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2003-07						63.6	63.7	64.4	65.4	66.4	67.2
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						63.6	64.4	66.5	66.3	66.3	66.3
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						63.6	65.0	68.8	68.7	68.8	68.9
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						63.6	69.5	74.8	74.9	75.1	75.5
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						63.6	69.7	78.3	78.5	78.9	79.4
6. Combination of 2-5 using one standard deviation shocks						63.6	70.0	77.8	78.0	78.4	78.9
7. One time 30 percent nominal depreciation in 2003						63.6	91.8	95.0	95.8	96.8	98.1
Historical Statistics for Key Variables (past 10 years)											
		Historical Average		Standard Deviation		Average 2002-07					
Current account deficit, excluding interest payments		0.1		1.7		-3.3					
Net non-debt creating capital inflows		1.7		1.8		1.1					
Nominal external interest rate (in percent)		6.4		0.3		6.1					
Real GDP growth (in percent)		4.6		2.8		2.5					
GDP deflator in US dollars (change in percent)		2.0		4.3		-2.1					

1/ Derived as $[r \cdot g - \rho(1+g) + \epsilon\alpha(1+r)] / (1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ϵ = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \epsilon\alpha(1+r)] / (1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\epsilon > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

FUND RELATIONS
(As of December 31, 2002)

I. **Membership Status:** Israel became a member of the Fund on July 12, 1954, and accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 21, 1993, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

II. General Resources Account:	SDR Millions	% Quota
Quota	928.20	100.00
Fund holdings of currency	624.20	67.25
Reserve position in Fund	304.01	32.75
Financial Transaction Plan transfers (net)	28.00	

III. SDR Department:	SDR Millions	% Allocation
Net cumulative allocation	106.36	100.0
Holdings	3.36	3.16
Designation Plan	0.00	

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. **Projected Obligations to Fund:** None

VII. **Implementation of HIPC Initiative:** None

VIII. **Safeguards Assessments:** Not applicable

IX. **Exchange Rate Arrangement:**

The exchange rate of the new sheqel is managed against a basket of currencies comprising the dollar, the euro, the pound sterling, and the yen. The market exchange rate fluctuates within a crawling band in response to market forces. The upper and lower limits of the band, which are adjusted daily, were originally derived to reflect the annual difference between the domestic inflation target and the projected inflation of the main trading partners. In the past few years, however, the practice has changed, such that only the slope of the lower limit has been reduced, whenever possible, while the upper limit has remained unchanged at a steeper slope. The slope of the upper limit has been 6 percent on an annual basis since July 26, 1993; the slope of the lower limit has been 2 percent since August 6, 1998. On December 23, 2001, the lower limit became flat and, on December 31, 2002, the width of the band, based on the average of the upper and lower limits, was 49 percent.

X. **Article IV consultation:**

The last Article IV consultation was concluded on July 30, 2001. Israel is on the standard 12-month consultation cycle.

XI. Technical Assistance:

For purposes of the Fund's operational activities, the West Bank and Gaza (WBG) continue to fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement.

The IMF has provided technical assistance to the Palestinian Authority (PA) in the WBG, with a focus on assisting the PA in establishing economic and financial institutions, and in monitoring and reporting on fiscal developments and institution building. In particular, technical assistance has been provided in the areas of tax and customs administration, expenditure management (Fiscal Affairs Department); in the areas of bank supervision (Monetary and Exchange Affairs Department); and in the areas of national accounts and monetary statistics (Statistics Department). The Middle Eastern Department has been assisting the PA with fiscal reporting to donors, in the context of the Ad-Hoc Liaison Committee (AHLC), and assisting and monitoring the fiscal reform in the context of the task force on Palestinian reform.

XII. Resident Representative:

A resident representative has been in the WBG since early 1996.

STATISTICAL ISSUES

Israel has subscribed to the Special Data Dissemination Standard. The periodicity, timeliness, coverage, and quality of Israel's economic data are generally adequate for surveillance. Nevertheless, the quality of some statistics could be enhanced.

Unemployment statistics are available only on a quarterly basis, and higher frequency data would be desirable. Data on capacity utilization is unavailable. The overall annual fiscal balance that is reported does not conform to the balance in most other countries because interest costs exclude the inflation component of such payments (the authorities are gradually moving toward the methodology that is standard in other countries, so the discrepancy will decline over time). There is no within-year monthly report of expenditures broken down by composition.

Israel: Core Statistical Indicators
(as of February 12, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates 1/	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt
Date of Latest Observation	2/12/03	Jan. 2003	Jan. 2003	Nov. 2002	Nov. 2002	2/12/03	Dec. 2002	Jan. 2003	Q3 2002	Jan. 2003	Q3 2002	Q3 2002
Date Received	2/12/03	2/3/03	1/31/03	1/14/03	1/14/03	2/12/03	1/15/03	2/12/03	12/24/02	2/4/03	12/24/02	2/10/03
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly 2/	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of Update	Reuters; BoI website	BoI; Reuters	BoI	BoI; Reuters	BoI; Reuters	BoI; Reuters	Central Bureau of Statistics; Reuters	Central Bureau of Statistics; Reuters	Central Bureau of Statistics; BoI; Reuters	MoF	Central Bureau of Statistics; Reuters	BoI/CBS
Mode of Reporting	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly

1/ Market rates are available daily through Reuters.

2/ On a cash basis.

Note: BoI = Bank of Israel; MoF = Ministry of Finance.

Statement by the IMF Staff Representative on Israel
March 7, 2003

1. This supplement contains information on recent economic developments in Israel that has become available since the circulation of the staff report for the Article IV consultation. The information does not alter the thrust of the staff appraisal.
2. Following the Likud Party's win in the recent elections, Mr. Sharon formed a new coalition government, which holds 68 seats in the 120-seat Knesset. Mr. Netanyahu was appointed as the new Finance Minister, replacing Mr. Shalom who was appointed as the Minister of Foreign Affairs.
3. Recent economic indicators show a slight improvement in economic conditions. Exports—particularly of the high tech sector—continued to recover during December 2002–January 2003, growing at an annual rate of 6 percent. The unemployment rate, seasonally adjusted, declined to 10.1 percent in the fourth quarter of 2002 from 10.3 percent in the previous quarter, albeit mainly because of an increase in employment of part-time workers.
4. A sharp fall in tax revenue—a 12 percent decline in real terms in January–February compared to the same period in 2002—prompted the Ministry of Finance to explore measures to amend the 2003 budget in order to meet the deficit target. However, no specific program has been put forward yet. Finance Minister Netanyahu has indicated that he would submit a comprehensive plan within the next few weeks.
5. Against the background of an increase in inflation expectations above the 3 percent upper limit of the inflation target and a rise in uncertainty, the Bank of Israel (BoI) kept its policy rate unchanged in January and February. Current inflation, however, continued to be modest, with the Consumer Price Index rising by 0.2 percent in January. Economic and political news—the fall in tax revenues, a warning by the Governor about the fiscal stance, and the formation of the new government—jolted the sheqel, though it remained between NIS 4.8–4.9 per dollar.
6. The authorities have volunteered to have a fiscal transparency ROSC. The fiscal ROSC will be presented to the Board in the context of the next Article IV consultation.



INTERNATIONAL MONETARY FUND

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March 13, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Israel

On March 7, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Israel.¹

Background

The Israeli economy is in the midst of a deep recession. Waning exports and investment, combined with stagnant private consumption, led to negative growth in 2001 and 2002. The stagnation can be attributed to the burst of the technology bubble, the global slowdown, and the deterioration in the security situation. Recently, some indicators suggest that economic activity is stabilizing, but there are no signs of recovery in sight.

Despite the recession, the sheqel had been remarkably stable until December 2001, when the Bank of Israel (BoI) slashed its policy rate by 2 percentage points as part of a policy package. During the following six months, the sheqel depreciated by about 20 percent vis-à-vis the currency basket. The sheqel's slide led to a surge in inflation; the CPI rose by 6.3 percent during the first half of 2002 alone, well above the inflation target range of 2-3 percent. Furthermore, inflationary expectations soared toward June 2002.

In an effort to halt the sheqel's depreciation and the surge in inflation, the BoI raised its policy rate in June by 4.5 percentage points to 9.1 percent. This rate hike partially reversed the sheqel's slide and reduced inflationary expectations, and the BoI cut the policy rate by 20 basis points in December 2002. However, exchange rate volatility remains high, and substantial risks

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. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the March 7, 2003 Executive Board discussion based on the staff report.

to exchange rate stability loom ahead, such as further economic deterioration, a loss of fiscal credibility, and a war in Iraq.

The government has struggled to retain control over the fiscal deficit in the face of falling revenues and security-related expenditure increases. The 2002 budget was adjusted twice, with each adjustment accompanied by an increase in the deficit target from 1.75 percent to 3.9 percent of GDP. The debt/GDP ratio continued to rise, reaching 104 percent by end-2002. The 2003 budget envisages a deficit of 3 percent of GDP, with an aim to return to a declining trend in the deficit, expenditure, and debt to GDP ratios. However, many analysts believe that a further significant expenditure cut will be needed in order to meet the deficit target, primarily due to revenue overestimation.

Labor market conditions are worrisome. Unemployment is high at 10.1 percent, one-third of which is accounted for by the long-term unemployed. The participation rate is low, partially because of disincentives to work and inefficient employment services. At the same time, the number of foreign workers is estimated at 11 percent of the labor force, a share second only to Switzerland among industrial countries.

External indicators are mixed. Despite the deterioration in the trade balance, the current account deficit is estimated to have increased only moderately in 2002 to around 2 percent of GDP. Capital inflows, especially foreign direct investment, have declined substantially. Gross external debt has risen above 60 percent of GDP, although net external debt remains negligible, and foreign reserves fully cover short-term foreign liabilities.

Bank profits have suffered from the deteriorated macroeconomic environment. The credit quality of the corporate sector has declined, and problem loans have risen considerably. Bank supervisors reacted promptly by requiring banks to increase supplementary provisions. They have also conducted focused on-site examinations of major banks to assess their credit classification and to require higher specific provisions so that banks' loan assessments better reflect underlying risks.

On the structural front, the government pushed forward a broad-based tax reform and introduced some labor market reform measures. Privatization has seen only limited progress.

Executive Board Assessment

Directors noted that the Israeli economy is facing major difficulties, which were caused largely by shocks that were either external or noneconomic in origin, although policy credibility has also been an issue. Directors observed that the ongoing security problem is of particular concern, and that its impact is gradually spreading to the whole economy through weaker investor and consumer sentiment. They emphasized that the restoration of peace, given Israel's strong fundamentals, would yield substantial economic gains to the region as a whole.

Directors considered that, under the current economic conditions, it is crucial for the authorities to pursue credible, transparent, and consistent policies that would maintain market confidence and stability. The cost of policy slippages could be high at this juncture.

Directors underscored the importance for the government to re-establish a declining path of debt, deficit, and expenditure ratios, so as to strengthen market confidence in the authorities' commitment to fiscal consolidation. In this respect, they commended the authorities for introducing a number of important fiscal reform measures, including tax reform and reductions in social benefits. However, Directors considered that achieving the 2003 fiscal deficit target would require additional measures, as revenues appear to be overestimated. They expressed concerns about the negative effects that a revenue shortfall might have on market sentiment, and urged the government to introduce additional expenditure cuts consistent with the deficit target as soon as possible. In this connection, Directors looked forward to the new comprehensive economic plan to be announced shortly. Over the medium term, they underscored that sustained reductions in the fiscal deficit and strong economic growth are essential to prevent further increases in the already high public debt-to-GDP ratio. Directors urged the government to take steps to ensure a declining path of the debt ratio, if necessary by cutting deficits faster than currently envisaged in the years ahead.

Directors stressed that the government should take a number of additional structural steps to enhance the credibility of the fiscal adjustment process, thus cushioning market reaction to temporary shocks. These should include, in particular, a medium-term fiscal program in which future spending plans and commitments, as well as the expiration of any one-off deficit cutting measures, are clearly identified in a transparent way.

Directors considered that the recent labor market reforms, including lower welfare payments and improved incentives for hiring, should serve to improve the low and falling participation rate, stem the high and rising unemployment, and absorb welfare recipients into the labor market. Effective implementation of these policies is necessary for strengthening the fiscal position. Directors also called for measures to reduce distortions favoring the employment of non-Israeli citizens and to improve the efficiency of employment services.

Directors underscored that a strong monetary policy is of paramount importance to shield the economy from shocks. They noted the difficult trade-off that the Bank of Israel (BoI) was facing between the need to ease the burden on the recessionary economy stemming from high interest rates and the need to maintain market stability by pursuing a cautious approach to reducing interest rates. Directors agreed that the BoI's task was to strike the right balance between easing its policy too fast and waiting too long. To this end, cutting interest rates by small steps whenever market conditions and inflationary prospects improve seems to be preferable to a less gradual approach. In this connection, Directors welcomed the BoI's rate cut in late-December 2002 as a good start, but recognized that the BoI's room for maneuver is currently limited, in light of the recent weakening of the sheqel in the context of the geopolitical tension and the fiscal risks. Directors welcomed the sheqel's attainment of full convertibility as a result of the removal of the last remaining capital control measures.

Directors underlined the increasing importance of the BoI's role as bank supervisor against the backdrop of declining bank profitability. They encouraged the BoI to be proactive in strengthening banks' ability to withstand an economic downturn, and urged the authorities to improve their capability to deal with banking sector problems should the need arise. Directors also encouraged the authorities to make further progress in improving their compliance with financial sector standards and codes, including through enhancing information exchange among

supervisors, and strengthening insurance supervisors' powers and expertise. They were pleased that Israel had made significant progress in improving its regime for anti-money laundering and combating the financing of terrorism, and called for further efforts in this area. Directors welcomed the authorities' request to have a fiscal transparency Report on the Observance of Standards and Codes.

Directors observed that Israel meets the Special Data Dissemination Standard specifications for coverage, periodicity, and timeliness of data, and that the quality of the data is adequate for the purpose of surveillance.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Israel: Selected Economic Indicators

	1998	1999	2000	2001	2002 1/
National accounts (constant prices)					
Real GDP	3.0	2.6	7.4	-0.9	-1.0
Private consumption	4.2	2.8	7.2	2.5	-0.6
Public consumption	2.0	3.0	1.3	3.3	5.5
Gross capital formation	-5.8	10.2	-2.8	-2.6	-8.0
Exports of goods and services	6.9	12.0	25.3	-11.7	-5.4
Imports of goods and services	1.7	14.9	12.3	-4.5	-3.0
Labor market indicators					
Unemployment rate (in percent)	8.6	8.9	8.8	9.3	10.3
Prices (end-period)					
Overall CPI	8.6	1.3	0.0	1.4	6.5
Underlying CPI (excluding housing, fruits and vegetables)	8.5	1.7	0.9	0.2	6.3
Money and credit (period average)					
Narrow money (M1)	12.1	9.6	11.0	14.2	15.6
Broad money (M3)	15.9	21.2	16.9	15.5	6.0
Nondirect domestic credit	16.1	16.7	13.1	10.8	10.5
Interest rates (average, in percent)					
Self-renewing overnight deposits	10.3	10.9	8.0	5.6	5.6
Bank of Israel policy rate	11.7	12.1	9.3	6.8	6.8
Public finance (percent of GDP)					
Central government balance 2/	-2.3	-2.5	-0.7	-4.5	-4.0
General government balance 2/	-3.8	-4.8	-2.2	-3.8	-4.2
Government debt	108.1	101.9	92.8	98.1	103.8
Balance of payments					
Trade balance (percent of GDP)	-3.2	-4.3	-2.7	-2.9	-3.4
Current account (percent of GDP)	-1.3	-3.2	-1.7	-1.7	-2.1
Foreign reserves (end-of-period, in billions of U.S. dollars)	22.7	22.5	23.2	23.2	23.6
Exchange rate and terms of trade indices					
Nominal effective exchange rate (period average) 3/	-6.4	-7.7	9.1	0.7	-13.5
Real effective exchange rate (period average) 3/	-3.0	-3.8	8.0	-0.3	-9.9

Sources: Bank of Israel, *Annual Report*; Central Bureau of Statistics; IMF, *International Financial Statistics*; and IMF

staff estimates and projections.

1/ IMF staff estimates and projections.

2/ Operational concept, excludes the inflation component of interest payments on domestic government debt.

3/ As of November 2002.

Statement by Jeroen Kremers, Executive Director for Israel
March 7, 2003

On behalf of the Israeli authorities I would like to thank staff for the constructive policy dialogue. In the authorities' opinion the staff report is a sound and balanced assessment of developments and prospects of the economy as well as the policy challenges facing Israel in the period ahead.

Background

Since the fall of 2000 Israel's economy has been adversely affected simultaneously by three external developments: (a) the global slowdown ; (b) the global technology spending collapse, and (c) the deterioration in the security situation. The economy is in the deepest recession in 50 years. GDP contracted by 0.9 percent in 2001 and by 1.1 percent in 2002.

The main thrust of the Israeli authorities' economic strategy has been the same for more than ten years: promoting macroeconomic stability and structural reforms as the preferred way to achieve a sustainable output and employment growth and to successfully integrate in the global economy. The falling fiscal revenue, because of recession, required repeated expenditure adjustments to keep the fiscal deficit under control. Inflation has been kept under control by a credible monetary policy, therefore the depreciation of the sheqel and rising oil prices only partially passed into inflation. The external debt, mainly of a long maturity, is almost fully covered by foreign reserves. The internal debt does not pose a threat to solvency given Israeli high potential growth.

The main current problem is growth. However, Israel is well prepared to benefit from a change for better in the global economic climate. The decrease in real wages by 6 percent and devaluation of the sheqel by 20 percent in 2002, contributed to the competitiveness of the Israeli economy traditionally led by exports. Many companies cut costs and further increased efficiencies by restructuring, and some demonstrated a remarkable resilience to difficult domestic circumstances. Moreover, Israel has good fundamentals which should help it to grow. To list some: (a) Israel has the world's highest investment in civilian research and development as percentage of GDP - 4.3 percent. (b) Israel has the world's highest rate of academic graduates as percentage of ages 25-64 – 25 percent; (c) the world's highest ratio of scientists and engineers per 10,000 – 135; (d) according to the World Economic Forum, Israel is number 4 measured by the competitive advantage index; (e) according to Transparency International, Israel is between the twenty least corrupted countries; (f) according to the World Economic Forum, Israel is number 12 on the 'network readiness index', which measures market and regulatory conditions of information technology, network infrastructure and the level of usage, and (g) Israel has a liberal trade policy.

Fiscal policy

In 2002, the government succeeded to contain the fiscal deficit to 3.9 percent of GDP. This was achieved despite the recession which sharply decreased revenue, and additional defense

expenditure. The government, true to its commitment, did not cut investment expenditure, including transport infrastructure, seeing in insufficient infrastructure an impediment to growth and to lowering the unemployment rate. The future needs for infrastructure investments in roads, rails, ports, electricity generation, desalination of sea water would require about NIS 90 billion. After many failed trials in the past, the government succeeded to implement broad-based tax reform. For the first time capital gains and interest income are taxed, allowing a lowering of the high taxes on labor income. For the first two months of 2003 the fiscal deficit reached NIS5.4 billion, one third of the planned deficit for the whole of 2003. The new government is fully aware of the challenges facing the Israeli economy. The Ministry of Finance is presently preparing a new comprehensive economic plan which would include a deep cut in expenditure, while continuing to invest in infrastructure. The plan will be unveiled at the end of March.

In the long term, the government intends to continue its commitment to promote economic activity based primarily on the business sector and a reduced government share in the economy through a continued gradual reduction of the budget deficit, government expenditure and government debt as a share of GDP.

Monetary policy and financial sector

Monetary policy has been committed to meeting the inflation targets set by the government. This commitment guided the central bank in the March 2002 hike of interest rates. The decision was based on the entire range of indicators that the central bank usually examines in assessing the need to change rates in order to meet the inflation target. The exchange rate is in no sense an objective in itself, as long as it is within the band; it is one of the indicators of inflationary pressure. The central bank lowered the interest rate by 0.2 percentage point to 8.9 percent in January 2003. The January – February 2003 higher than expected fiscal deficits caused market concerns. If the high deficits were to continue, they might disturb market stability and make the central bank's decision to lower the interest rate rather difficult.

In March 2002 the government drafted an amendment of the central bank law. This amendment, however, turned out to lack clarity as to the central bank's objective, infringed on the bank's operational independence and inappropriately selected the members of its policy-making body. The amendment, which caused aggravating market concerns, was shelved by the former government. The new heads of the Ministry of Finance issued a statement that they too would not pursue the amendment under any circumstances.

The authorities are strictly supervising banks and the banks in Israel are encouraged, through on-site and off-site supervision, to promptly recognize bad loans and to make adequate provisions. In view of a further deterioration of economic conditions, the authorities encourage the banks to strengthen their capital base by refraining from paying dividends and by raising a new capital.

The authorities are committed to make further progress by implementing the FSAP and the ALM/CTF ROSC mission reports' recommendations.

Structural reforms

By abolishing the limit on the share of investments abroad in the total assets of institutional investors, Israel finished a long process of liberalization of the foreign exchange regime and as of January 1, 2003 the Israeli sheqel became fully convertible.

The Israeli labor market conditions are worrisome: labor participation rates are lower than in the OECD countries on average, and while in recent years the participation rate rose in the OECD countries, in Israel it fell; moreover, the share of employment in the private sector fell. The new government is committed to reverse this trend by implementing a broad labor market reform which would encourage to hire new employees and to reduce the number of foreign workers.

The government is committed to pursue the privatization of public enterprises at an accelerated pace.