June 2004
IMF Country Report No. 04/158

Israel: 2003 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

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 2003 Article IV consultation with Israel, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 15, 2003,** 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 26, 2004.** 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 **April 19, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its April 19, 2004 discussion** of the staff report that concluded the Article IV consultation.

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

Report on the Observance of Standards and Codes—Fiscal Transparency Module
Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 2003 Article IV Consultation

Prepared by Staff Representatives for the 2003 Article IV Consultation with Israel

Approved by Michael Deppler and Martin Fetherston

February 26, 2004

- Consultation discussions were held in Jerusalem and Tel Aviv during December 2–15, 2003. 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 East and Central Asia Department is undertaking the Fund's work on the West Bank and Gaza Strip. The staff team—Messrs. Fajgenbaum (head), Brunner, and Mehrez (all EUR), and Ms. Polan (ICM)—met with Minister of Finance Netanyahu, Ministers Olmert and Sheetrit, 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, the manufacturing association, and a labor union organization. Mr. Litman (OED) participated in the meetings.

- Israel has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I) and maintains an exchange system free of restrictions.

- Israel subscribes to the Special Data Dissemination Standard and comprehensive economic data are available on a timely basis.

- The last Article IV consultation was concluded on March 7, 2003. On that occasion, Directors agreed that the government should re-establish a declining path of public debt, deficit and expenditure ratios to GDP so as to strengthen market confidence in the authorities' commitment to fiscal consolidation. Directors noted the difficult trade-off that the Bank of Israel was facing between the need to maintain financial market stability and the need to ease the burden on the economy stemming from high interest rates. They recommended cutting interest rates gradually as market conditions and inflation prospects eased. Directors welcomed the authorities' request for fiscal transparency ROSC.

- Throughout the downturn the authorities agreed, in general, with the Fund recommendations to re-establish fiscal discipline and ease monetary policy, but implementation fell short.

- The authorities have indicated their intention to publish this staff report.

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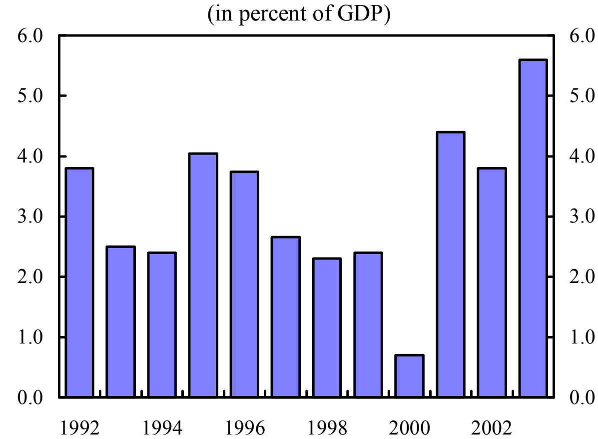
I. Background

1. **The strong and sustained growth experienced by the Israeli economy since the mid-1980s came to a halt in late 2000 as a result of the burst of the high-tech bubble, the global slowdown, and the deterioration in the security situation.** Waning exports and investment, combined with declining private consumption led to a deep recession, with negative GDP growth in both 2001 and 2002 (Figure 1). There is a consensus that most of the shortfall in GDP growth in 2001–02 is of a quasi permanent rather than cyclical nature. The authorities estimate that the deterioration in the security situation accounted for a loss of 6-8 percent of GDP, and the burst of the high-tech bubble amounted to a loss of about 3 percent of GDP.

2. **Throughout the downturn, the authorities struggled to maintain macroeconomic stability and re-establish the basis for a resumption of growth, but fiscal policy faltered and monetary policy remained tight.** The government deficit, under the mounting pressure of rising defense expenditures and falling revenues, swelled from an average of 1.5 percent of GDP in 1999–2000 to 3.8 percent in 2002 (Figure 2). To regain credibility prior to the elections, the government presented the 2003 budget with a deficit target of 3 percent of GDP. This budget, however, was based on unrealistic revenue projections and a major fiscal gap emerged very early in the year. Monetary policy during most of 2002–03 was tight in view of the large fiscal deficits and in an effort to regain credibility after a large interest rate cut in late 2001 led to a sharp depreciation of the sheqel and a bout of inflation. After raising it in June 2002, the Bank of Israel (BoI) maintained its policy rate around 9 percent through the first half of 2003.

Israel: Central Government Deficit, 1992 -2003
(in percent of GDP)

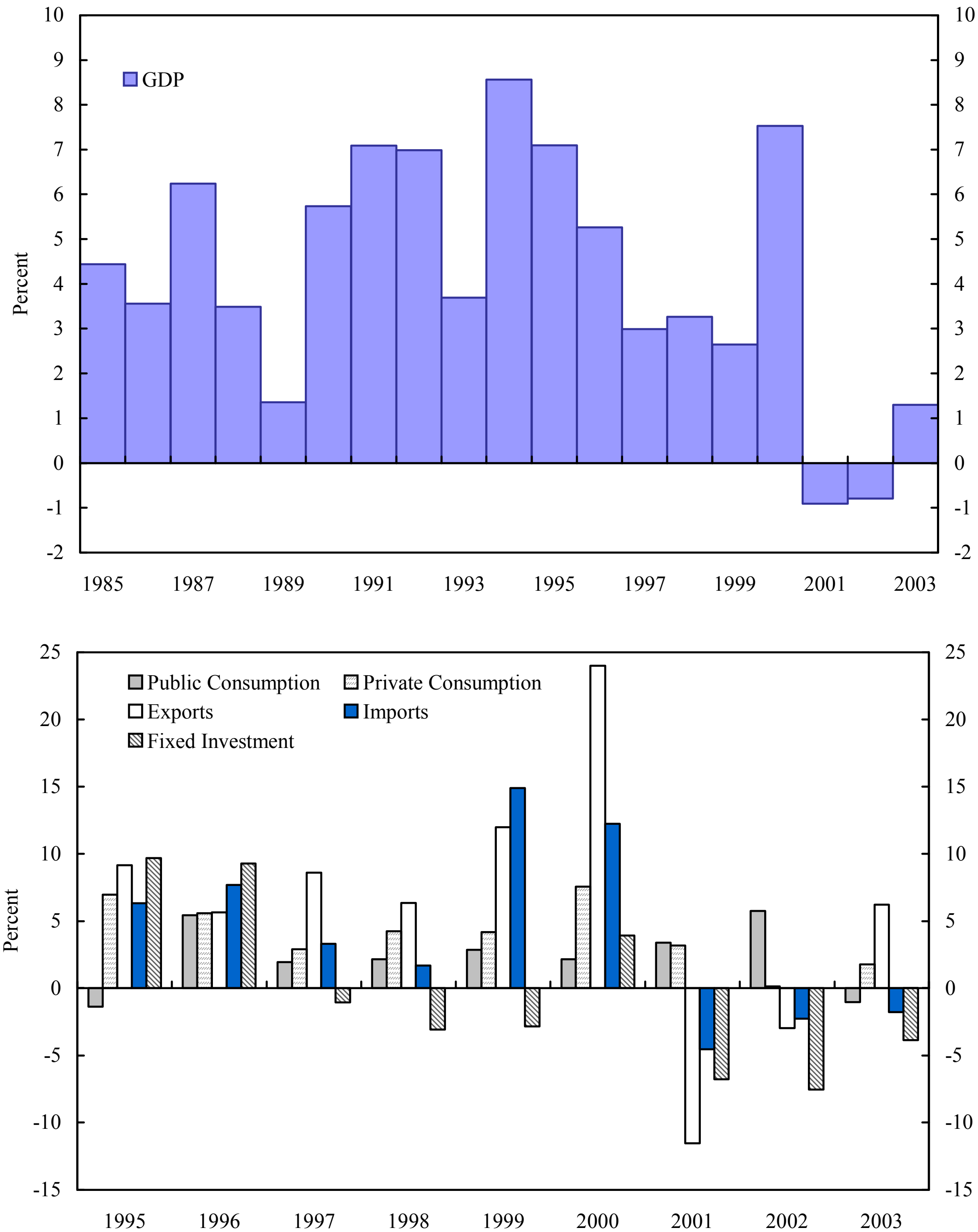


Source: Data from Israeli authorities.

3. **The extended recession worsened the already burdened labor market and welfare system.** The unemployment rate rose from 8.5 percent in early 2001 to 10.7 percent in November 2003, while the share of long-term unemployed (jobless for more than six months) in total unemployment reached 35 percent (Figure 3). The participation rate is low,[1] partly because of social or religious values and partly because of disincentives to work

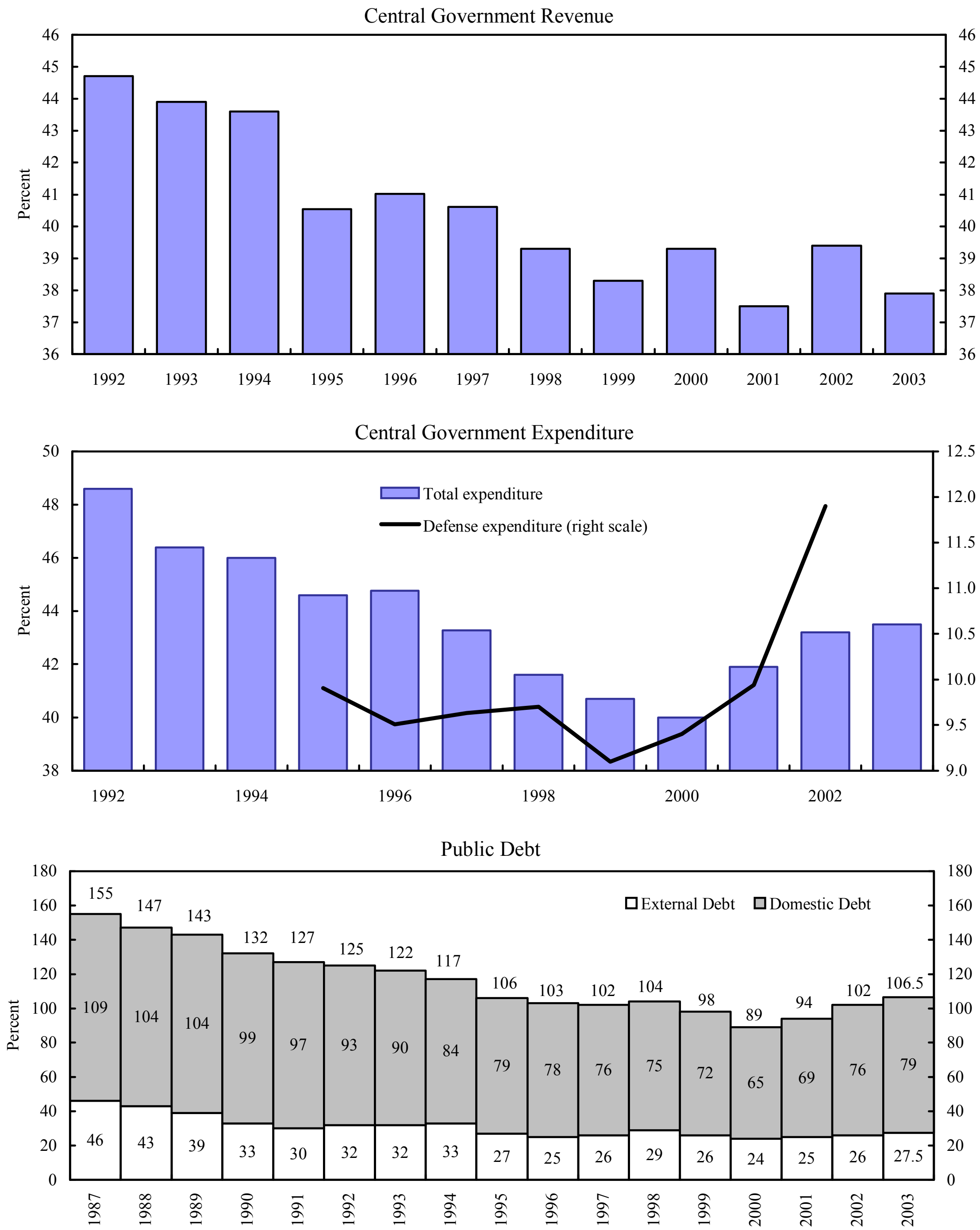
[1] The participation rate among men and women between the ages 25–55 is 84 percent and 68.5 percent, respectively, compared with OECD averages of 93 percent and 71 percent, respectively.

Figure 1. Israel: Real Demand and Output, 1985–2003
(year-on-year change)



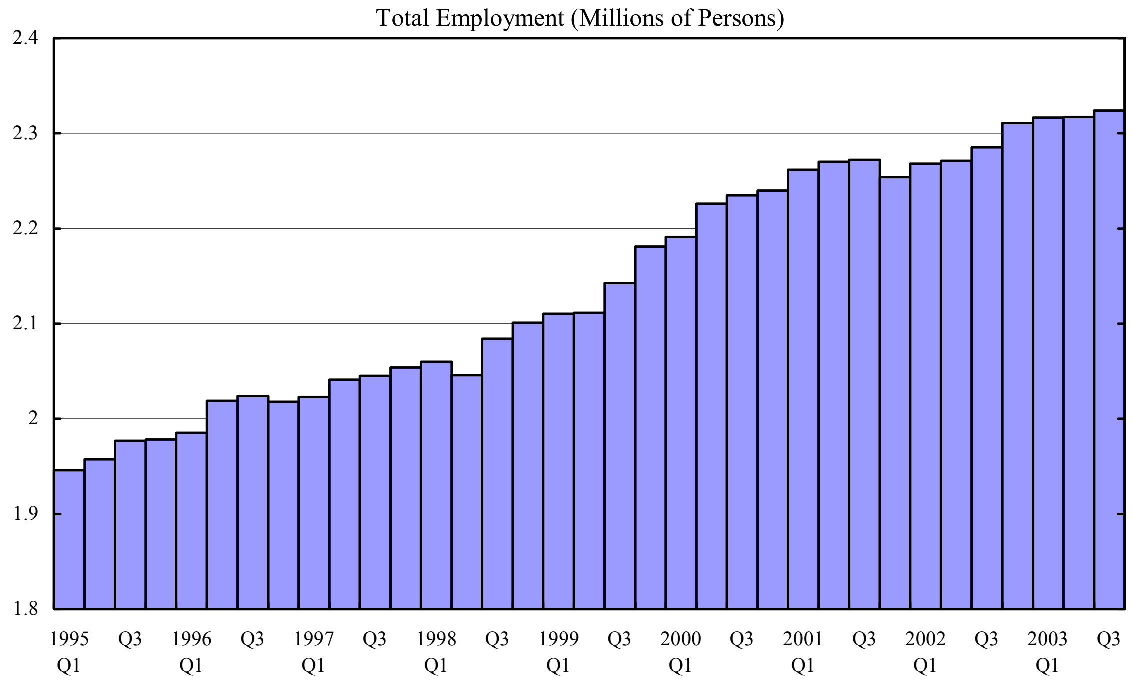
Sources: Central Bureau of Statistics; Bank of Israel; and Fund staff projections.

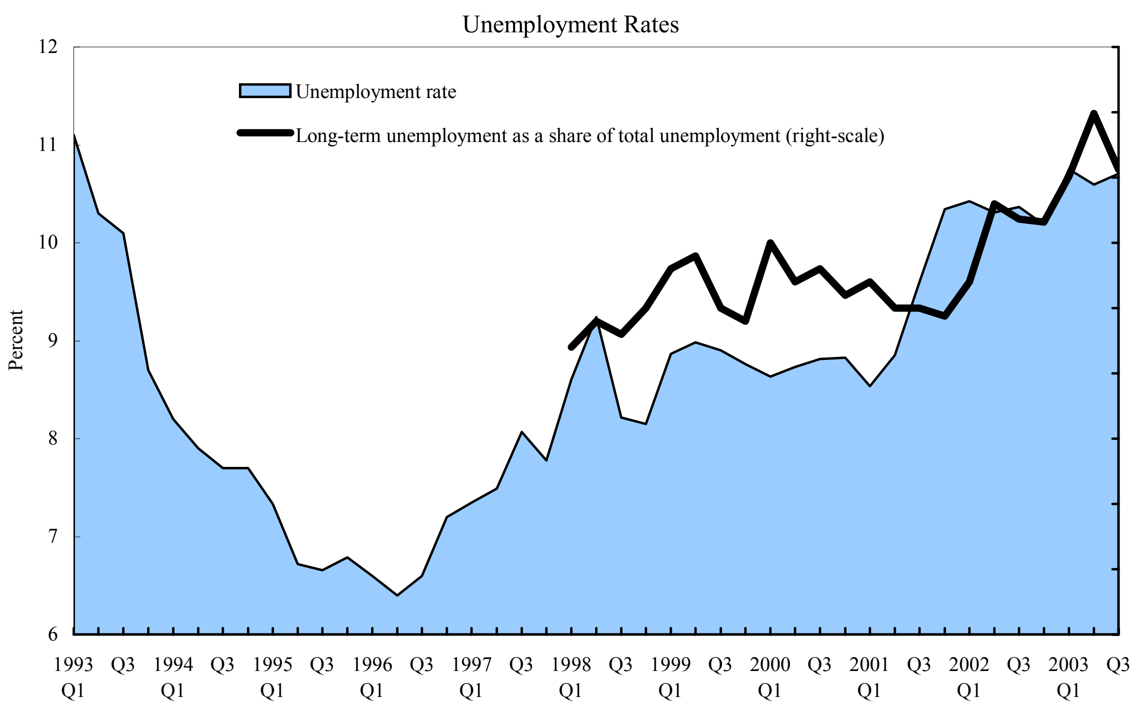
Figure 2. Israel: Selected Fiscal Indicators, 1992–2003
(In percent of GDP; unless otherwise stated)



Sources: Israeli authorities; Ministry of Finance; and Fund staff estimates.

Figure 3. Israel: Labor Market Indicators, 1993–2003





Source: Central Bureau of Statistics.

created by the relatively generous welfare system. In some cases, the loss of welfare benefits from accepting employment implies an effective tax rate that exceeds 100 percent. Reflecting the frail economy and the high unemployment rate, real wages dropped some 3 percent during 2003, while poverty increased, [2] in part because of a reduction in welfare benefits (see below). The decline in income was more pronounced among poor families, resulting in a widening of income inequality. The average income of the poor relative to the poverty line fell 10 percent, and the Gini coefficient for income inequality has climbed to about 0.37 (Figure 4).

4. **With the advent of a new coalition government in February 2003, fiscal and structural policies shifted to a more decisive course.** On the fiscal front, the new government's emergency economic program included a temporary public sector wage reduction of 4 percent on average (14.5 percent wage reduction to high wage earners and executives) and a postponement of cost of living adjustments and bonuses until June 2005; a uniform 12 percent cut in government ministry budgets; a reduction in transfers to local authorities; a sharp cut in welfare benefits;[3] an increase in taxes on the employment of foreign workers;[4] and a broadening of the tax base by reducing geographic exemptions. In addition, to foster private consumption, investment and growth, the planned reduction of taxes on labor income was accelerated by one year.[5] Overall, the adjustments amounted to about 2 percent of GDP in 2003, of which about ½ percent of GDP was transferred to the Ministry of Defense. Nevertheless, the budget deficit reached a worrying 5.6 percent of GDP in 2003, compared to a target of 3 percent in the budget, and public debt rose to about 106 percent of GDP by the end of the year.

5. **The economic program also featured a number of key structural reforms.** These include streamlining the public sector by reducing the number of employees, merging units and outsourcing activities; modifying child allowances, by reducing benefits and eliminating gradually the progressivity of benefits linked to the number of children; reforming the

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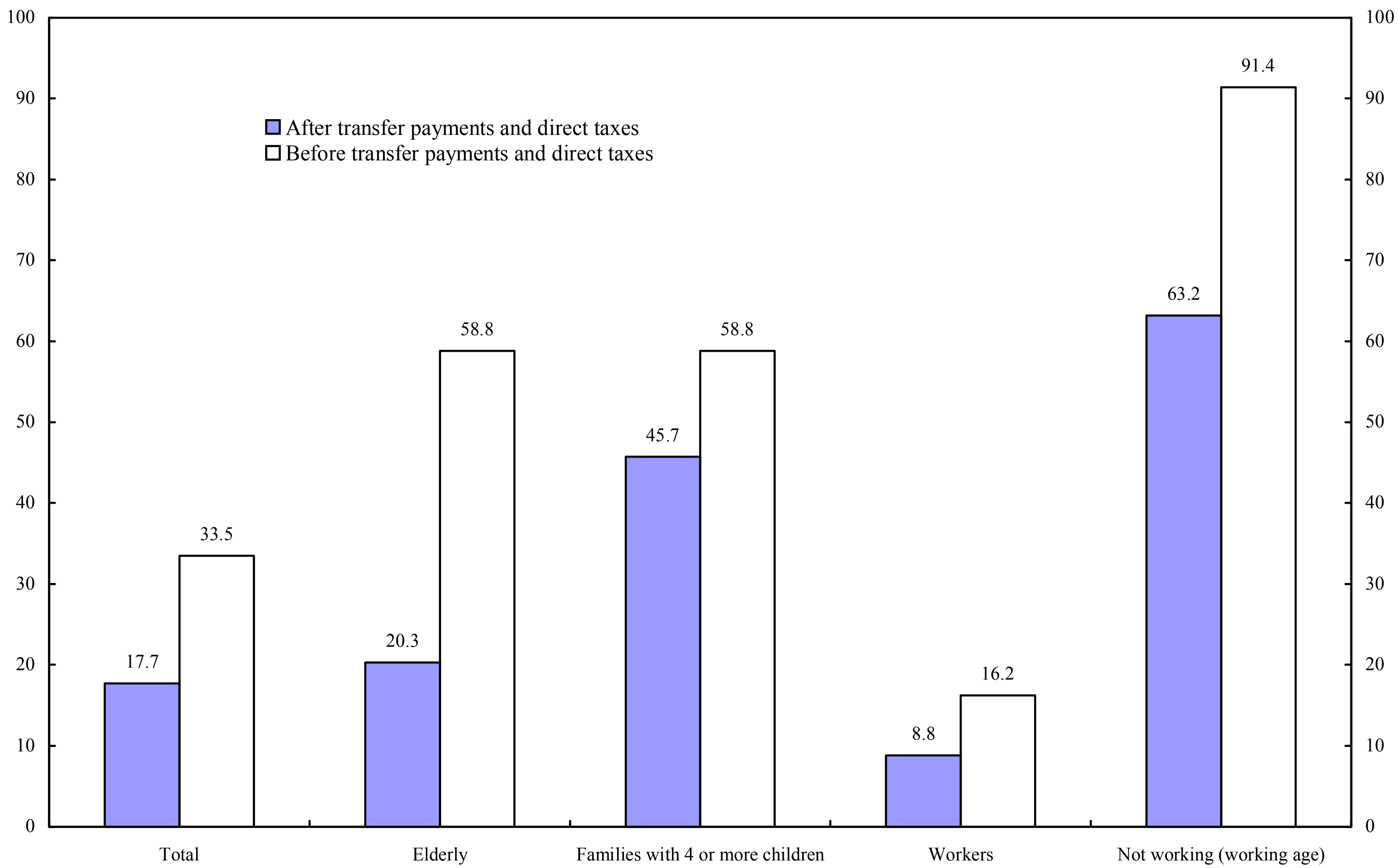
[2] The National Insurance Institute estimates that poverty incidence—measured as income below 50 percent of median income, adjusted for family size—climbed from about 300,000 families in 2000 to 340,000 in 2003.

[3] Unemployment benefits were reduced by about one third (by restricting eligibility and shortening the eligibility period), and income support benefits were slashed by 30 percent for most recipients.

[4] Foreign workers comprise 8 percent of the labor force, despite a considerable decline in 2003. This share is markedly larger than in the OECD countries, except Switzerland.

[5] Starting January 1, 2003, marginal tax rates on labor income are to be reduced gradually by about 10 percentage points on average by 2008.

Figure 4. Israel: Poverty Incidence among Families in Specific Population Groups, 2002



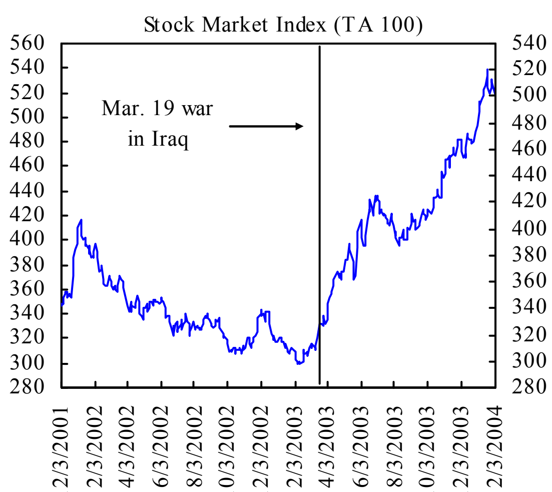
Source: National Insurance Institute.

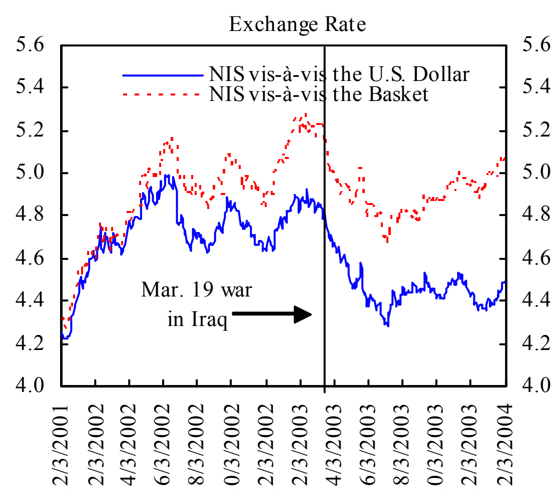
1/ Defined as income below 50 percent of median income adjusted for family size.

- 8 -

pension system by raising the retirement age and lowering benefits, providing funds to rescue insolvent funds, and increasing pension fund participation in the capital market (Box 1).[6]

6. **In tandem with the improvement in global conditions, these policies have led to a return of confidence.** The formulation of the economic program, the ending of the major conflict in Iraq, some progress in the security situation, the rebound in world stock markets (particularly the NASDAQ), and the decision by the United States to extend US$1 billion in additional grants and nearly US$9 billion in loan guarantees (spread over three years) led to buoyant financial markets. The stock market surged close to 60 percent during 2003, long-term real rates on indexed bonds declined from 5.9 percent to 4.2 percent during this period, the sheqel recovered, and inflation expectations fell to within the inflation target range of 1-3 percent. At the same time, in response to the improved outlook and the authorities' regained credibility, the implied volatility of the NIS/US$ exchange rate declined, and Israel's risk premium fell from 200 to 70 basis points.





[6] Israel does not have a population-aging problem as many other advanced countries.

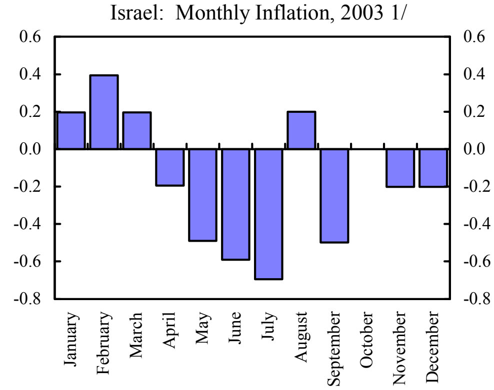
Box 1. Pension Reform in Israel

The government's last major reform was in 1995. An important objective of the reform was to shift participants from a defined benefit to a defined contribution system. As part of the reform, any participant who entered the system after 1995 became a member of the "new" pension funds, which were characterized by defined contributions and more investment possibilities. Those who were already in the system prior to the 1995 reforms remained in the "old" pension funds. At the end of 2002, about 1.2 million workers and pensioners were covered by the "old" funds, approximately 52 percent of the workforce. The "old" pension funds continued to accumulate actuarial deficits, reaching about NIS 110 billion (23 percent of GDP) at the end of 2002.
To bring these funds to an actuarial balance, the government implemented in 2003–04 the following changes:

- the government will provide up to NIS 73 billion to the "old funds" over the next 35 years.
- starting in 2004, employers will contribute an additional 1.5 percent of their salary (to 13.5 percent), while employees will contribute an additional 1.5 percent (to 7.0 percent).
- starting in 2004, benefit payments to current pensioners were reduced 2 percent.
- the retirement age will increase from 65 to 67 for men and from 60 to 64 for women. These changes will be phased in gradually, with a four months increase in the retirement age every year.
- all benefits will be calculated according to the career-average salary rather than the salary during the last three years, and the annual increase in real terms of the pensionable salary will be limited to 2 percent.
- pension funds will be allowed to invest only up to 30 percent in non-traded government bonds with an assured real return of 4.8 percent yield, compared with 5.5 percent previously. To lower the risk affecting individual pension accounts, an insurance scheme will be implemented and the government will set a reserve of NIS 15 billion to hedge against investment risk.
- management of funds will be carried out by professional managers, with approval of investment strategies by a 3–5 person investment committee and supervision by the state controller.

7. **Inflation turned negative in 2003, owing to the tight monetary policy, the appreciation of the sheqel against the U.S. dollar, and the weakness in economic activity (Figure 5)**. The CPI declined 1.9 percent during 2003, compared with a 6.5 percent increase during 2002. The decline was not uniform during the year—after rising 0.8 percent in the first quarter prices fell sharply in the second and third quarter, and leveled off toward the end of the year. The bulk of the decline can be attributed to a drop in housing rental prices of 5.7 percent—mainly due to the 9 percent nominal appreciation of the sheqel against the U.S. dollar during 2003.[7] Excluding housing, inflation decelerated from 6.1 percent to -0.5 percent between 2002 and 2003. Twelve months ahead inflation expectations—derived from capital markets and forecasters' surveys—have diminished since April 2003 and reached 0.7 percent in December, while two to three years ahead expectations fell to around the middle of the inflation target range of 1–3 percent.

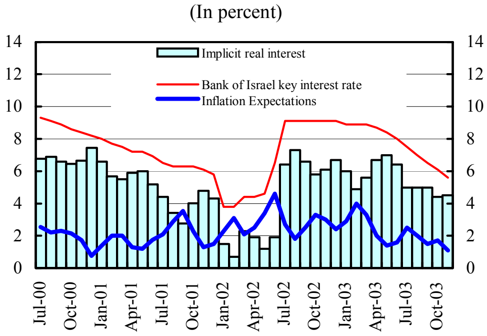
Israel: Monthly Inflation, 2003 1/



Source: Central Bureau of Statistics.
1/ Month on month percent change.

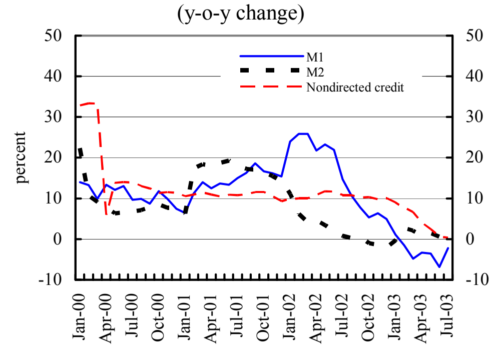
8. **The drop in inflation and in inflationary expectations, the enhanced fiscal commitment and the strengthening of financial markets prompted the BoI to cut interest rates.** Starting in mid-2003, the BoI lowered its policy rate in successive steps to 4.5 percent by February of 2004. Nevertheless, real interest rates remained high as the drop in inflation and inflation expectations outpaced the decline in interest rates. The high interest

Interest Rates and Inflation Expectations
(In percent)



Source: Bank of Israel.

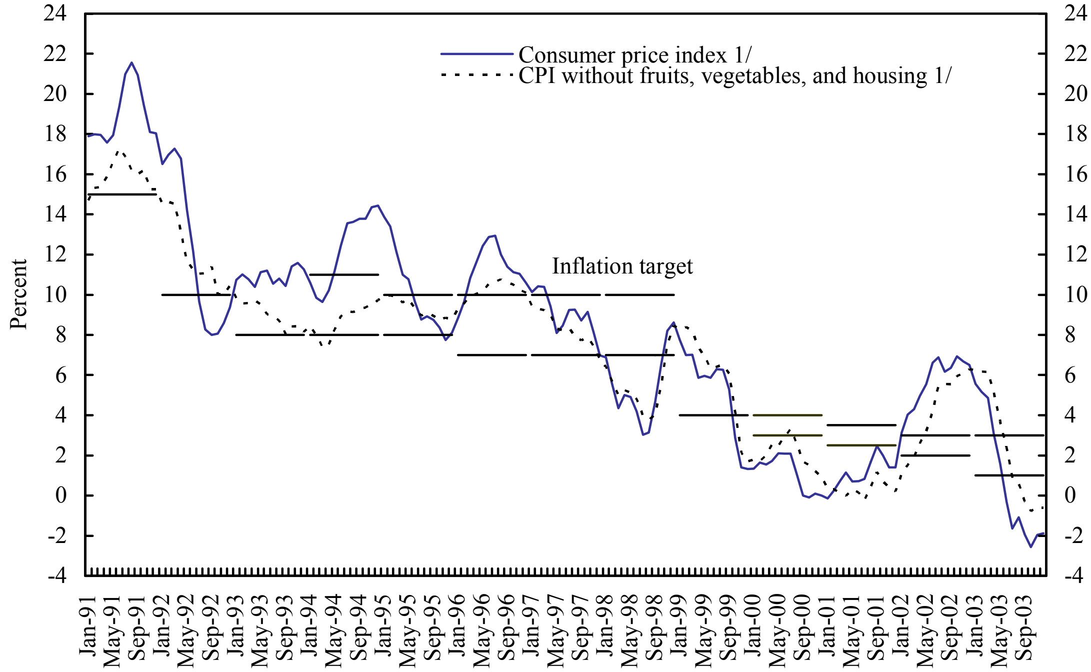
Monetary Aggregates
(y-o-y change)

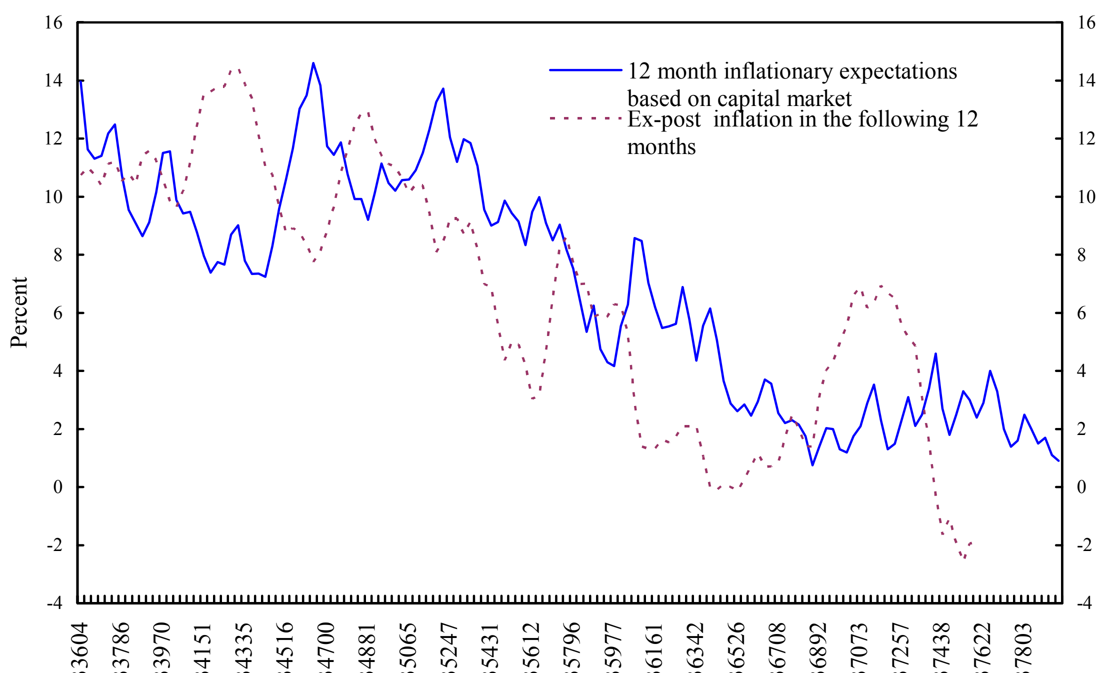


Source: Bank of Israel.

[7] As a remnant of the past high inflation period, prices of some durable goods—particularly housing rent—are still denominated in U.S. dollars.

Figure 5. Israel: Inflation, 1991–2003



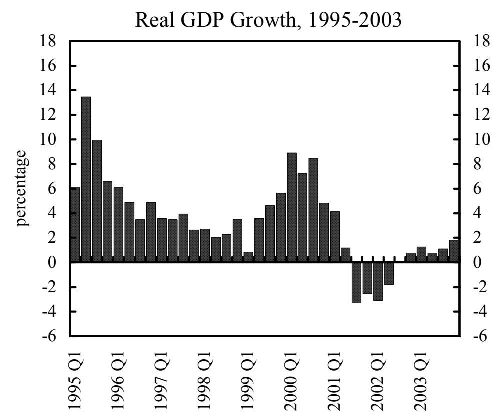


Sources: Central Bureau of Statistics; and Bank of Israel.

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

rates, the negative inflation, and the still weak economic activity led to marked reductions in the growth of monetary and credit aggregates Table 1).

9. **Against this background, the protracted decline in economic activity has given way to a mild rebound in 2003, led by a surge in external demand.** The Central Bureau of Statistics estimates that real GDP grew by 1.3 percent in 2003, despite anemic investment (Figure 1). This estimate reflects a boost in external demand with exports growing 6.2 percent. Furthermore, high frequency indicators, such as industrial production, retail trade, and tourist arrivals, suggest that output is recovering, private consumption is growing, and tourism is rebounding from its trough prior to the war in Iraq (Figure 6).



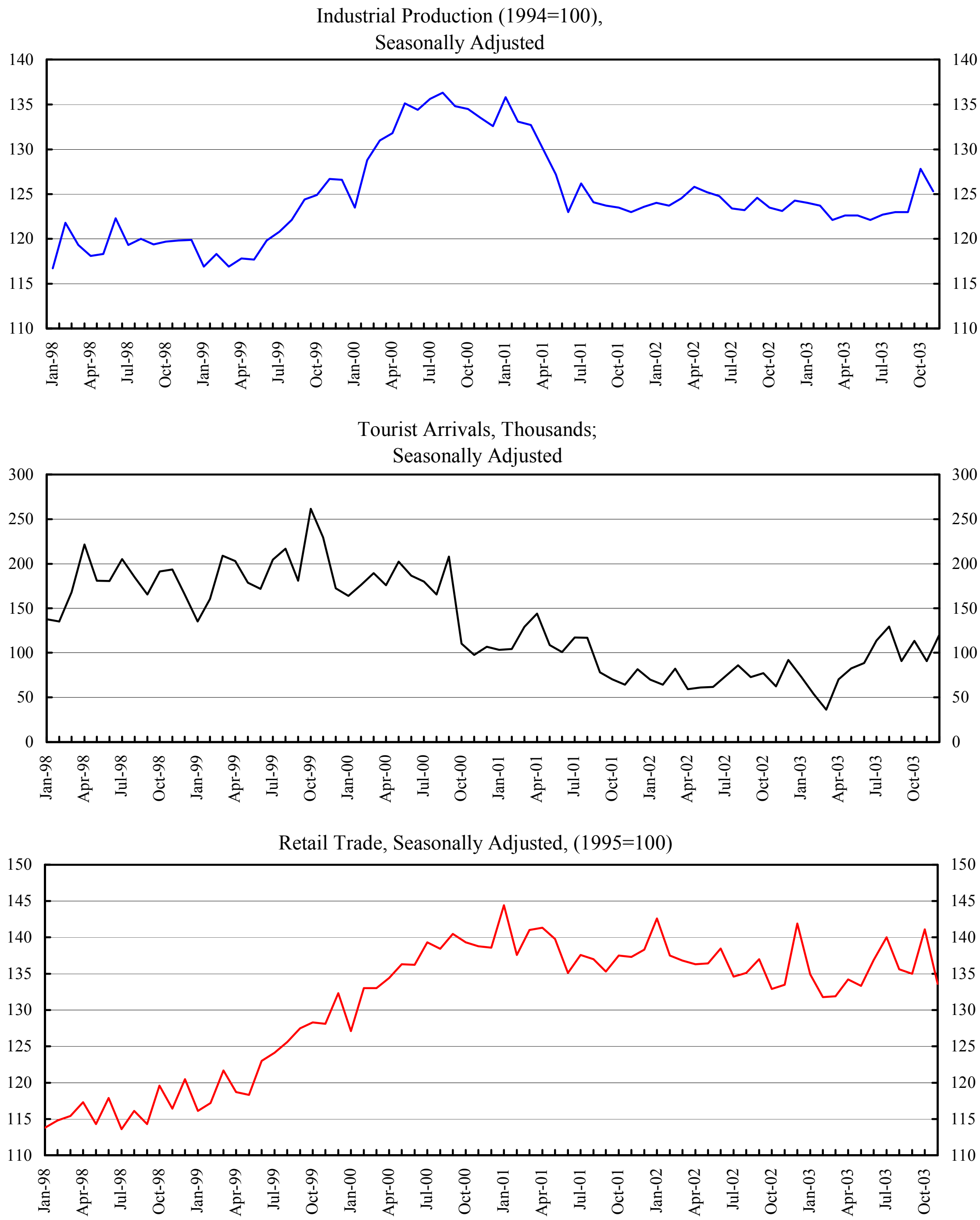
Source: Central Bureau of Statistics; and Fund staff projections.

II. Policy Discussions

10. **The staff very much welcomed the authorities' shift to public expenditure and structural reform, and the discussions concentrated on the policies needed to support the budding recovery and enhance long-term potential growth.** There was agreement that the fiscal-cum-structural reform policies were the right, even if somewhat delayed, response to the quasi-permanent loss in potential output occasioned by the security situation and the bursting of the high tech bubble. These policies had contributed to confidence and helped instill a moderate if potentially fragile recovery. Against this background, staff viewed fiscal policy as broadly on the right track, and providing some room for monetary easing. To be credible, however, this approach would need to be sustained by steadfast implementation of the envisaged structural reforms and faster progress on debt reduction.

11. **The authorities and staff concurred that the economic recovery is likely to gain some strength in 2004, assuming no deterioration in the security situation.** The real GDP growth rate projection in the budget of 2.5 percent appears realistic and is in accordance with the BoI and staff forecasts. There was agreement, however, that a swift recovery is unlikely, and that downside risks—a deterioration of the security situation, a weaker than envisioned global demand, or a decline of the high-tech sector—are significant.

Figure 6. Israel: Recent Developments, 1998–2003



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

A. Fiscal Affairs

12. **The authorities stressed their determination to pursue the announced economic program, which aims at reducing the tax burden and the hefty public sector as well as the budget deficit and public debt as a share of GDP**. The commitment to across-the-board medium-term fiscal discipline is embodied in the recently enacted law, which limits real annual expenditure growth to 1 percent and the deficit to less than 3 percent of GDP during 2005–10. Assuming that the authorities will target deficit of about 3 percent of GDP through this period, staff projects that the public debt ratio to GDP would rise slightly in 2004 before beginning to decline in 2005, and falling to about 100 percent in 2010 as a result of the projected growth of income. However, if real GDP continues to grow by one percent or the budget deficit remains at about the 2003 level, staff projects that public debt would reach more than 115 percent of GDP by 2010 (Table 6).

13. **The 2004 budget aims to hold the deficit to 4 percent of GDP because of the full year effect of the measures adopted in mid-2003 and further across-the-board and defense expenditure cuts**. As a result, overall expenditure as share of GDP is projected to decline by 2 percentage points. Capital outlays in infrastructure—highways, rapid rail system, desalination plants, and a rail link from the Red Sea to the Mediterranean—are to increase marginally, but with about ½ percent of GDP financed off-budget: the railway has been converted into a public corporation and the usual capital transfers are now recorded as equity investment and not as expenditures. Staff took the view that the planned deficit of 4 percent of GDP in 2004 budget, given the medium-term fiscal framework and the wide-ranging reform program, represents an appropriate step toward fiscal consolidation, while providing support to the incipient recovery. Yet, staff stressed that adhering to this target is crucial to maintaining credibility and to allying concerns about sustainability. With regard to the capital transfer to the railway, the mission recognized that this recording procedure is consistent with Eurostat guidelines, but noted that government debt would increase irrespective of how this transaction was recorded.[8]

14. **The authorities expressed confidence in the revenue projections.** Domestic revenue as a share of GDP is projected to grow by about ½ percent, while foreign grants are projected to decline by a similar amount. The bulk of the increase in domestic revenue is due to one-off transfers of surpluses from government insurance companies to the budget and an increase in the surplus of the National Insurance Institute. In contrast to past years, when revenue projections were based mainly on assumptions about nominal GDP growth, the projections for 2004 are based on a vector of quantities and prices (e.g., business GDP,

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[8] A similar issue arises with the recording of the scoring of the U.S. loan guarantees. (Upon issuing a bond backed by U.S. guarantee, about 5–7 percent of the receipt is transferred back to the U.S. government to cover the risk premium.) The authorities have spread the cost of the guarantees over the life of the bond, while they should have recorded the full cost at the time of payment, i.e. in 2004, because Israel follows cash budget accounting.

private consumption, and imports). The authorities added that revenue collections had strengthened in recent months, suggesting that revenue may actually exceed budget projections in 2004. In this respect, staff encouraged the authorities to use any additional tax revenue to lower the deficit and the debt—as this would enhance credibility in the authorities' commitment to fiscal consolidation—rather than raise expenditures or lower taxes. Correspondingly, if growth in 2004 appears to be lower than expected and a return to potential growth in 2005–08 remains realistic, the mission suggested that a limited deviation from the deficit target—say, up to ½ percent of GDP—to moderate the downturn could be considered.[9]

15. **The Minister of Finance welcomed the flexibility in the event of revenue shortfalls,[10] but thought that part of any revenue windfalls ought to be used to lower taxes and thus enhance growth prospects**. The mission suggested that tax cuts at this stage could be perceived as too hasty and could undermine the credibility of the authorities' commitment to fiscal discipline, which would hamper growth prospects and financial stability. The mission proposed that before considering any such cuts, the government prepare and make public a realistic and detailed medium-term expenditure plan that fulfills the government commitments to keep the deficit below 3 percent of GDP and to limit real expenditure growth to 1 percent starting in 2005. However, in early February, the Ministry of Finance announced a reduction in taxation amounting to ½ percent of GDP,[11] based on the expectation of continued higher revenue collection than budgeted.

16. **Following the mission, the Knesset approved the budget, but it became increasingly apparent that some ministries—mainly the defense ministry and local authorities—were facing unexpectedly difficult budgetary situations**. The authorities have said that adjustments to the budget totaling close to 1 percent of GDP are needed to raise the allocations to defense and local authorities, but have vowed to reduce other expenditures in order to keep the budget envelope intact.[12]

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[9] On cyclical grounds, one could argue that if GDP were to grow one percent less than the projected 2.5 percent, the deficit should be increase by about 0.4 percent (given that revenues amount to 40 percent of GDP, and assuming income elasticity of one). However, the already large public debt outstanding and the uncertainty surrounding future growth suggest the need to err on the side of caution and avoid a mechanic approach to automatic stabilizers.

[10] The authorities also welcomed the recommendation that the government presents a semi-annual detailed report on progress in achieving its public finance goals and the implementation of the various measures and reforms, including in the labor market.

[11] These consist of a reduction in the VAT from 18 percent to 17 percent (nine months earlier than planned), a decline in taxes on consumer durables, and a decrease in customs duties on basic food items.

[12] Some use of the contingency reserve is also being contemplated.

B. Monetary Policy

17. **The BoI emphasized that the goal of monetary policy is price stability—an annual inflation rate of 1–3 percent over the next 12–24 months**. They did not seek to achieve a particular target over short periods. In particular, the sharp interest rate reduction that would have been needed to bring inflation within the target range during 2003 would have been inappropriate. It would have called for a major subsequent reversal, introducing undue volatility in output, the exchange rate, and prices. In fact, inflation expectations throughout most of 2003 were within the target range, indicating that market participants considered monetary policy to be consistent with the price stability target. While agreeing that policies should not overreact to shocks, the staff argued that with the benefit of hindsight, inflationary risks had been overestimated. As a result, monetary policy was excessively conservative and contributed to a marked undershooting of the inflation target.

18. **Looking forward, there was general agreement that inflationary pressures are limited.** Output remains subdued, inflation over the last 12 months has been negative, long-term interest rates have declined in both real and nominal terms, the foreign exchange market has remained calm following recent reductions in interest rates, and most importantly, inflationary expectations over the next 12 months are below the lower bound of the inflation target range. Moreover, upside inflationary risks appear modest and take primarily the form of a depreciation of the sheqel. In this regard, the decline in the country and currency risks is an encouraging sign. Furthermore, staff noted that compared with other emerging markets with inflation targeting regimes, Israel's monetary policy appeared tight.

19. **The authorities agreed that there was room to continue with monetary easing.** The BoI, however, stressed the importance of maintaining financial stability, which called for moving gradually and cautiously with interest rate reductions. Indeed, since the mission, the BoI has gradually lowered its policy rate from 5.6 percent to 4.5 percent.

20. **Discussions also covered several aspects of the inflation targeting framework.**

- **The roles of inflation forecasts and expectations.** The BoI currently places a great deal of emphasis on measures of real interest rates and inflation expectations that are derived from capital markets rather than its own forecasts. This approach could inherently contribute to price instability since market measures may be biased and inefficient as they reflect the authorities' credibility and risk premium. Moreover, there is a certain degree of circularity in the approach: while the central bank relies on market-derived measures, markets look to central bank actions to assess inflationary prospects. The mission argued, therefore, that in addition to the use of market expectations, mainly to gauge the bank's credibility, more emphasis could be placed on the Bank's forecast models that do not rely on market expectations as a framework for policy decisions. BoI staff welcomed the suggestions.

- **Anchoring expectations through greater transparency**. Because of the lags between policy actions and their impact on inflation, the public has difficulty monitoring policy commitment to inflation targets on an ongoing basis. This difficulty is particularly marked in emerging market countries with a history of high and volatile inflation. To help assure that short-term deviations from inflation targets do not unhinge expectations, the mission suggested adopting procedures used in other inflation targeting frameworks, e.g. by supplementing the semi-annual Inflation Reports with interim quarterly updates and by giving more attention in those reports to the dynamics of future inflation (Box 2). The BoI agreed with the call for more transparency while expressing concerns that markets may misinterpret the added information, particularly, the assessment of risks and possible policy response, and react in an unwarranted manner.

- **The establishment of a monetary policy committee**. The mission noted that Israel is the only emerging market country with an inflation targeting regime that does not have a monetary policy committee. Such a committee would broaden the range of perspectives in the decision-making process and increase the delegation of authority within the central bank. The authorities agreed on the need to amend the BoI Law to reflect international best practices, along the lines of the recommendations of the Levin Committee (appropriately updated).[13]

C. Other Policy Issues

21. **The structural reforms in the fiscal dimension of the economic program are complemented by equally broad-based reforms** in product and labor markets. As regards the former, the reforms aim at (a) increasing competition of the business sector through breaking up of monopolies in the ports, oil refineries, electricity, water, milk distribution, and mail, and pushing forward with privatization of Bezeq Telecom, Discount Bank, Bank Leumi, Zim Shipping[14], Bazan Oil Refineries and the defense industry companies (privatization would be carried out mainly via the stock exchange, as with the recently successful privatization of El-Al (airline)); (b) streamlining bureaucracy and reducing the public sector, while improving its efficiency and accessibility through enhancing

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[13] The Levin Committee's main recommendations (in December 1988) were to create a monetary policy committee, and to establish that the BoI's main objective is to achieve and maintain price stability.

[14] Zim Shipping was indeed privatized after the mission.

Box 2. A Comparison of IT Regimes Among Emerging Market Countries

Successful inflation targeting requires that central banks undertake extensive analysis and forecasting of inflation, operate transparently, and be held accountable for their actions. These goals have been particularly challenging for emerging market economies given their histories with price and financial market instability, and their tradition of stricter controls and regulations and reluctance to communicate their intentions and economic outlooks. To overcome these difficulties, many countries have taken the following important steps. First, to improve their governance structure many countries incorporated a broader range of perspectives into their decision-making process and increasing the delegation of authority. Second, to enhance transparency and accountability, countries issue regular press releases and inflation outlook reports, carry out an ongoing dialogue with the private sector and media, and, in some cases, publish inflation forecasting models.

The table below presents a snapshot of current practices among emerging market economies. While there are a number of commonalities, Israel differs in two important aspects. First, all of these countries have set up monetary policy committees, and most of these committees include non-central bank members. Second, most central banks issue quarterly inflation reports. The inflation reports differ in their content, although the trend is toward issuing model-based inflation forecasts with highly analytical discussions of the inflation outlook.

Selected Countries: Characteristics of Inflation-Targeting Regimes Among Emerging Market Economies

Characteristic	Brazil	Chile	Czech Republic	**Israel**	Poland	South Africa
1. Primary Objective	Price Stability	Price Stability plus others	Price Stability	**Price Stability plus others**	Price Stability	Price Stability
2. Decision-making Body						
a) policy committee	Yes	Yes	Yes	**No**	Yes	Yes
b) non-central bank members	No	Yes	No	**--**	Yes	No
c) executive responsibilities	--	Yes	Yes	**--**	Yes	Yes
3. Inflation Target Design						
a) Target set by:	Government	Central Bank	Joint	**Government**	Central Bank	Government
b) Escape clauses [1]	No	No	Yes	**No**	No	Yes
4. Inflation Report						
a) frequency of report	Quarterly	Quarterly	Quarterly	**Semi-Annual**	Quarterly	Quarterly
b) format of inflation outlook						
i) forecast?	fan chart	fan chart	2-year forecast	**fan chart**	point estimate	fan chart
ii) discussion?	analytical	analytical	analytical	**qualitative**	qualitative	qualitative
c) publishes forecasting models	No	No	No	**Some**	No	No

Sources: Schaechter and others (2000) and central bank websites.

[1] Requires either indicating a time frame for returning to within target range or establishing a new target.

computerization and services available through the internet; (c) assisting impoverished families by increasing employment opportunities, fighting welfare fraud, improving the quality of education, and reducing the number of illegal foreign workers. The mission welcomed this reform agenda, and underscored the benefits of close consultation and cooperation with all parties involved.

22. **Quite aside from their fiscal implications, the authorities viewed the cuts in benefits and the welfare to work program as essential to improving the functioning of the labor market.** They stressed that cuts in income support to those capable of work was key to enticing people back to the labor market and improving the social structure. The mission agreed, in principle, but underscored the importance of protecting the poor. It also cautioned that the pace of the recovery may not permit absorbing many workers quickly, and suggested facilitating mobility and increasing job training opportunities and education. The authorities thought that the soon to be established employment centers, based on the Wisconsin model for welfare reform, would ease the transition. The mission noted that the scope of the welfare to work program is very limited and suggested that the authorities consider temporary tax incentives linked to job creation and training.

23. **The authorities are also taking steps to develop the financial markets and reduce the dominance of the two largest banks**. These steps include revamping regulations and enforcement practices that hinder capital market development, limiting banks' exposures to large corporate borrowers, and increasing pension funds' involvement in the capital market. These efforts would be buttressed by the introduction by the BoI of a state-of-the-art payment and settlement system. Staff noted that these steps—which are in line with the FSAP recommendations—together with the necessary legislation to increase the number of market players and instruments, should improve the agility and resiliency of the Israeli financial markets.

24. **The banking system strengthened in 2003**. The economic downturn had a significant impact on the banking system, sharply reducing bank profitability and borrower repayment ability. Against this background, the Supervisor of Banks took important regulatory steps to strengthen banks' monitoring and risk-management systems in order to improve banks' ability to assess and manage operational, liquidity, and credit risks. While problem loans continue to grow, albeit at a reduced pace, and loan concentration is high (although significantly reduced from a year ago), positive signs have emerged: profitability has increased, capital adequacy ratios have improved, and provisions relative to non-performing loans have risen substantially.

Israel: Banking Soundness Indicators—Five Largest Banking Groups, 1997—2003
(in percent)

	1997	1998	1999	2000	2001	2002	2003 1/
Asset growth	6.1	8.5	10.9	7.9	7.5	-0.6	-1.6
Credit growth	7.3	10.5	12.0	13.7	12.7	1.0	-3.7
After-tax return on equity	12.0	9.9	11.3	11.7	5.9	2.5	7.6
After-tax return on assets	0.6	0.5	0.5	0.5	0.3	0.1	0.4
Problem loans to total loans ratio	10.5	9.9	9.0	6.7	8.1	9.9	10.3
Capital to risk-weighted assets ratio	10.0	9.2	9.4	9.2	9.4	9.9	10.4

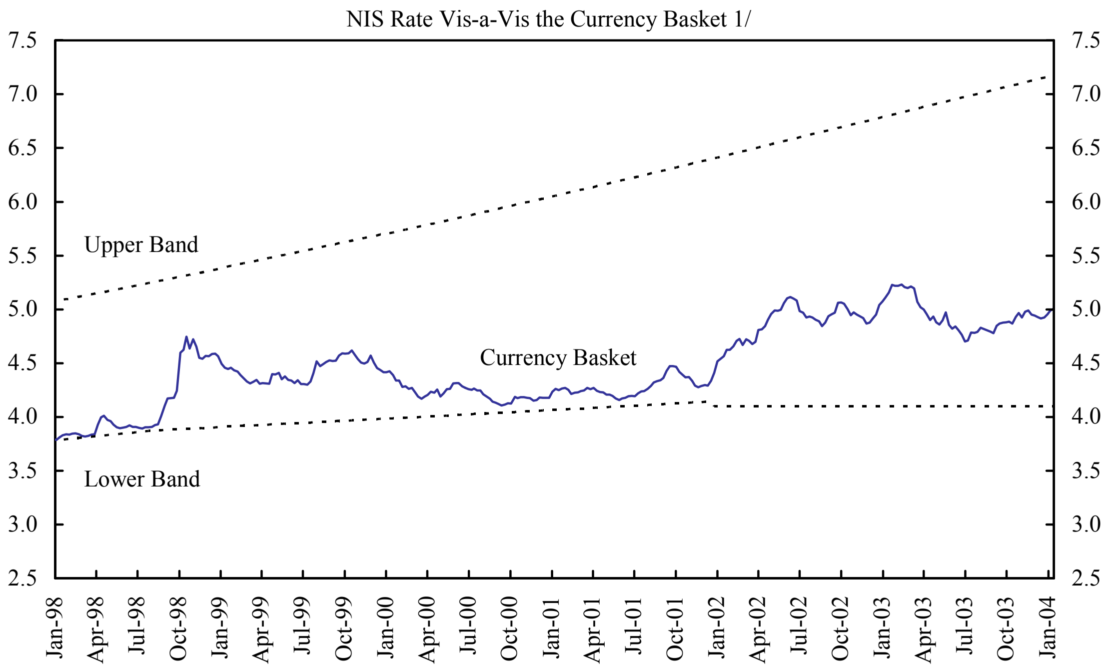
Sources: Bank of Israel and Fund staff estimates.
1/ Annualized based on the first nine months of the year.

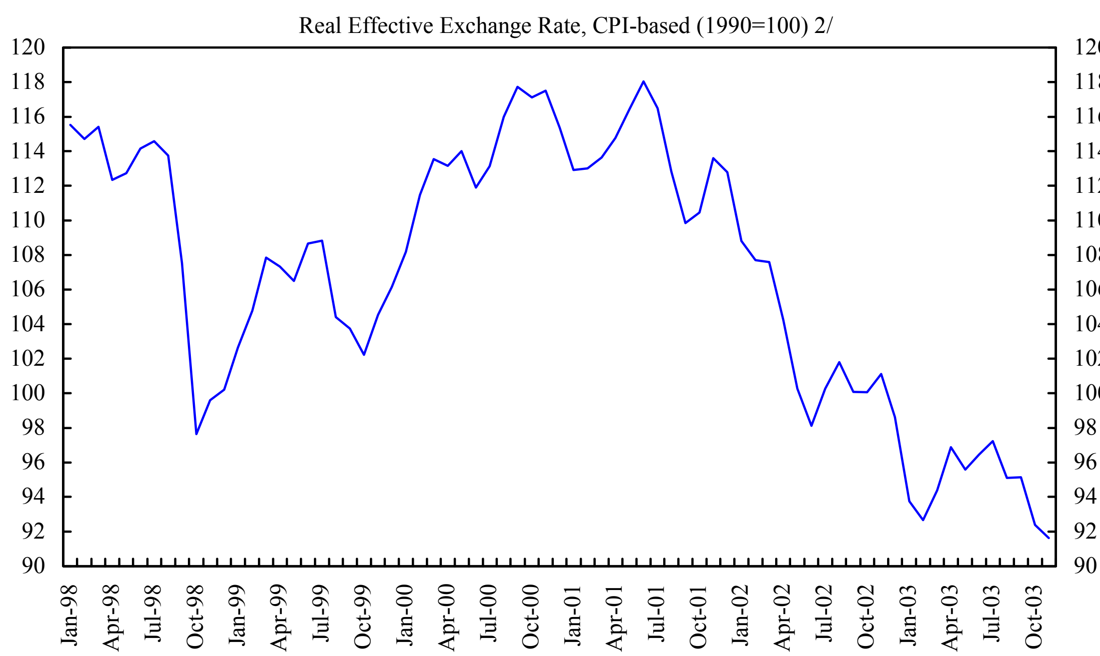
25. **There have been no major developments recently in the area of trade policy.** Israel's trade policy aims at expanding its network of bilateral trade agreements and enhancing the process of trade liberalization at the multilateral level. After completing free trade agreements with the European Union and the United States during the 1980s, Israel has expanded its free trade agreements to many other countries. Presently, more than 75 percent of Israel's trade is covered by free trade agreements. Except for security considerations and in a few cases involving antidumping rules and agricultural products, Israel maintains a trade system free of non-tariff barriers.

26. **External vulnerability appears to have declined significantly**. The current account deficit continues to fall and is now close to balance. The sizeable capital outflow of the last quarter of 2002 and the first quarter of 2003—prior to the war in Iraq—has been reversed, and foreign direct investment rebounded. Total gross external debt is about 60 percent of GDP, but net external debt remains negligible.[15] Of the external debt, 80 percent is backed by U.S. guarantees or is held by the Jewish Diaspora, the average maturity is about 6.5 years, and the new U.S. guarantees cover most of the government external debt maturing in the next 3 years. Staff noted that given that the BoI follows a de facto fully floating exchange rate system (as the exchange rate band is not actually binding (Figure 7)) and that international reserves (amounting to US$25 billion at end-2003) cover most of short-term debt, the level of reserves appears adequate. There are also no apparent problems of external competitiveness. Exports to all major markets are recovering markedly as a result of the global upturn and the depreciation of the sheqel in real effective terms (about 20 percent in 2002–03).

[15] Net external debt is defined as gross external debt minus foreign reserves assets of the BoI and commercial banks.

Figure 7. Israel: Exchange Rates, 1998–2004





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

1/ Weekly average of daily rates. Updated to February 13, 2004.

2/ A decrease represents depreciation.

27. **A fiscal ROSC mission concluded (its draft report is being reviewed by the authorities) that Israel meets the requirements of the fiscal transparency code in many areas, including internal and external audit and fiscal accounting.** The greatest scope for improvement lies in the way the budget is prepared and presented. In particular, the budget documents should include a more systematic analysis of the sensitivity of the budget to economic and financial shocks, and additional information on budget execution (including a revised projection for the year in course). In addition, the expenditure classification should be revised to conform more closely to international standards. This reform would facilitate assessments of the effectiveness and efficiency of the government's expenditure programs.

III. Staff Appraisal

28. **The policies of consolidation and reform put in place over the past year have set the stage for a more balanced policy mix, but they need to be sustained and complemented with a stronger commitment to debt reduction**. The structural reforms in both the fiscal area and labor and product markets are the right response to the tougher economic environment that Israel has been and is facing. It has already led to an improvement in confidence and allowed a needed rebalancing of the policy mix. This, together with the rebound in the global economy and the considerable improvement of the financial and foreign exchange markets, has laid the foundation for a gradual recovery of activity after almost three years of recession, assuming no deterioration in the security situation.

29. **The 2004 budget, with a deficit target of 4 percent of GDP, is a key element of the necessary change of course.** The budget strikes an appropriate balance between fiscal consolidation and sustainability, on the one hand, and the need to support the budding economic recovery on the other. Upward deviations from this target may raise concerns about the government's commitment and ability to rein in its deficit and debt. In this regard, recent cabinet consideration of expenditure cuts in several ministries and the use of part of the contingency reserves to accommodate increases in defense and local authorities so soon after the budget was approved is troublesome.

30. **Given the high level of public debt the scope for allowing automatic stabilizers to play a role is limited.** Only if the recovery in 2004 is weaker than expected but a return to potential growth in 2005–08 appears realistic, should a limited deviation from the deficit target be considered. However, if the recovery is stronger than expected, the likely additional revenues should be used to lower the deficit and curb the substantial public debt. In this context, the authorities' decision in early February to reduce taxes is disappointing insofar as it portends a slower pace of debt reduction than would be desirable given its still very high level.

31. **The adoption of a limit of one percent on expenditure growth in real terms and a ceiling of 3 percent of GDP on the overall deficit for 2005–10 is welcome**. It is important that the authorities adhere strictly to this framework, as this would help the government

achieve its goals of gradually reducing the public debt as a share of GDP and the size of the public sector, allowing for a reduction of the tax burden. The frequent amendments of the deficit targets during downturns and the inability to limit expenditures during upturns have eroded the government's credibility, making it essential to introduce a new credible medium-term beacon to navigate by.

32. **To further raise credibility and facilitate the implementation of the fiscal adjustment, the preparation and publication of a more detailed spending plan with medium-term expenditure targets would be critical**. This could be supplemented by semi-annual detailed reports on progress in achieving the government's public finance goals and the implementation of the various measures and reforms.

33. **The authorities' efforts to undertake structural reforms, including the pension and welfare systems, and the push forward with privatization and infrastructure investment are commended.** These steps are overdue, and their steadfast implementation will help improve the efficiency of the economy and the structure of the public finances.

34. **A further relaxation of monetary policy seems warranted, and the recent reductions in the BoI policy rate are welcome.** Several factors suggest that inflationary pressures are limited: the CPI has fallen nearly 2 percent over the last 12 months, long-term real and nominal interest rates have declined markedly. Most importantly, as a result of the BoI efforts inflationary expectations over the next 12 months are below the lower bound of the inflation target range, and upside inflationary risks appear modest and stem primarily from a depreciation of the sheqel. In this respect, the declines in country and currency risks are encouraging signs. These factors, together with the subdued state of economic activity, suggest that further interest rate reductions are unlikely to push future inflation above the upper bound of the price stability target. Accordingly, there is still some room for the BoI to continue lowering its policy interest rate gradually, while closely watching developments in the foreign exchange and financial markets.

35. **It would be important to support the implementation of monetary policy by strengthening BoI efforts to communicate more clearly its policy and its views regarding the inflationary environment in order to continue anchoring expectations within the inflation target range**. To this end, supplementing the semi-annual Inflation Report with interim quarterly updates and rebalancing the focus of the Report by giving more attention to the dynamics of future inflation would be advisable.

36. **There is a need to amend the BoI law to reflect international best practice regarding monetary policy objectives and procedures, along the lines of the recommendations of the Levin Committee**. This would help monetary policy become more transparent and accountable to ensure financial market stability and to minimize the risks that temporary breaches of inflation targets unhinge expectations.

37. **The situation in the labor market is worrisome**. High social benefits relative to the minimum wage and high penalties for joining the labor market at the lower end, combined

with steady inflows of foreign workers, have induced many to exit the labor market. Therefore, cuts in social benefits to those capable of work are an essential part of any policy that aims to entice people back to the labor market and improve the social structure. Staff lauds the authorities for implementing these necessary changes in such difficult times, while stressing the importance of protecting the disabled and the truly needy.

38. **Eliminating these distortions may lead to temporary social hardship, as the current frail labor market may be unable to absorb quickly most of those affected by these reforms.** There is a need to complement the reduction in benefits with additional steps, such as facilitating mobility and increasing job training opportunities and education, in order to assist the rapid absorption of unemployed and income support recipients in the labor market. In this regard, the "Welfare-to-Work" pilot project, based on the so-called Wisconsin Program, is promising, but its scope is limited and should be expanded over time. Consideration could be given to establishing temporary tax incentives linked to job creation and training.

39. 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.

40. 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, 1999-2003

Demographic and other data:	
Population (2003)	6.7 million
GDP per capita (2002)	US$ 16,292
Social indicators (1993-2001)	
Life expectancy at birth	
Male (2001)	76.5
Female (2001)	80.6
Infant mortality rate (2001)	6 per 1,000 live births
Physicians per 1,000 people (1998)	3.85
Population per sq. km. (2001)	308.6

	1993		2003	
	Billions of U.S. Dollars	Percent of GDP	Billions of U.S. Dollars	Percent of GDP
Private consumption	41.0	61.0	64.2	59.0
Public consumption	18.9	28.1	33.0	30.4
Gross capital formation	15.0	22.3	17.2	15.8
Exports of goods and services	21.6	32.0	41.9	38.5
Imports of goods and services	31.7	47.1	48.9	44.9
GDP	67.3	100.0	108.8	100.0

	1999	2000	2001	2002	2003 1/
	(Percent change unless otherwise indicated)				
National account indicators (constant prices)					
Private consumption	4.2	7.5	3.2	0.1	1.8
Public consumption	2.9	2.2	3.4	5.7	-1.8
Fixed capital formation	-2.8	3.9	-6.8	-7.5	-3.9
Exports of goods and services	12.0	24.0	-11.5	-3.0	6.2
Imports of goods and services	14.9	12.2	-4.5	-2.3	-1.8
Real GDP	2.6	7.5	-0.9	-0.8	1.3
Labor market indicators					
Unemployment rate (in percent)	8.9	8.8	9.3	10.3	10.7
Real wages	2.5	6.3	3.0	-6.0	-3.4
Prices					
Overall CPI (end period)	1.3	0.0	1.4	6.5	-1.9
Underlying CPI (excluding housing, fruit and vegetables, end period)	1.7	0.9	0.2	6.3	-0.6
Interest rates (average, in percent)					
BOI policy rate	12.1	9.3	6.8	6.8	7.5 2/
Money and credit (period average)					
Nondirect domestic credit 3/	16.7	13.1	10.8	10.5	1.7
Narrow money (M1) 3/	9.6	11.0	14.2	15.6	8.7
Broad money (M3) 3/	21.2	16.9	15.5	6.1	2.2
Public finance (percent of GDP)					
Central government revenue	37.5	37.9	35.8	37.1	35.3
Central government expenditure	39.3	38.1	40.1	40.7	40.5
Central government balance	-1.8	-0.2	-4.3	-3.6	-5.2
General government balance	-4.2	-2.1	-4.1	-4.5	-6.4
Government debt	96.7	85.9	92.8	101.2	106.5
Balance of payments					
Current account (percent of GDP)	-1.5	-0.6	-1.6	-1.3	-0.2
Foreign reserves (e.o.p., in US$ billion)	22.6	23.3	23.4	24.1	25.0
Reserve cover (in months of imports)	6.7	6.0	6.5	6.8	6.7
Exchange rate and terms of trade indices					
NEER appreciation (period average) 3/	-7.7	9.1	0.7	-13.5	-6.3
REER appreciation (period average) 3/	-3.8	8.0	-0.3	-10.0	-9.4
Terms of trade (1990=100; index level)	114.4	116.3	113.3	113.4	109.8

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/ The Bank of Israel set the policy rate at 4.5 percent in February 2004.

3/ As of November 2003.

Table 2. Israel: Balance of Payments, 2000-08 1/
(in billions of U.S. dollars)

					Projections				
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Current account balance	-0.7	-1.8	-1.4	-0.2	0.0	-0.1	0.2	0.4	0.3
Merchandise	-2.9	-3.0	-3.7	-2.6	-2.2	-3.0	-2.2	-2.1	-1.8
Exports, f.o.b.	31.2	28.0	27.5	29.8	31.9	35.0	37.7	40.2	42.8
Imports, f.o.b.	34.0	31.0	31.2	32.3	34.1	38.0	39.9	42.3	44.6
Civilian imports	32.1	28.8	28.8	30.3	31.4	35.0	36.8	39.0	41.1
Military imports	1.9	2.1	2.4	2.1	2.7	2.9	3.1	3.3	3.5
Services	2.7	-0.6	-0.6	0.5	0.3	0.4	0.6	0.9	1.2
Exports	15.2	12.0	10.9	12.3	13.4	14.6	16.0	17.6	19.3
Imports	-12.5	-12.5	-11.5	-11.8	-13.2	-14.2	-15.4	-16.7	-18.0
Factor Income	-6.9	-4.6	-3.6	-4.4	-4.5	-4.0	-4.6	-4.8	-5.5
Receipts	3.8	2.9	2.9	2.0	2.4	3.0	3.0	3.5	3.5
Payments	-10.7	-7.5	-6.5	-6.5	-6.9	-7.0	-7.6	-8.3	-9.0
Net transfers	6.5	6.4	6.5	6.3	6.4	6.4	6.4	6.4	6.4
Capital and financial account balance 3/	4.5	0.9	-1.6	0.1	0.0	0.3	0.1	-0.1	-0.2
Capital account	0.5	0.7	0.2	0.4	0.3	0.3	0.3	0.3	0.3
Financial account	4.1	0.2	-1.7	-0.3	-0.3	0.0	-0.2	-0.4	-0.5
Direct investment, net	1.5	2.7	0.4	2.1	2.8	3.0	3.0	3.0	2.9
Foreign direct investment (in Israel)	5.0	3.5	1.6	3.7	3.9	4.2	4.3	4.4	4.4
Portfolio investment, net	2.2	-1.5	-1.9	-0.6	-1.5	-1.4	-1.4	-1.6	-1.6
Other investment	-0.4	-1.5	-0.4	-1.9	-1.6	-1.6	-1.8	-1.8	-1.8
Errors and omissions	-3.1	0.8	2.2	1.0	0.0	0.0	0.0	0.0	0.0
Change in reserves 4/	-0.8	0.8	0.7	-0.8	-0.1	-0.2	-0.3	-0.3	-0.2
Memorandum items (percentage of GDP):									
Current account balance	-0.6	-1.6	-1.3	0.4	0.0	-0.1	0.2	0.3	0.2
Civilian trade balance	-0.8	-0.8	-1.3	-0.5	0.5	0.0	0.7	0.9	1.2
Gross external debt	56.4	57.7	65.2	65.3	64.5	64.1	63.1	61.9	60.4
Net external debt 5/	3.2	0.2	-2.9	-6.3	-5.7	-7.8	-9.7	-11.5	-13.2
Gross external debt (in US$ billions)	64.7	65.0	67.6	71.0	71.1	74.0	76.9	79.8	82.7
Net external debt (in US$ billions)	3.7	0.2	-3.0	-6.8	-6.2	-9.0	-11.8	-14.8	-18.0
GDP (in US$ billions)	114.8	112.7	103.7	108.7	110.2	115.5	121.9	129.0	136.9

Sources: Central Bureau of Statistics, *Monthly Bulletin of Statistics;*

1/ Fund staff estimates and projections.
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/ Gross external debt minus the foreign reserve asset holdings of the Bank of Israel and commercial banks.

Table 3. Isreal: Indicators of External and Banking Sesctor Vulnerability, 1998-2003

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	Latest Data 2003	Date
Financial indicators							
Government debt	103.1	96.7	85.9	92.8	101.2	...	Dec. 2002
Broad money (percent change, 12-month basis)	15.9	21.2	16.9	15.5	6.1	2.3	Oct. 2003
Private sector credit (percent change, 12 month basis)	17.7	34.9	16.4	10.8	10.5	-2.4	Oct. 2003
External Indicators							
Exports of G&NFS (percent change)	6.1	14.5	24.3	-14.5	-3.7	13.1	Sept. 2003
Imports of G&NFS(percent change)	-1.5	13.0	19.0	-10.9	-3.6	6.4	Sept. 2003
Terms of trade (percent change, average) 1/	-0.1	-1.9	0.1	-0.2	0.7	...	Dec. 2002
Current account surplus	-1.3	-1.5	-0.6	-1.6	-1.3	-3.1	Sept. 2003
Capital and financial account balance	1.8	4.1	3.3	0.9	-0.8	1.2	Sept. 2003
Of which: Inward portfolio investment (debt securities etc.)	2.4	1.7	2.5	-0.9	-1.7	1.1	Sept. 2003
Other investment (loans, trade credits etc.)	0.1	-0.8	-1.9	-1.0	-2.4	0.9	Sept. 2003
Inward foreign direct investment	1.7	3.0	4.3	3.1	1.6	1.7	Sept. 2003
Gross official reserves (in US$ billions; e.o.p.)	22.7	22.6	23.3	23.4	24.1	25.8	Dec. 2003
Short-term foreign assets of the financial sector (in US$ billions)	13.2	14.3	15.7	15.6	15.4	17.8	Sept. 2003
Short-term foreign liabilities of the financial sector (in US$ billions)	19.2	21.2	22.7	23.8	24.5	24.2	Sept. 2003
Official reserves in months of imports GNFS	6.4	5.6	4.9	5.5	5.9	6.4	Sept. 2003
Ratio of foreign reserves to Broad Money	0.5	0.4	0.4	0.4	0.4	0.3	Oct. 2003
Ratio of foreign reserves to short-term debt	88.3	79.0	83.6	81.6	79.8	83.3	Sept. 2003
Total net external debt/GDP (in percent)	10.9	7.1	3.2	0.2	-2.9	-5.3	Sept. 2003
Total gross external debt/GDP (in percent)	56.2	60.3	56.4	57.7	65.2	61.9	Sept. 2003
Of which: Government debt/GDP (in percent)	26.7	26.8	23.9	23.8	26.4	25.8	Sept. 2003
Total gross external debt to exports GNFS (in percent)	165.4	155.2	129.2	151.9	164.0	164.6	Sept. 2003
Ratio of short-term debt to total debt (in percent)	44.2	45.7	43.0	44.0	44.7	42.4	Sept. 2003
Country risk ratings (S. & P. / Moody's) 4/	A- / A3	A- / A3	A- / A2	A- / A2	A- / A2	A- / A2	Dec. 2002
Exchange rate (per US$, period average)	3.80	4.14	4.08	4.21	4.74	4.42	Jan. 2004
REER appreciation (+) (period average)	-3.0	-3.8	8.0	-0.3	-10.0	-7.7	Oct. 2003
Change in Stock Market Index (in percent)	0.6	64.4	0.3	-6.6	-19.9	55.4	Dec. 2003

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.

Table 4. Israel: State Budget, 1998-2004
(In percent of GDP)

	1998	1999	2000	2001	2002	2003		2004
						Budget	Est.	Budget
Revenue	**39.3**	**38.3**	**39.3**	**37.5**	**39.4**	**40.6**	**37.5**	**37.7**
Domestic	34.9	34.5	36.5	35.0	34.4	36.5	33.4	34.1
Tax	29.5	29.6	31.1	30.8	29.9	31.2	29.0	28.9
Of which: On income and profits	16.3	16.2	18.1	17.9	16.3	16.8	15.4	15.4
On domestic goods and services	13.2	13.3	12.9	12.9	13.7	14.3	13.6	13.5
Nontax domestic	5.4	5.0	5.4	4.2	4.4	5.4	4.3	5.1
Of which: Loans from the National Insurance Inst	1.4	1.4	1.5	0.9	1.6	2.5	1.9	2.2
Foreign	4.5	3.8	2.8	2.5	5.0	4.1	4.2	3.6
Of which: Grants	3.2	2.6	2.5	2.1	3.1	2.7	2.7	2.3
Expenditure	**41.6**	**40.7**	**40.0**	**41.9**	**43.2**	**43.6**	**43.1**	**41.7**
Domestic	37.7	37.3	37.0	38.6	37.9	38.8	38.7	37.4
Current	39.8	39.1	38.3	40.2	41.3	41.5	...	39.8
Of which: Wages	8.4	5.9	8.8	8.7	8.8	8.8	...	8.5
Interest	4.8	4.5	4.6	4.6	4.5	4.9	5.3	5.4
Subsidies & transfers	14.7	15.0	14.1	14.9	14.5	14.6	...	13.3
repayment	9.8	8.9		9.5	0.0	10.9	...	...
Capital	1.8	1.7	1.7	1.7	1.9	2.1	...	1.9
Foreign	3.9	3.4	3.0	3.3	5.3	4.8	4.4	4.2
Of which: Interest	1.5	1.4	1.3	1.3	1.1	1.7	1.2	1.5
Budget balance	**2.3**	**2.4**	**0.7**	**4.4**	**3.8**	**3.0**	**5.6**	**4.0**
Domestic	2.5	2.5	0.2	3.5	3.2	2.3	5.0	3.5
Foreign	-0.6	-0.4	0.1	0.8	0.2	0.7	0.2	0.6
Financing	1.9	2.1	0.3	4.3	3.4	3.0	5.2	4.1
Domestic	1.0	1.7	-0.1	3.5	5.0	2.7	4.5	1.9
Sale of assets	1.3	0.5	0.6	0.0	0.1	0.3	0.1	0.5
Other	0.0	-0.1	-0.1	1.4	-1.2	0.0	-0.7	0.0
Foreign	-0.4	-0.1	-0.2	-0.6	-0.4	0.0	1.4	1.7
Memorandum item:								
Defense expenditure	9.7	9.1	9.4	9.9	11.9	9.4	...	9.2
Primary balance	4.0	3.4	5.2	1.5	1.8	3.6	0.9	3.0

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

Table 5. Israel: Medium Term Scenario, 1998-2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
	(In percent unless indicated otherwise)									
GDP growth rate	3.3	2.6	7.5	-0.9	-0.8	1.3	2.5	3.4	3.5	3.7
Inflation (end of period)	8.6	1.3	0.0	1.4	6.5	-1.9	1.1	1.3	1.3	1.3
Fiscal deficit/GDP										
Central government deficit	-1.9	-1.8	-0.2	-4.3	-3.6	-5.2	-4.0	-3.0	-3.0	-2.5
Public debt/GDP (end of period)	103.1	96.7	85.9	92.8	101.2	106.5	108.6	107.8	106.6	104.7
Current account/GDP	-1.3	-1.5	-0.6	-1.6	-1.3	-0.2	0.0	-0.1	0.2	0.3
Foreign reserves (in billions of U.S. dollars)	22.7	22.6	23.3	23.4	24.1	25.0	25.5	25.6	25.8	26.0
Memorandum Items:	(percentage changes)									
Aggregate domestic demand	1.8	4.3	3.9	1.6	-0.7	-1.6	1.9	3.4	2.8	3.3
Private consumption	4.2	4.2	7.5	3.2	0.1	1.8	2.6	3.4	4.0	4.0
Public consumption	2.2	2.9	2.2	3.4	5.7	-1.0	-2.4	1.0	1.0	1.0
Gross capital formation	-4.3	6.7	-2.9	-4.9	-12.4	-14.0	7.7	7.7	1.3	4.6
Exports of Goods and Services	6.4	12.0	24.0	-11.5	-3.0	6.2	5.8	6.7	6.7	5.9
Imports of Goods and Services	1.7	14.9	12.2	-4.5	-2.3	-1.8	3.7	6.4	4.6	4.7

Source: Fund staff estimates and projections.

Table 6. Israel: Public Sector Debt Sustainability Framework, 1998-2010
(In percent of GDP, unless otherwise indicated)

	Actual 1998	1999	2000	2001	2002	10-Year Historical Average	10-Year Standard Deviation	2003	2004	2005	2006	2007	2008	2009	2010	For debt stabilization	Debt-stabilizing primary balance 10/ / Projected Average
									I. Baseline Projections								
1 **Public sector debt 1/**	103.1	96.7	85.9	92.8	101.2			**106.5**	**108.6**	**107.8**	**106.6**	**105.2**	**103.7**	**101.9**	**100.1**		**1.6**
o/w foreign-currency denominated	25.9	26.2	23.6	29.1	29.0			26.8	26.0	25.3	25.2	25.2	25.1	25.1	25.0		
2 Change in public sector debt	1.8	-6.4	-10.8	6.9	8.4			5.3	2.1	-0.8	-1.2	-1.4	-1.5	-1.8	-1.8		
3 Identified debt-creating flows (4+7+12)	6.1	3.7	-5.4	7.5	10.1			5.0	3.2	-0.3	-0.7	-0.9	-1.1	-1.0	-1.0		
4 Primary deficit	-2.7	-1.8	-3.8	-1.8	-0.9			-0.2	-1.7	-2.7	-2.7	-2.7	-2.7	-2.7	-2.7		
5 Revenue and grants	49.3	47.9	48.9	49.7	50.7			48.4	48.9	49.4	49.4	49.4	49.4	49.4	49.4		
6 Primary (noninterest) expenditure	46.6	46.1	45.1	47.9	49.8			48.2	47.2	46.7	46.7	46.7	46.7	46.7	46.7		
7 Automatic debt dynamics 2/	6.7	3.0	-1.6	8.7	7.6			4.9	5.4	2.0	1.2	1.0	0.9	1.1	1.1		
8 Contribution from interest rate/growth differential 3/	2.4	3.0	-0.9	6.1	5.7			6.0	5.4	2.0	1.2	1.0	0.9	1.1	1.1		
9 Of which contribution from real interest rate	5.4	5.5	5.8	5.3	4.9			7.3	8.0	5.5	4.8	4.8	4.8	4.9	4.9		
10 Of which contribution from real GDP growth	-3.0	-2.5	-6.7	0.8	0.7			-1.3	-2.6	-3.5	-3.6	-3.8	-3.9	-3.8	-3.8		
11 Contribution from exchange rate depreciation 4/	4.3	-0.1	-0.7	2.6	1.9			-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
12 Other identified debt-creating flows	2.1	2.5	0.0	0.6	3.4			0.3	-0.5	0.5	0.8	0.8	0.7	0.6	0.6		
13 Privatization receipts (negative)	-1.3	-0.5	-0.6	0.0	-0.1			-0.1	-0.5	-0.5	-0.4	-0.4	-0.5	-0.5	-0.6		
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.2	0.2	0.2	0.2	0.2	0.2	0.1		
15 Other (indexed debt)	3.4	3.0	0.6	0.6	3.5			0.4	-0.2	0.7	1.1	1.1	1.0	1.0	1.0		
16 Residual, including asset changes (2-3)	-4.3	-10.1	-5.4	-0.7	-1.7			0.3	-1.1	-0.5	-0.5	-0.5	-0.4	-0.8	-0.8		
Public sector debt-to-revenue ratio 1/	209.1	201.9	175.7	186.6	199.7			220.1	222.2	218.3	215.8	213.0	209.9	206.4	202.7		
Gross financing need 5/								19.6	16.2	16.0	15.8	15.7	15.5	15.3	15.1		
in billions of U.S. dollars								21.3	17.8	18.4	19.3	20.2	21.2	22.2	23.3		
Key Macroeconomic and Fiscal Assumptions																	
Real GDP growth (in percent)	3.3	2.6	7.5	-0.9	-0.8	3.9	3.2	1.3	2.5	3.4	3.5	3.7	4.0	3.9	3.9	4.0	3.1
Average nominal interest rate on public debt (in percent) 6/	13.0	12.5	8.0	8.5	10.0	13.6	3.8	6.6	6.6	6.7	6.8	6.9	7.0	7.1	7.2	7.0	6.7
Average real interest rate	6.1	6.0	6.6	6.3	5.5	6.1	0.3	7.2	5.7	5.5	5.5	5.3	4.9	6.3	5.2	4.9	5.7
Nominal appreciation (increase in US dollar value of local currency, in percent)	-15.0	0.2	2.8	-8.5	-6.8	-5.1	5.1	4.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7
Inflation rate (GDP deflator, in percent)	6.9	6.5	1.4	2.2	4.5	7.5	3.9	-0.7	-1.0	1.3	2.0	2.0	2.0	2.0	2.0	2.0	0.9
Growth of real primary spending (deflated by GDP deflator, in percent)	1.9	1.5	5.2	5.3	3.1	4.0	2.8	-2.0	0.3	2.3	3.5	3.7	4.0	3.9	3.9		2.0
Primary deficit	-2.7	-1.8	-3.8	-1.8	-0.9	-2.2	1.1	-0.2	-1.7	-2.7	-2.7	-2.7	-2.7	-2.7	-2.7		-2.1
									II. Stress Tests for Public Debt Ratio								**Debt stabilizing primary balance 9/**
A. Alternative Scenarios																	
A1. Key variables are at their historical averages in 2004-10 7/								**106.5**	**105.0**	**104.9**	**105.1**	**105.2**	**105.4**	**105.2**	**104.8**		**2.8**
A2. Primary balance under no policy change in 2004-10								**106.5**	**110.3**	**112.1**	**113.2**	**114.0**	**114.8**	**115.2**	**115.6**		**1.5**
A3. GDP growth is 1 percent 2004-10								**106.5**	**110.2**	**111.9**	**113.5**	**115.0**	**116.7**	**118.0**	**119.3**		**5.3**
B. Bound Tests																	
B1. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								**106.5**	**116.7**	**128.7**	**133.1**	**137.4**	**141.7**	**145.7**	**149.7**		**2.0**
B2. Primary balance is at historical average minus two standard deviations in 2004 and 2005								**106.5**	**110.3**	**112.3**	**111.1**	**109.8**	**108.3**	**106.6**	**104.8**		**1.6**
B3. One time 30 percent real depreciation in 2004 8/								**106.5**	**119.5**	**118.9**	**117.8**	**116.5**	**115.1**	**113.4**	**111.8**		**1.7**

1/ General government gross debt.
2/ Derived as [(r - ÷5] ┌g÷- g + ÷5] ┌ r÷]/(1+g+÷+g÷)) times previous period debt ratio, with r = interest rate; ÷ = growth rate of GDP deflator; g = real GDP growth rate; ÷ = share of foreign-currency denominated debt; and ÷ = 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 - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ÷5(1+r).
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/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
9/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table 7. Israel: External Debt Sustainability Framework, 1998-2010
(In percent of GDP, unless otherwise indicated)

	Actual								Projections							
	1998	1999	2000	2001	2002			2003	2004	2005	2006	2007	2008	2009	2010	
									I. Baseline Projections							Debt-stabilizing non-interest current account 7/
1 **External debt**	56.2	60.3	56.4	57.7	65.2			**63.3**	**64.5**	**64.1**	**63.1**	**61.9**	**60.4**	**58.9**	**57.3**	**1.5**
2 Change in external debt	2.8	4.0	-3.9	1.3	7.5			-1.8	1.2	-0.4	-1.0	-1.2	-1.5	-1.5	-1.5	
3 Identified external debt-creating flows (4+8+9)	-3.3	-3.2	-11.3	2.5	5.7			-0.9	0.6	0.1	-0.3	-0.4	-0.5	-0.7	-0.7	
4 Current account deficit, excluding interest payments	-2.1	-2.2	-3.1	-1.6	-1.9			-3.5	-3.3	-3.1	-3.3	-3.4	-3.2	-3.4	-3.3	
5 Deficit in balance of goods and services	3.3	3.2	0.2	3.2	4.2			2.2	1.7	2.2	1.3	0.9	0.4	-0.2	-0.7	
6 Exports	31.3	36.1	40.3	35.4	37.0			38.9	41.2	43.0	44.1	44.8	45.4	46.0	46.6	
7 Imports	34.7	39.3	40.5	38.6	41.2			41.1	42.8	45.2	45.4	45.7	45.8	45.8	45.9	
8 Net non-debt creating capital inflows (negative)	-2.9	-3.2	-6.4	0.4	1.2			0.2	2.1	2.0	2.0	2.1	2.0	2.1	2.0	
9 Automatic debt dynamics 1/	1.7	2.1	-1.9	3.7	6.4			2.4	1.7	1.1	1.0	0.9	0.7	0.6	0.6	
10 Contribution from nominal interest rate	3.4	3.6	3.7	3.2	3.3			3.2	3.2	3.2	3.2	3.1	3.0	2.9	2.9	
11 Contribution from real GDP growth	-1.7	-1.5	-4.1	0.5	0.5			-0.8	-1.5	-2.1	-2.1	-2.2	-2.3	-2.3	-2.3	
12 Contribution from price and exchange rate changes 2/	0.1	0.0	-1.5	0.0	2.7			...	...	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	6.0	7.2	7.4	-1.1	1.8			-0.9	0.6	-0.5	-0.7	-0.8	-1.0	-0.9	-0.8	
External debt-to-exports ratio (in percent)	179.4	166.8	139.7	162.9	176.2			163.0	156.8	149.2	143.2	138.2	133.2	127.9	122.9	
Gross external financing need (in billions of US dollars) 4/	29.7	31.0	32.8	32.8	33.6			33.9	35.0	36.4	37.5	38.8	40.3	41.4	42.9	
in percent of GDP	28.7	29.9	28.6	29.1	32.4	10-Year Historical Average	10-Year Standard Deviation	31.2	31.7	31.5	30.8	30.1	29.5	28.5	27.8	Projected Average
Key Macroeconomic Assumptions																
Real GDP growth (in percent)	3.3	2.6	7.5	-0.9	-0.8	3.9	3.2	1.3	2.5	3.4	3.5	3.7	4.0	4.1	4.1	3.1
GDP deflator in US dollars (change in percent)	-3.0	-2.3	2.9	-0.9	-7.3	0.7	4.9	3.5	-1.0	1.3	2.0	2.0	2.0	2.0	2.0	1.6
Nominal external interest rate (in percent)	6.3	6.5	6.7	5.5	5.2	6.9	1.2	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Growth of exports (US dollar terms, in percent)	4.4	15.6	23.6	-13.8	-3.9	7.5	10.6	10.1	7.4	9.4	8.3	7.5	7.5	7.7	7.6	8.4
Growth of imports (US dollar terms, in percent)	-3.5	13.6	14.2	-6.6	-1.8	5.8	8.4	4.6	5.8	10.4	6.1	6.5	6.3	6.3	6.3	6.6
Current account balance, excluding interest payments	2.1	2.2	3.1	1.6	1.9	0.7	1.8	3.5	3.3	3.1	3.3	3.4	3.2	3.4	3.3	3.3
Net non-debt creating capital inflows	2.9	3.2	6.4	-0.4	-1.2	2.9	2.5	-0.2	-2.1	-2.0	-2.0	-2.1	-2.0	-2.1	-2.0	-1.8
									II. Stress Tests for External Debt Ratio							Debt-stabilizing non-interest current account 6/
A. Alternative Scenarios																
A1. Key variables are at their historical averages in 2004-10 5/								**63.3**	**61.1**	**59.2**	**57.4**	**55.4**	**53.3**	**51.2**	**49.0**	**3.2**
A2. Country-specific shock in 2004, with reduction in GDP growth (relative to baseline) of one standard deviation 6/								**63.3**	**65.5**	**66.6**	**67.2**	**67.6**	**68.0**	**68.3**	**68.5**	**3.7**
A3. Selected variables are consistent with market forecast in 2004-10								**63.3**	**64.5**	**64.1**	**63.1**	**61.9**	**60.4**	**60.2**	**60.6**	**1.5**
B. Bound Tests																
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005								**63.3**	**67.1**	**69.3**	**68.3**	**67.0**	**65.5**	**63.9**	**62.4**	**1.5**
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								**63.3**	**68.0**	**72.1**	**71.3**	**70.3**	**69.1**	**67.7**	**66.4**	**1.7**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005								**63.3**	**69.1**	**75.1**	**74.6**	**73.8**	**72.7**	**71.6**	**70.5**	**1.9**
B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005								**63.3**	**70.7**	**76.3**	**75.2**	**73.9**	**72.3**	**70.7**	**69.0**	**1.4**
B5. Combination of 2-5 using one standard deviation shocks								**63.3**	**74.3**	**87.2**	**85.9**	**84.5**	**82.7**	**80.8**	**78.9**	**1.6**
B6. One time 30 percent nominal depreciation in 2004								**63.3**	**86.4**	**87.1**	**87.1**	**86.8**	**86.1**	**85.4**	**84.6**	**2.2**

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

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

3/ For projection, line includes price and exchange rate changes

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ The implied change in other key variables under this scenario is discussed in the text.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last proje

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Fund Relations

(As of December 31, 2003)

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	573.42	61.78
Reserve position in Fund	354.79	38.22

III. **SDR Department**: **Allocation**

	SDR Millions	%
Net cumulative allocation	106.36	100.0
Holdings	6.39	6.01

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

V. **Financial Arrangements**: None

VI. **Projected Payments to Fund**:

	Forthcoming				
	2004	2005	2006	2007	2008
Principal					
Charges/Interest	1.58	1.58	1.58	1.58	1.58
Total	1.58	1.58	1.58	1.58	1.58

VII. **Implementation of HIPC Initiative**: Not applicable

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 February 3, 2004, the width of the band, based on the average of the upper and lower limits, was 57.1 percent.

X. **Article IV consultation**:

The last Article IV consultation was concluded on March 7, 2003. 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).

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. The methodology underlying the reported overall annual fiscal balance is not in conformity with internationally accepted practice as interest costs exclude the inflation component of such payments. The authorities are gradually moving toward the methodology that is standard in other countries, so that 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 4, 2004)

	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	2/4/04	Jan. 2004	Jan. 2004	Oct. 2003	Oct. 2003	2/4/04	Dec. 2003	Dec. 2003	Q3 2003	Jan. 2004	Q3 2003	Q3 2003
Date Received	2/4/04	2/2/04	1/31/04	Jan. 14, 2004	1/14/04	2/4/04	1/15/04	1/12/04	12/16/03	2/3/04	1/4/04	12/16/03
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
April 19, 2004

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. The authorities approved the changes to the budget mentioned in the Staff Report. The amendments amount to almost NIS 5 billion (about 1 percent of GDP) and include a NIS 1.6 billion supplement to the defense budget and NIS 1.3 billion to local municipalities. The supplements will be financed by reducing the contingency reserves by about NIS 2.8 billion and by a uniform 6% cut in all ministry procurement budgets.

3. The Bank of Israel (BoI) reduced its policy rate by 0.2 percentage points in both March and April to 4.1 percent. The BoI stated that this reduction in the interest rate was made possible by the continued calm in financial markets, the actual reduction in the Consumer Price Index last year, and the continued moderate level of activity in the economy which is emerging from recession.

4. In early April, the Ministry of Finance announced a plan to reduce taxation amounting to about ¼ percent of GDP in 2004. The plan is expected to become effective in the third quarter and consists of decreasing income taxes for middle and lower wage earners, lowering the corporate tax rate from its current level of 36 percent to 30 percent by 2007, and reducing customs duties on various construction goods.

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IMF Concludes 2003 Article IV Consultation with Israel

On April 19, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the 2003 Article IV consultation with Israel.[1]

Background

The economy has entered a modest recovery path, after almost three years of recession. Led by external demand, real GDP is estimated to have grown 1.3 percent in 2003, despite anemic investment. Furthermore, high frequency indicators suggest that output is recovering, private consumption is growing, and tourism is rebounding.

A major change of policy took place around mid year and contributed to a restoration of confidence and helped instill a moderate if potentially fragile recovery. A new coalition government took office in February 2003 and soon thereafter it presented a program designed to return to a path of declining deficits and public debt. In addition, key structural reforms were launched, including reforming the pension system, streamlining the public sector, reducing taxes, and speeding up privatization.

Notwithstanding the budgetary adjustments, the deficit reached 5.6 percent of GDP in 2003, compared to a target of 3 percent in the budget, and public debt rose to about 107 percent of GDP by the end of the year.

The formulation of an emergency economic program in March, the ending of the major conflict in Iraq, some progress in the security situation, the rebound in world stock markets (particularly

[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 Executive Board discussion based on the staff report.

the NASDAQ), and the decision by the United States to extend nearly US$9 billion in loan guarantees contributed to an upturn in financial markets since April 2003. A notable resurgence in financial markets also took place in 2003: the stock market surged, long-term rates declined, and the sheqel recovered.

Inflationary pressures have eased considerably. The Consumer Price Index declined 1.9 percent during 2003, compared with a 6.5 percent increase during 2002, and inflation expectations fell to below the lower inflation target bound of one percent. The drop in inflation and in its expectations to within the inflation target range, the enhanced fiscal commitment and the strengthening of financial markets prompted the Bank of Israel (BoI) to lower its policy interest rate from close to 9 percent during the first half of 2003 to 4.5 percent by February of 2004.

The recession worsened the already burdened labor market and welfare system. The unemployment rate rose from 8.5 percent in early 2001 to 10.7 percent in November 2003, while the share of long-term unemployed (jobless for more than six months) in total unemployment reached 40 percent.

The external current account deficit continues to fall and is now close to balance. The sizeable capital outflow of the last quarter of 2002 and the first quarter of 2003 has been reversed, and foreign direct investment rebounded. Total gross external debt is about 60 percent of GDP, but net external debt is negative and international reserves (amounting to nearly US$26 billion at end-2003) cover most short-term debt.

The banking system has strengthened in 2003. While problem loans continue to grow, albeit at a reduced pace, and loan concentration is high (although significantly reduced from a year ago), positive signs have emerged: profitability has increased, capital adequacy ratios have improved, and provisions relative to non-performing loans have risen substantially.

Executive Board Assessment

Executive Directors welcomed the economic program of consolidation and reform the Israeli authorities have put in place over the past year. This has allowed a needed rebalancing of the policy mix which, together with the rebound in the global economy and a return of market confidence, has laid the ground for a gradual economic recovery after three years of recession. At the same time, Directors cautioned that establishing the basis for stronger and more sustained medium-term economic growth remains a challenge going forward. Meeting this challenge will require a steady and consistent policy stance complemented with a steadfast implementation of structural reforms and a stronger commitment to debt reduction. Directors recognized that prospects for stronger and more durable economic recovery also depend on improved security conditions.

Directors welcomed the authorities’ renewed commitment to fiscal discipline. They considered that the 2004 budget strikes an appropriate balance between fiscal consolidation, on the one hand, and the need to support the recovery, on the other. However, given that the public debt as a share of GDP and the budget deficit still remain high against the backdrop of an uncertain economic environment, most Directors recommended that any revenue windfall be used to lower the deficit and the public debt. In this regard, they expressed disappointment at the

authorities' recent decision—based on higher-than-budgeted revenue collection—to reduce taxes, as this will not allow for a much-needed faster pace of debt reduction.
Directors welcomed the authorities' commitment to re-establish declining paths for the public debt, budget deficit, and expenditure ratios. They commended the authorities for adopting a limit of one percent on expenditure growth in real terms and a ceiling of 3 percent of GDP on the overall deficit for 2005-10. Directors called on the authorities to adhere strictly to this medium-term framework in order to help achieve their goals of gradually reducing the public debt as a share of GDP and the size of the public sector, while allowing for a reduction of the tax burden.

Directors recommended that the authorities take several structural measures that would enhance the credibility of the fiscal adjustment process and cushion market reaction to temporary setbacks. These include formulating a detailed medium-term spending plan consistent with the adopted expenditure limits, and preparing semi-annual reports on progress made in achieving the government's public finance goals and reform objectives.

Directors expressed concern about the high rate of unemployment, notwithstanding a labor market participation rate that is low relative to other developed economies. Reforms are needed to raise the incentive to work, and to better target welfare policy to the truly disadvantaged. In this vein, Directors welcomed the cuts in social benefits to those fully able to work. They urged the authorities to complement this reform with measures to enhance job training and education, in order to assist the unemployed and those affected by the social benefit cuts to adapt more quickly to the requirements of the job market. Directors noted that the broad-based reforms being pursued in the product markets, including measures to increase competition in the business sector by dismantling monopolies and streamlining bureaucracy, should also contribute to improving employment prospects in the medium term.

Directors welcomed the relaxation of monetary policy, as upside inflationary risks appear modest. Noting that real interest rates remain relatively high, most Directors encouraged the BoI to continue lowering its policy rate gradually, while closely watching developments in the exchange and financial markets. Directors supported the view that the BoI law should be amended to strengthen the central bank's independence and reflect international best practice regarding monetary policy objectives and procedures, so as to enhance confidence and minimize the risk that temporary breaches of inflation targets could unhinge expectations.

Directors welcomed the indications of a strengthening of the banking system in 2003, with improvements in banks' capital adequacy ratios, provisioning for nonperforming loans, and profitability. They also welcomed the enhancement in banks' monitoring and risk-management systems stemming from the initiative of the Supervisor of Banks. At the same time, they noted that problem loans continue to grow—albeit more slowly than in previous years—and loan concentration is high, suggesting a need for continued vigilance on the part of the bank regulatory authorities.

Directors agreed that Israel's external vulnerability has declined, with exports to all major markets recovering, the current account moving to close to balance, foreign direct investment rebounding, the level of foreign reserves adequate, and net external debt negative.
They considered that the current floating exchange rate system remains appropriate, and external competitiveness appears to be sound.

Directors observed that Israel meets the Special Data Dissemination Standard specifications for coverage, periodicity, and timeliness of the 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 c onclusion 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

	1999	2000	2001	2002	2003
National account indicators (constant prices)					
Real GDP	2.6	7.5	-0.9	-0.8	1.3
Private consumption	4.2	7.6	3.2	0.1	1.7
Public consumption	2.9	2.2	3.4	5.7	-1.8
Gross capital formation	6.7	-2.9	-4.9	-12.4	-13.4
Exports of goods and services	12.0	24.0	-11.5	-3.0	6.1
Imports of goods and services	14.9	12.2	-4.5	-2.3	-2.3
Labor market indicators					
Unemployment rate (in percent)	8.9	8.8	9.3	10.3	10.7
Prices (end-period)					
Overall CPI	1.3	0.0	1.4	6.5	-1.9
Underlying CPI (excluding housing, fruits and vegetables)	1.7	0.9	0.2	6.3	-0.6
Money and credit (period average)					
Narrow money (M1)	9.6	11.0	14.2	15.6	0.5
Broad money (M3)	21.2	16.9	15.5	6.1	2.2
Domestic credit	34.9	16.4	10.8	10.5	1.7
Interest rates (average, in percent)					
Bank of Israel policy rate	12.1	9.3	6.8	6.8	7.5 1/
Public finance (percent of GDP)					
Central government balance	-1.8	-0.2	-4.3	-3.6	-5.6
General government balance	-4.2	-2.1	-4.1	-4.5	-6.1
Public debt	101.4	91.4	96.4	104.9	107.4
Balance of payments					
Trade balance (percent of GDP)	-4.1	-2.5	`-2.7	-3.6	-2.4
Current account (percent of GDP)	-1.5	-0.6	-1.6	-1.3	-0.2
Foreign reserves (end-of-period, in billions of U.S. dollars)	22.6	23.3	23.4	24.1	26.3
Exchange rate indices					
Nominal effective exchange rate (period average; depreciation -)	-7.7	9.1	0.7	-13.5	-7.0
Real effective exchange rate (period average; depreciation -)	-3.8	8.0	-0.3	-10.0	-7.9

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

1/ The Bank of Israel set the policy rate at 4.1 percent in April 2004.