April 2005
IMF Country Report No. 05/133

**Israel: 2004 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 2004 Article IV consultation with Israel, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 20, 2004, 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 March 1, 2005. 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 21, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 21, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Israel.

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

Selected Issues Paper

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**
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INTERNATIONAL MONETARY FUND

ISRAEL

**Staff Report for the 2004 Article IV Consultation**

Prepared by Staff Representatives for the 2004 Article IV Consultation with Israel

Approved by Ajai Chopra and Martin Fetherston

March 1, 2005

- Consultation discussions were held in Jerusalem and Tel Aviv during December 8–20, 2004. The staff team—Messrs. Haas (head), Epstein, Mehrez and Ms. Ohnsorge (all EUR), and Mr. Pratt (MFD expert)—met with Minister of Finance Netanyahu, 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). It subscribes to the SDDS and is in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars. The exchange rate regime is free of restrictions on the making of payments and transfers for current international transactions.[1]

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

[1] 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.

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## EXECUTIVE SUMMARY

***Economic recovery is underway after a prolonged recession.*** Growth is supported by more favorable global economic conditions, an improvement in the security situation, and appropriate policies, which have involved tightening the fiscal stance and easing monetary policy somewhat**.** Real GDP grew by an estimated 4.3 percent in 2004, with exports and private consumption leading the way. The economy is expected to continue to strengthen, albeit at a slightly lower growth rate this year. Unemployment remains high, but is on a declining path. The exchange rate is stable and inflation is low.

***Continued fiscal consolidation is essential.*** The authorities face the difficult task of adhering to the strategy of reducing the government size and public debt. In order to pay down the debt faster, the authorities should refrain from unplanned tax cuts should revenue over perform. Over the medium term the authorities need to strictly observe the deficit target of 3 percent of GDP and limit expenditure growth, in real terms, to no more than 1 percent a year.

***The easing of the monetary stance was appropriate, but there is further scope for strengthening the implementation of monetary policy in the inflation targeting regime.*** The authorities should continue to enhance transparency regarding their views about the inflationary environment and the Bank of Israel law should be updated.

***Development of the capital markets should be promoted by a wide range of measures.*** The authorities are already in the process of removing barriers to such development. The plan to require banks to divest themselves of mutual and provident funds could strengthen competition, but goes against trends elsewhere towards universal banking and entails risks. Improving the regulatory framework and strengthening supervisory enforcement will hence need to be an important part of the package.

***The authorities' commitment to boost competition and efficiency have laid the foundations for future growth and enhanced market confidence.*** Welfare reform will improve the functioning of the labor market, privatization will improve competition and market efficiency, tax reform will increase competitiveness, and pension reform should aid the development of the capital market.

## I. INTRODUCTION

1. **After nearly three years of depressed activity, growth has rebounded, supported by a favorable global environment, improvement in the security situation, and appropriate policies (Box 1).** Over the medium term, growth is projected to be around 4 percent, a rate that, by itself, is insufficient to significantly reduce either the high unemployment rate or the substantial public debt (relative to GDP), both of which deteriorated substantially during the recession years. The key challenges facing Israel are to adhere to the ambitious agenda of limiting the fiscal deficit and thereby reducing the size of the public debt, to further reform the labor market to increase employment, and to carefully promote the development of the capital markets.

**Box 1. Fund Policy Recommendations and Implementation**

**Fiscal consolidation:** During the 2003 Article IV consultation, the Executive Board considered the 2004 fiscal stance to be broadly appropriate. However, Directors noted that given the high public debt as a share of GDP it was important that any windfall revenues be used to lower the deficit and curb the public debt. In the event, the authorities' decided to reduce taxes, based on higher revenue collection than budgeted.

**Monetary policy:** Consistent with the Fund's recommendation last year, the BoI continued to gradually lower its policy rate and has taken steps to increase the transparency of its semi-annual Inflation Report, including by giving more attention to the dynamics of future inflation.

**Structural fiscal reforms:** During the 2003 Article IV consultation, Directors stressed a number of steps that the government should take to enhance the credibility of the fiscal adjustment process, including the adoption of a medium term spending plan and semi annual reports on achieving other public finance goals. The authorities are concerned about loss of budget flexibility, but have agreed in principle to explore these recommendations further.

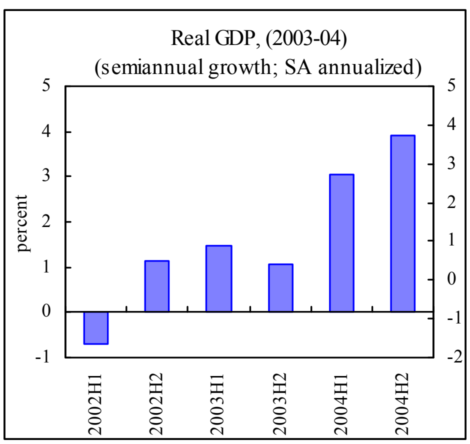
**Labor market reforms**: These are proceeding in line with previous recommendations. The authorities are in the process of complementing the reduction in welfare benefits with steps such as increasing job training and education, in order to assist the rapid absorption of the unemployed and income support recipients in the labor market.

2. **Political uncertainty surrounding the Gaza disengagement plan has altered the make-up of the coalition government and delayed the approval of the 2005 budget**. In early 2004, Prime Minister Sharon officially presented a plan to withdraw from Gaza. Although the plan passed in the Knesset by a large margin, some members of the coalition did not support the plan, forcing PM Sharon to form a new coalition with the Labor party. While the Knesset approved the 2005 budget on its first reading, uncertainty remains about

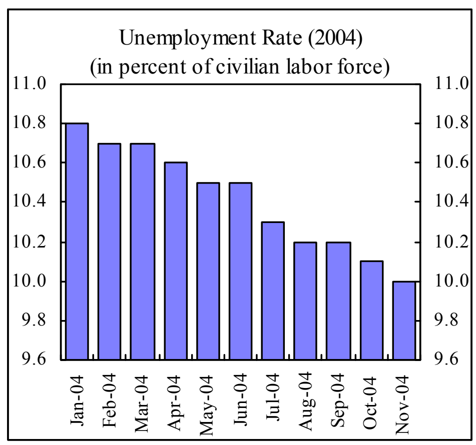
whether the coalition will muster enough support to pass the budget on its final reading. In the meantime, the government is operating using the 2004 budget framework which allows 1/12 of that budget to be spent each month. If the Knesset fails to pass the budget by March 31, new elections must be held within 3 months.

## II. THE CURRENT SETTING AND OUTLOOK

3. **The upturn in economic activity began in mid 2003 and strengthened in 2004; the economy grew by an estimated 4.3 percent in 2004 with exports and private consumption leading the way (Figure 1).** Exports surged by 14.6 percent (year-on-year), led by the rapid growth of high tech exports in an improved global environment and a rebound in tourism as the security situation improved (Figure 2). Private disposable income increased with rising employment, pushing up private consumption by 5.2 percent. Despite these positive signs, fixed investment remains weak, reflecting continued uncertainty about the global environment as well as the political and security situation, limited construction, and a low domestic savings rate. Furthermore, unemployment and labor market participation rates, while responding to the economic recovery and welfare reforms, are still worrisome at 10 and 54.5 percent, respectively.



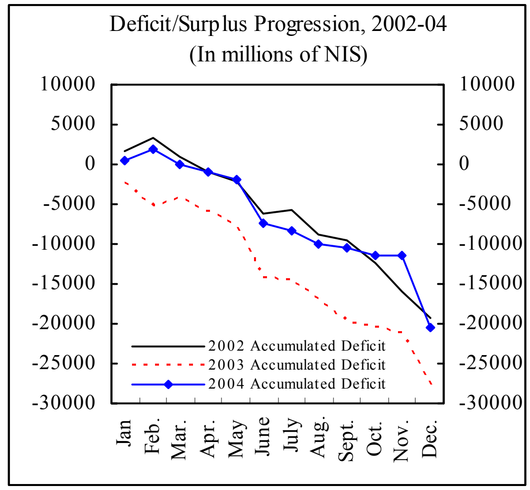

Source: Central Bureau of Statistics.



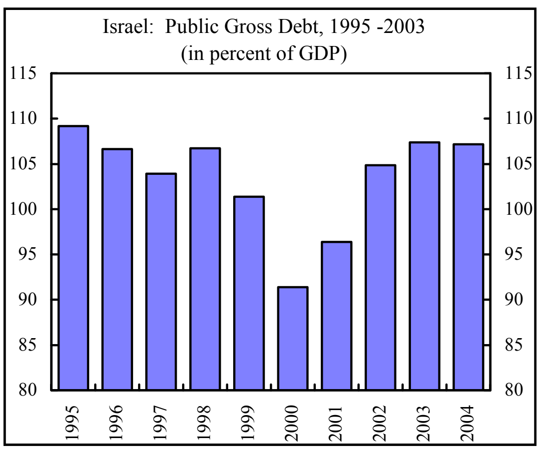

Source: Central Bureau of Statistics.

4. **The recovery has proceeded hand in hand with a consolidation of the fiscal stance, an easing of monetary policy, and the implementation of key structural reforms**. The government is establishing a credible commitment to maintain future deficits below

three percent of GDP and to limit government expenditure growth, in real terms, to no more than one percent a year. The 2004 budget deficit reached 3.9 percent of GDP.[2] Although such a deficit is still relatively high, particularly in light of the large public sector debt— about 105 percent of GDP—it represents a marked improvement compared to 2003 when the deficit was 5.6 percent of GDP. The fiscal effort is noteworthy because, in large part, it is based on curtailing government expenditures, which were estimated to decline by 2.4 percent of GDP in 2004 (Table 2).




Source: Ministry of Finance



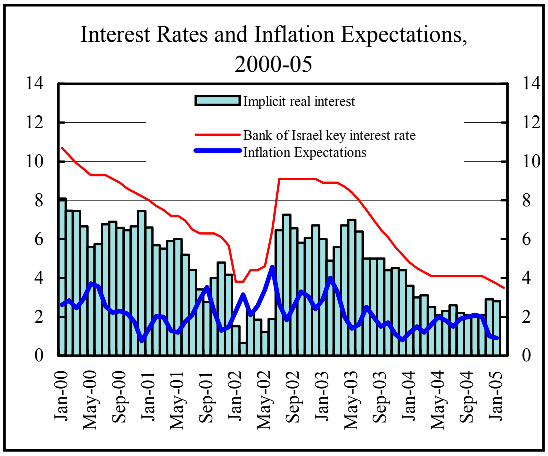

Source: Data from Israeli authorities.


Source: Data from Israeli authorities.

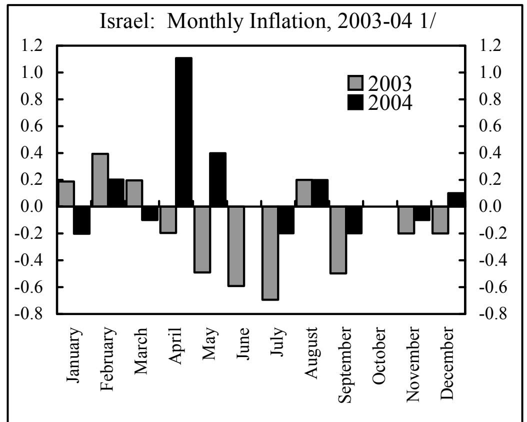
5. **The relaxation of monetary policy continued during the first few months of 2004 and, again, more recently.** The BoI continued the gradual reduction of its policy rate, lowering it from 5.2 percent in December 2003 to 4.1 percent in April 2004. The BoI kept the rate unchanged for the next six months arguing that inflation expectations were in the middle of the 1–3 percent target range. However, despite a one-off price increase in April, CPI inflation in 2004 was close to the lower bound of the inflation target (Figure 3). Subdued inflation against a background of sheqel appreciation during the second half of the year

[2] The deficit would have been lower, perhaps by an estimated 0.5 percent of GDP, had the government not decided in early 2004 to use revenue-over-performance to lower taxes.

prompted the BoI to lower its policy rate by 20 basis points in December 2004 and again in January and February of 2005 to 3.5 percent.




Source: Bank of Israel.




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

6. **While rebalancing their macroeconomic policy mix, the authorities have also embarked on structural reform policies aimed at boosting competition and efficiency.** Privatization of the national airline (El–Al) and the shipping entity Zim was completed in 2004, the sale of the third largest bank, Bank Discount, was finalized early this year, and the government has taken steps towards privatizing the telephone monopoly, ports, oil refineries, and water and electricity distribution. In addition, pension reform has improved the solvency of the system and should aid the development of capital markets, and welfare reform reduced expenditures and decreased distortions in the labor market.

7. **The authorities are in the process of reducing the dominance of the two largest banks in order to improve the capital market.** They have long been concerned that domination of the financial system by the banks restricts competition and inhibits the capital market (Box 2). Early in 2004, the government formed a high-level committee to address these issues (the Bachar committee), and their report was made public late in the year. The key recommendations include requiring banks to divest themselves of their mutual and provident fund activities and restrictions on the maximum market share of individual firms.

8. **Most financial soundness indicators for the banking system have improved, albeit marginally, due to the strengthened macroeconomic environment**. While the quality of banks' loan portfolios has yet to improve, we expect it to strengthen further as the recovery takes hold.

Israel: Banking Soudness Indicators--Five Largest Banking Groups, 2000-2004 1/
(in percent)

| | 2001 | 2002 | 2003 | Q2 2004 |
|---|---|---|---|---|
| Asset growth (12-month percent change) | 6.9 | -0.3 | 1.3 | 2.2 |
| Credit growth (12-month percent change) 2/ | 10.1 | 0.9 | -3.0 | 1.0 |
| After-tax return on equity 3/ | 5.9 | 2.3 | 7.4 | 12.4 |
| Problem loans to total loans ratio 3/ | 8.4 | 9.8 | 10.5 | 10.6 |
| Capital to risk-weighted assets ratio 3/ | 9.4 | 9.8 | 10.2 | 10.7 |

Source: Bank of Israel.

1/ Five largest according to assets (Hapoalim, Leumi Le, Discount, United Mizrah, First International). On a consolidated basis.
2/ Credit to the public.
3/ Unweighted average.

## Box 2. Israel's Capital Markets

*This box provides an overview of the current Israeli financial system, which is dominated by banks that provide most of the financing for the private sector; while capital markets are relatively undeveloped. The factors that have inhibited capital market development and the various actions the authorities have taken – and are taking – to address the situation are also discussed.*

**The financial system in Israel is highly concentrated among three banks, particularly within the largest two (Hapoalim and Leumi)**. By end-2003, the largest three banks (Hapoalim, Leumi and Discount) had 78 percent of bank deposits, managed 80 percent of mutual fund assets and 85 percent of provident fund[3] assets, and dominated the underwriting of new equity issues. More generally, the banking system provides 95 percent of all financing to the private sector, whether in the form of credit, investments through mutual funds, or the underwriting of corporate financing.[4]

**Table: Market Share of Leading Entities According to Activity Area**
(December 2003)[5]

| Banking | Mutual funds | Provident funds | Underwriting |
|---|---|---|---|
| Public's deposits (percent) | Managed assets (percent) | Managed assets (percent) | No. of issues* (percent) |
| Bank Hapoalim -- 30 | Hapoalim -- 36 | Hapoalim -- 40 | Hapoalim -- 46 |
| Bank Leumi -- 30 | Leumi -- 31 | Leumi -- 35 | Leumi -- 42 |
| Bank Discount (IDB) -- 18 | IDB -- 13 | IDB -- 15 | IDB -- 11 |
| **Total = 78** | **80** | **85** | **99** |

* Out of total issues (private and public) in the period between January 2002 and August 2003.

**The capital markets, particularly the corporate bond and money markets, remain underdeveloped and unbalanced.** The corporate bond market accounts for only 3 percent of GDP (2003), and the size of the money market is also relatively small. In contrast, a wide variety of non-tradable and tradable government securities dominate the fixed income markets. Other instruments that are common in other developed markets, such as real estate investment trusts, municipal bonds, funds of funds, and foreign based mutual funds are largely absent from the Israeli capital markets. Finally, total market capitalization of the Tel Aviv Stock Exchange, equivalent to about 39 percent of GDP, is also small in comparison to other advanced economies (e.g., in recent years, the equivalent figures were about 110% for France, 60% for Germany; 70% for Italy, 150% for the U.S. and 185% for the U.K.).

**Specific factors appear to have frustrated the development of the Israeli capital markets:** First, the extent of government bonds and the allocation of non-traded real indexed bonds to institutional investors have reduced the demand for alternative assets and risk management and diverted the supply of institutional savings. Second, a 35 percent tax on investment in foreign securities made foreign mutual funds relatively unattractive, as has the requirement that such funds register in Israel and meet local prospectus requirements. Third, Israeli prospectus requirements more generally may have added high fixed costs that discouraged the development of the corporate bond market and asset-backed securities. Fourth, legislation did not permit municipal bonds or funds of funds. Fifth, the rights of participants in REPO transactions are not well defined. Sixth, the bankruptcy law appears outdated. Finally, high costs associated with the issuance of corporate paper have frustrated a more rapid development of that important market.

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[3] A provident fund is a long term investment, which enjoys tax incentives designed to encourage long term savings for contingencies such as hospitalization, redundancy and retirement.
[4] Inter Ministerial Committee Report on Structural Reform in the capital market headed by Dr Yosef Bachar, Director General of the Ministry of Finance, published November 2004 (Inter Ministerial Committee Report).
[5] Source: Inter Ministerial Committee Report.

**The authorities have recently taken actions to remove the barriers to the development of new products and to enhance the development of capital markets in general.**

- The pension reform has started a process of reducing the proportion of pension funds held in non-tradable government bonds (see table below) and established professional managers for the old and under-capitalized funds.
- The new pension funds that were controlled by the old pension funds were recently sold to insurance companies and brokerage firms.
- The authorities have introduced a new law that clarifies the rules governing market makers for government bonds. Additionally, the Tel Aviv Stock Exchange recently designated one bank to act as a market maker in foreign currency derivative products.
- The authorities are in the process of removing barriers that would simplify and reduce the costs associated of issuing corporate paper.
- The authorities amended important regulatory changes in banking, such as the limit on a bank's credit to a single borrower and a directive aimed at improving the management of liquidity risks.
- The commission structure for insurance was reformed in a way that introduces greater transparency and incentives for insurance companies and their agents to sell mutual and provident funds.
- The government has proposed legislative and regulatory changes to encourage corporate bonds, short term commercial paper, foreign funds, funds of funds, real estate investment trusts, exchange traded funds and other instruments.
- The government is putting in place measures designed to encourage customers to switch more readily between banks.
- The authorities are moving towards the introduction of International Financial Reporting Standards.
- The regulators have shown a determination to enforce the regulatory regime and the requirements designed to deal with conflicts of interest, in a way that has been successfully achieved elsewhere.
- The tax reform of reducing and equalizing the tax rates applied to securities traded abroad with those traded in Israel, which took effect in January 2005, removes a key obstacle for the entry of foreign mutual funds.

**Indeed, the development of the capital markets appears to have accelerated recently, albeit from a very small base.** The corporate bond market has significantly increased since 2000, with an increase in both issuance and a shift of institutional investors from non-traded government bonds to corporate bonds. This trend is particularly apparent at the pension funds where there have been falling share of government bonds and rising share of corporate bonds.

**Government and Corporate Bond Holdings (percent of total assets)***

| | Old Pension Funds<br>Gov. / Corp. | New Pension Funds<br>Gov. / Corp. | Provident Funds<br>Govt. / Corp. |
|---|---|---|---|
| 2000 | 94.5 / 0.4 | 84.4 / 3.0 | 44.8 / 11.0 |
| 2001 | 94.7 / 0.4 | 83.0 / 4.1 | 46.6 / 13.0 |
| 2002 | 95.0 / 0.6 | 84.0 / 4.9 | 48.1 / 14.9 |
| 2003 | 92.7 / 1.8 | 80.7 / 8.1 | 45.5 /15.7 |
| 2004 (through end-Sept.) | 91.1 / 3.2 | 76.1 /11.0 | 43.5 / 18.5 |

*Source: Bank of Israel

9. **The sheqel has been relatively stable over the past year, balanced by the drop in interest rates on the one hand, and the rebound in economic activity on the other (Figure 4)**. In principle the exchange rate system in Israel is a crawling peg; in practice the bands around the peg are sufficiently wide that the system is effectively a float consistent with the inflation targeting regime the BoI has adopted. Indeed, since 1997, the BOI has not intervened in the foreign exchange market to influence the exchange rate. This system has

served the country well. Owing largely to the low inflation rate, competitiveness has improved somewhat as evidenced by a depreciation of the real effective exchange rate, and has remained in line with economic fundamentals. The decline in interest rates prompted some short-term capital outflows, but these were offset by long-term capital inflows attracted by the improved outlook. Moreover, the implied volatility of the NIS/US$ exchange rate, based on the pricing of put and call options, has been low, and Israel's risk premium, as measured by the yield spread on its 10 year foreign-currency denominated sovereign bonds, has remained low at about 75 basis points over U.S. treasuries.[6]

10. **Key external vulnerability indicators suggest that near-term balance of payments risks are manageable.** The current account remains near balance and the net external asset position is $12 billion. Foreign reserves—totaling around US$26 billion—cover 91 percent of gross short-term external debt. About 43 percent of total external public debt is held by the Jewish Diaspora (33 percent) or backed by U.S. government guarantees (10 percent), while short-term external public debt is very low at roughly 2 percent of GDP, all of which mitigate rollover risks.

11. **Israel has taken steps to reduce tariffs and non-tariff barriers.** In 2004, some tariffs were cut and import licensing requirements were reduced. Tariffs remain for certain goods, e.g., electronics, wood and agricultural products, but the authorities plan to further reduce them. Most trade is already covered by bilateral free trade agreements, and additional free trade agreements with neighboring countries are under consideration.

12. **While there was a consensus between the authorities and the mission that near- and medium-term outlook is favorable, there are several downside risks.** After the strong rebound in 2004, real GDP growth in 2005 is expected to decelerate somewhat to just under 4 percent. In the medium-term, as the labor market situation improves after the reforms of the recent years and as productivity increases, especially in the newly privatized state monopolies, growth in the order of 4 percent is expected to be maintained. Barring external shocks, inflation is expected to remain in the target range, around 2 percent. The fiscal consolidation in 2005, accompanied by an improvement in the current account, is expected to continue in 2006, consistent with the fiscal deficit target of 3 percent of GDP. The economy remains, however, vulnerable to the possibility of a worsening global environment, especially in the market for high tech exports, political volatility in the region, and a deterioration of the security situation. Should real interest rates rise, the exchange rate depreciate rapidly, or real GDP growth slow substantially, the public-debt-to-GDP ratio risks becoming entrenched at around 110 percent or higher (Table 6), making the fiscal consolidation all the more difficult.

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[6] Recently, the rating agency S&P raised Israel's country outlook from negative to stable.

## III. Policy Discussions

13. **Discussions focused on four main areas: fiscal policy, the planned reform of the capital market, monetary policy, and the labor market.** The mission shared the authorities' view that that fiscal consolidation was essential as was the authorities' ambitious structural reform agenda. Staff was more concerned than the authorities about the high level of public sector debt and suggested that the authorities refrain from unplanned tax cuts. On promoting capital market development, the discussions focused on the various steps underway and planned, especially the need to strengthen regulation and improve enforcement if the authorities proceed as planned with the divestiture of mutual and provident funds from the banks. Staff welcomed the easing of monetary policy and urged the authorities to continue to develop their inflation forecasting tools and enhance transparency regarding their views about the inflationary environment. Finally, both staff and the authorities agreed that the welfare reform had contributed to the recent improvement in the labor market and that active labor market policies could help absorb some of the unemployed.

### A. Fiscal Policy

14. **The authorities stressed their determination to continue to reduce the size of the public sector, the tax burden, and the welfare system.** The Minister of Finance described Israel's economy as trapped between high taxation, a generous welfare system, and strong state monopolies. As a consequence, the private sector is being suffocated. To reverse that trend, the government has embarked on a series of fiscal and structural reforms aimed at reducing the public sector and its drag on private sector growth.

15. **The authorities explained that the 2005 budget, which initially adhered to the government's commitments to limit the growth in expenditures and the deficit, has been adjusted to accommodate spending associated with the Gaza disengagement plan**. After presenting a budget consistent with the government commitments to limit real expenditure growth to 1 percent and the deficit to 3 percent of GDP, the government announced its plan to raise the deficit target to 3.4 percent of GDP and real expenditure growth to 2 percent in 2005 as a one-time adjustment to accommodate the cost of the Gaza disengagement plan—estimated at about one percent of GDP.[7] The authorities are fully aware of the need to revert back to the original fiscal path in 2006. The mission agreed that a temporary—and capped—deviation of up to 0.4 percent of GDP for an exceptional expense should not raise undue concerns about the government's commitment to fiscal discipline. However, the mission argued that given the high level of public debt and in the absence of established fiscal credibility, the authorities needed to make a concerted effort to adhere to the budget framework and resist any further deviations from their fiscal targets.

[7] The cost of the disengagement plan is expected to be spread over 2005-2007.

16. **The mission took the position that the authorities should accelerate debt reduction by abstaining from further tax cuts, by broadening the tax base through the elimination of various tax exemptions, and allowing the automatic stabilizers to operate fully should revenues over perform.** The authorities agreed that more attention should be given to lowering the deficit and public debt, but maintained that the tax burden is high and that cutting taxes is essential to promote private sector led growth. The mission noted that the planned central government deficits of 3 percent of GDP would result in a decline in the public debt to GDP ratio of only about 2 percentage points a year, given current growth forecasts. Indeed, as the debt sustainability assessment shows (Table 6), the baseline scenario implies only a gradual reduction in the public debt to GDP ratio—from 105 percent today to 97 percent in four years. By contrast, if real GDP growth, real interest rate, and the primary balance were to remain at their historical averages, Israel's public debt would rise to 108 percent of GDP by 2009. The mission further argued that a more ambitious fiscal goal would help reduce interest rates, aid capital market development, and increase the scope for countercyclical fiscal policy.

17. **The mission encouraged the authorities to present a medium-term budget framework with detailed expenditure plans consistent with the overall expenditure ceiling.** International experience suggests that multi-year budget plans buttress fiscal consolidation, minimize expenditure growth, and strengthen adjustment. Furthermore, setting a multi-year budget would enhance the government's credibility, diminish political pressure to raise expenditures, and avoid allocations based on short-term budget rigidities rather than according to longer-term policy objectives. In addition, the mission recommended presenting mid-year reports covering the budget developments and progress in achieving the economic agenda. The authorities agreed, in principle, with multi-year budgeting, but were concerned that it might reduce budget flexibility.

## B. Capital Market Reform

18. **The authorities are concerned that capital markets are underdeveloped and financial markets, more generally, are subject to excessive concentration, inadequate competition, and conflicts of interest.** Corporate bond issues are very limited, there is little securitization of bank assets, and instruments that are common in developed markets—such as real estate investment trusts, municipal bonds, funds of funds, foreign based mutual funds—are almost non-existent. The mission shared the authorities' view of the current situation as well as their goal of fostering a stable, competitive financial system with a well-developed capital market.

19. **The authorities attributed the underdeveloped capital markets to the dominance of the two largest banks–Bank Hapoalim and Bank Leumi—in the financial markets.** The authorities are concerned that the dominant position of these banks has hindered the development of capital markets and exacerbated the conflicts of interest that exist in universal banking in the following ways:

- Banks, despite being legally bound to offer objective advice to investors, in practice persuade the majority of their customers to buy the mutual and provident funds in which they have a direct interest.
- Banks may encourage their customers to borrow excessively for the purpose of investment in their own funds.
- The managers of mutual and provident funds may be inclined to channel their investments to equity issues for which the bank is the underwriter.
- A bank may encourage a corporate customer in financial difficulty to repay loans to the bank using funds raised through debt or equity issues underwritten by the bank, thus transferring the risk of default by the company from the bank to the investors in its funds.

Furthermore, the authorities noted that their experience with earlier capital market reforms indicated that banks would derail gradual capital market reform measures and, therefore, it was necessary to radically restrict their activities in order to enhance capital market development and decrease concentration in the financial system.

20. **Accordingly, the authorities believe it is essential to divest banks of any holdings in mutual or provident funds**. Specifically, they note that this will reduce conflicts of interest, open the system to competition, improve the quality of financial services, increase returns on savings, and, importantly, remove major obstacles to the development of non-banking financial intermediaries. Thus, the key steps planned by the authorities to address existing deficiencies include:

- Banks would be prohibited from managing mutual and provident funds and would be obliged to sell their interests in such funds over a four-year period. There would be limits on the maximum share of the market that any buyer could acquire at the time of purchase.
- Banks would not be permitted to act as pricing underwriters for public offerings of securities where the issuer (or entities it controls) owes the banks (or related parties) more than NIS 5 million or a sum equivalent to 10 per cent of its total financial liabilities.[8]
- The introduction of a law to regulate provident funds and a review of the regulatory supervisory structure to ensure consistency, better coordination, and greater effectiveness.
- Measures to enhance liquidity using market makers in the secondary markets.
- Measures to facilitate bank customers switching between banks.
- An examination of deposit insurance.

[8] Inter Ministerial Committee Report.

21. **The mission agreed with a number of the planned measures, but noted that the plan to force banks to divest themselves of the mutual and provident fund business involves risks.** The mission acknowledged that the concentration of banks was high, but suggested that it would be wrong to view the Israeli experience as wholly unique, and that divestiture represented a step away from the strategies in other countries, where there is a clear trend towards universal banking. In this regard, the mission warned against the risks associated with forcing the banks to divest themselves of their mutual and provident fund activities. For example, forced divestiture may discourage potential new participants from entering the market—in part because a decision by the authorities to intervene in the capital markets to impose restrictions that are being lifted elsewhere in the world may create uncertainty about the authorities' future intentions. Divestiture could also potentially reduce the diversification of banks' exposure by reducing fee based income and thereby making profits more dependant on interest rate developments. There is also the risk that banks would take actions to circumvent the restrictions as well as test the new restrictions, thereby creating new regulatory challenges for the authorities. Finally, regulation and supervision of provident funds are, in practice, currently inadequate to ensure an informed and well-functioning market. It is, therefore, important that the new managers of these provident funds be well regulated lest systemic risks increase.

22. **The authorities acknowledged these risks but argued that they are manageable and that there is little chance of achieving the agreed goals without the planned "one-time intervention" aimed at changing the structure of the Israeli financial system.**

23. **The mission also noted that capital market development was hindered by obstacles other than bank dominance in financial markets—many of which are already being addressed by the authorities.** First, persistently high fiscal deficits in the past absorbed a large share of institutional savings, especially as, until recently, the government had directed a high proportion of the assets of the pension funds, provident funds and insurance companies into special non-traded, index-linked government bonds. The government's use of institutional funds in such a manner may well have helped hinder the development of capital markets. Second, other factors, identified by the authorities, have also frustrated the development of the capital markets. For example, the 35 per cent tax on investment in foreign securities has made foreign mutual funds relatively unattractive; as noted in the 2001 ROSC, Israel requires foreign funds to register in Israel and bear the often prohibitive cost of restructuring a fund or rewriting a prospectus to meet local requirements; and legislation that does not permit the development of municipal bonds or funds of funds (Box 2). The mission agreed with the authorities that regulatory measures had not been successful in addressing the issues in the past, and the authorities pointed out that banks had sought to block such action through appeals to the courts. The mission observed that this experience suggested that regulatory powers of enforcement should be strengthened.

24. **The authorities responded that many of these changes are not complete yet, and in any case will not be sufficient to ensure their ultimate goal of a developed capital market.** Therefore, they viewed legislation to divest banks of their mutual and provident fund activities as a crucial element in restructuring Israel's financial system. Overall, they

saw the benefits of this approach—which takes into account the history of financial markets and the banking industry in Israel—as far outweighing the potential risks. The mission pointed out that a number of the reforms cited above have only been recently undertaken or are, as yet, in the form of proposals, but those that have been implemented are already showing some results and ought to be given time to work before restricting the operations of banks (Box 2). Although the necessary legislation for divestiture has yet to be forwarded to the Knesset, this is just a matter of time. The general expectation is that the legislation will be submitted and passed.

## C. Monetary Policy

25. **The BoI emphasized that the primary objective of monetary policy is price stability with allowance for maintaining financial sector stability.** The BoI explained that the price stability objective, as opposed to the inflation target, is ongoing and does not refer to a specific calendar period. Subject to the price stability objective, the BoI also takes into account real growth and employment when setting monetary policy.

26. **The BoI explained that its monetary policy decisions in 2004 were mostly based on market assessments of inflation.** The large forecast errors from their econometric models had prompted them to base recent interest rate decisions primarily on market expectations of low inflation. The measures of inflationary expectations they used included the yield spread between CPI-indexed and non-indexed bonds and inflation forecasts of professional private sector forecasters.

27. **The mission agreed that the recent interest rate reductions had been appropriate given the subdued inflation environment, but recommended developing additional tools to gauge inflation**. Market measures of expectations and real interest rates may be biased and inefficient because they reflect a certain degree of circularity: markets look to the central bank to forecast inflationary prospects, but, in turn, the central bank relies on market-derived measures to help assess those prospects (Box 3). The BoI's emphasis on measures of inflation expectations and real interest rates that are derived from the markets rather than its own forecasts could potentially contribute to price instability. The mission argued, therefore, that in addition to the use of market expectations, more emphasis could be placed on utilizing improved forecast models that do not rely primarily on market expectations as a framework for policy decisions (see also Selected Issues paper).

28. **The mission also pointed out that supplementing the BoI's semiannual inflation report with interim quarterly updates that reflect the BoI's expectation of future inflation dynamics would further enhance the framework.** The inclusion of a 'fan chart' of future inflation outlook in the two most recent BoI's inflation reports was a welcome step. Nevertheless, the inflation outlook shown in the chart is only one among many measures of inflation expectations quoted by the BoI and does not appear to be the one underlying BoI's monetary policy decisions. The BoI contended that the only forecast it can publish is the inflation target itself, any other forecast would be inconsistent and could confuse the market.

29. **An update of the BoI law to reflect international best practices is also warranted.** The mission noted that Israel is the only emerging market country with an inflation targeting regime that does not have a monetary policy committee. The BoI supported fully the mission's call to amend the Bank of Israel law and was already working on a new proposal. However, the Minister of Finance wondered if monetary policy should have economic growth, in addition to price stability, as a primary objective. The mission argued that monetary policy cannot impact long-term economic growth and that adding an economic growth target to the BoI's objective might undermine the bank's credibility and thus its ability to maintain stable prices.

**Box 3. Potential Difficulties with Inflation Targeting Rules**

Inflation targeting can be viewed as setting the policy interest rate as follows:

$$i^T = \overline{rr} + \pi^T + \lambda(\pi^E - \pi^T)$$

where $i^T$ is the policy rate, $\overline{rr}$ is the long-run real interest rate, $\pi^T$ is the inflation target, $\pi^E$ is a measure of the expected inflation, and $\lambda$ is a parameter representing the degree to which the central bank addresses emerging inflationary or deflationary pressures.

There are two implementation issues with this rule: determining the long-run real interest rate and ascertaining future inflationary environment (expected inflation).

1. The BoI relies on a CPI-indexed ten-year government bond as a proxy for the long-run real interest rate, but this measure could misstate the actual real rate, especially in a country with a high public debt and a history of past inflation. Not surprisingly, the real ten-year interest rate has fluctuated between 2 and 6 percent over the past ten years.

2. With regard to the inflationary environment (expected inflation), the BoI relies heavily on private forecasts and capital markets expectations. These measures may be biased since they incorporate confidence in the BoI's policies, the difficulty in predicting a controlled variable, i.e., the Bernanke-Woodford (1997) problem, which argues that in a credible inflation targeting regime, both market-based and professional inflation forecasts will not be informative as they will simply reflect the target, and the existence of a risk premium. Indeed, over the past decade, market participants have over-predicted inflation by 1 percentage point, on average, and their forecast errors are highly correlated with information that was available at the time of the forecast.

## D. Labor Market

30. **The authorities noted that welfare reform has already led to a marked improvement in the labor market.** The participation rate in 2004 has increased by roughly one half a percentage point to 54.9 percent, while employment has risen by 3.0 percent. The mission concurred, but expressed concern that the recent welfare reforms may have hurt some vulnerable groups, including the elderly and disabled. The authorities shared the mission's

31. concern about adequate protection for these groups and pointed to plans to increase support for the truly needy.

32. **The authorities are also undertaking steps to improve existing active labor market policies.** These include initiating pilot welfare-to-work centers, wage subsidies to

single mothers and enhanced employment services (for details see Selected Issues paper). The mission welcomed these steps, but noted that the persistently high unemployment, especially among the long-term unemployed, indicated the need for additional steps to facilitate labor market absorption. Such steps could include improving the effectiveness and scope of existing programs, an expansion of the pilot programs, and carefully designed additional vocational training programs. The authorities largely agreed and noted that vocational training programs had already been focused on the needs of the longer-term unemployed and that a wage subsidy pilot program was under preparation.

## IV. Staff Appraisal

33. **Notable improvements in policies are prompting improved economic performance in Israel.** Economic growth has revived and prices and the exchange rate are stable. While a favorable external environment and a better security situation have been important factors, appropriate policies have been instrumental in contributing to growth. In particular, the authorities have rebalanced macro policies and undertaken an ambitious fiscal consolidation while appropriately easing monetary policy. Furthermore, the government's commitment to boost competition and efficiency have enhanced market confidence and laid the foundations for future growth. Welfare reform will improve the functioning of the labor market, privatization will improve competition and market efficiency, tax reform will increase competitiveness, and pension reform, while assuring solvency of the system, should aid the development of the capital market.

34. **The welcome commitment to limit the growth of public expenditure to one percent in real terms requires medium-term planning and a detailed spending plan.** Developing a detailed medium-term spending plan would enhance credibility and ensure that future budgets are allocated according to long term priorities. In addition, to enhance transparency and planning, the government should present a detailed semi-annual report on progress in achieving its fiscal objectives as well as in implementing various structural measures.

35. **It is important to accelerate the path of debt reduction by abstaining from further unplanned tax cuts and by broadening the tax base through the elimination of various tax exemptions.** Maintaining a deficit of 3 percent of GDP in the years ahead implies but a modest decline in public debt, relative to GDP, and is insufficiently ambitious. A smaller fiscal deficit would be preferable as the correspondingly more pronounced decrease in the stock of public debt would allow for lower interest rates, increased private investment, lower taxes in the future, and higher medium-term growth. Accordingly, the automatic stabilizers ought to be allowed to operate fully should revenues over perform, and should be reined in partially should revenues under perform.

36. **The BoI success in maintaining low inflation is commendable.** The reductions in interest rates of the past year were warranted. Given that inflationary pressures are subdued and the inflation outlook well within the BoI target range, the policy rate appears appropriate provided the external environment remains stable.

37. **It will be important to update the current Bank of Israel Law to reflect international best practices**. This would help reinforce central bank independence and enhance transparency and accountability. The new law should clearly specify that the primary function of the central bank is to ensure price stability. The law should also provide for instrument independence and the establishment of a committee to set monetary policy.

38. **There is also scope for the BoI to enhance its tools and procedures for implementing inflation targeting.** Placing too much emphasis on measures derived from markets of long-term real interest rates and inflation expectations could potentially contribute to price volatility. Developing and improving statistical forecasting models for assessing the inflationary outlook is therefore warranted. Furthermore, to increase transparency and accountability, it is also recommended that the authorities develop and present their view of the inflation outlook, and that the semi-annual Inflation Reports be supplemented with interim quarterly updates explaining unexpected developments.

39. **With the high level of concentration in the banking sector and the underdeveloped capital market, many of the steps being taken to remove obstacles to capital market development are to be applauded.** Reducing the use of non-tradable, indexed government bonds will stimulate the demand for capital market instruments, as will limiting banks' exposure to individual and connected lenders. The authorities are already in the process of removing barriers to capital market development, such as the unequal tax treatment on different instruments, excessive stamp taxes, excessively onerous prospectus requirements on commercial paper and asset backed securities, inadequate rights for participants in repo markets, the regulatory prohibition on funds of funds, and legal restrictions on the issue of municipal bonds. The removal of these barriers and the move towards the introduction of International Financial Reporting Standards will have a substantial beneficial effect on the development of the capital market. The plan to force banks to divest themselves of mutual and provident funds could strengthen competition, but goes against trends elsewhere towards universal banking and involves risks.

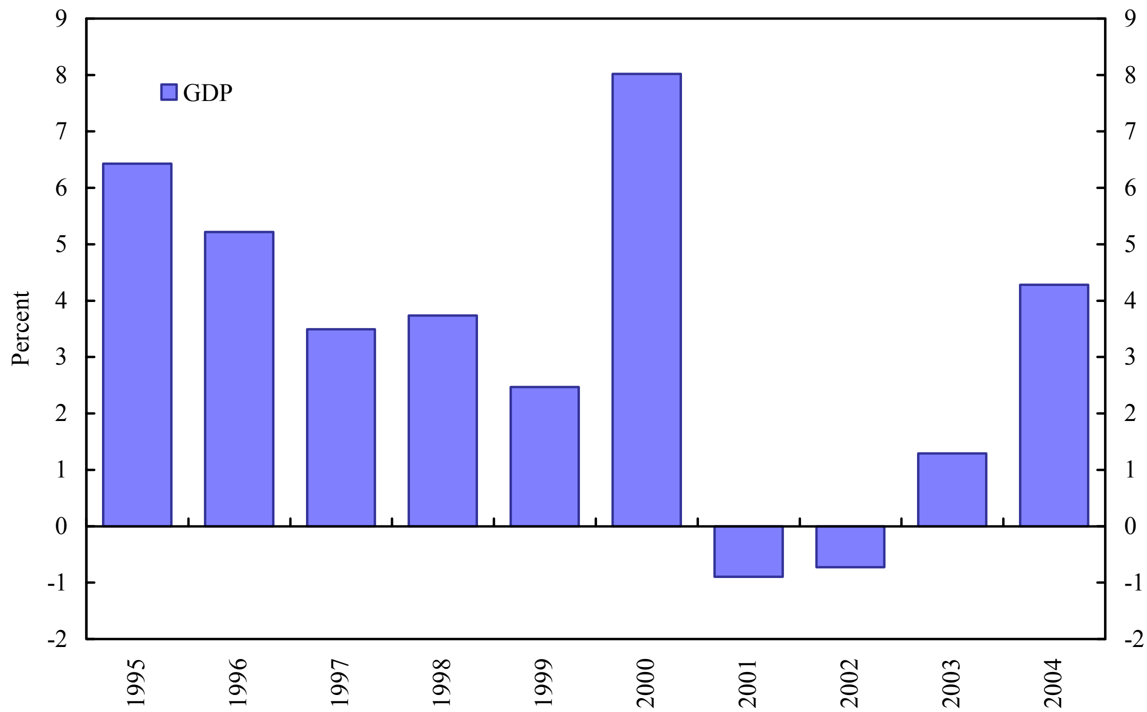
40. **If the authorities proceed to legislate the divestiture of mutual and provident fund activity by banks, there will be a need to strengthen regulation and improve enforcement.** Specifically, it is important that they vigorously enforce the regulations already on the books and ensure that the supervisory and regulatory functions are sufficiently enhanced to ensure that transferring mutual and provident funds to the non-bank sector does not result in increased systemic risk. In particular, the introduction of an effective regulatory law for provident funds will be critical. Currently, the poorly enforced regulation of provident and pension funds does not, in practice, result in suppliers disclosing their investment policies and the attendant risks with sufficient detail and clarity to allow the investor to make an informed choice. Enforcement of full disclosure is essential as the investor's previous expectations that these funds were essentially risk-free are no longer valid. Monitoring of the implementation of such investment policies by independent custodians is an international best practice and should be adopted by the authorities. It is also important to reassure potential market participants that the measures are a "once and for all" event to encourage future market entry and thus more competition. Finally, it will be

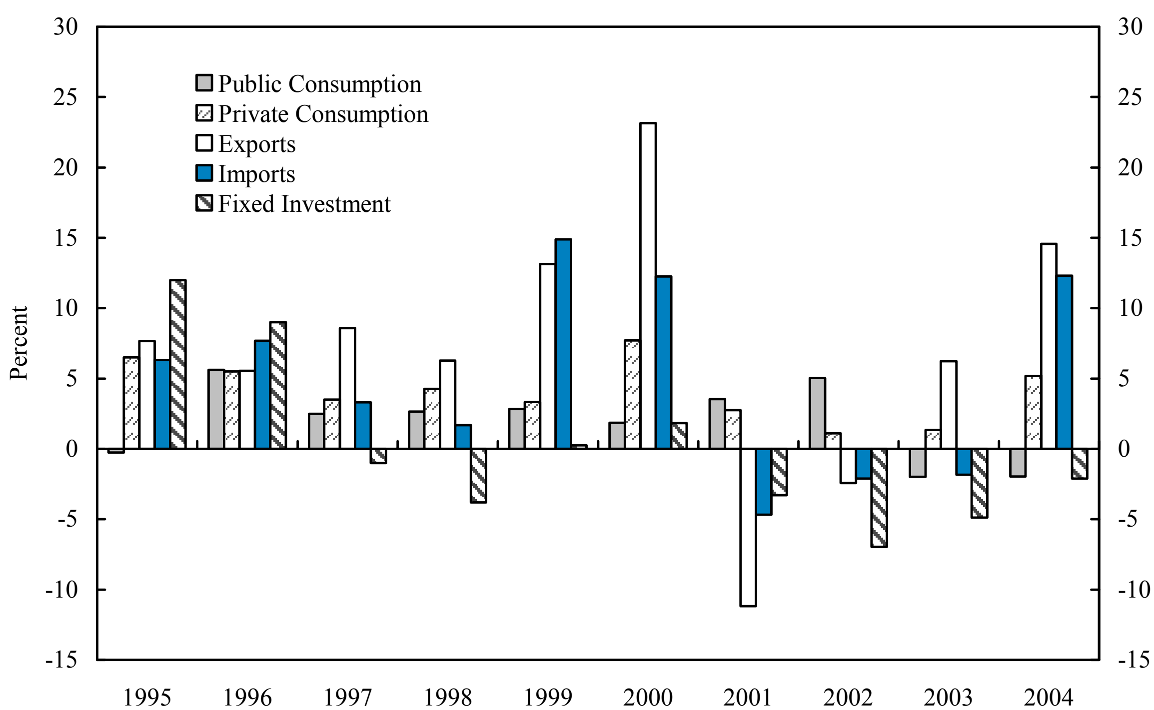
important to proceed diligently with the other, more conventional capital market reform measures already underway and planned, since divestiture can not be a substitute for such measures.

41. **Welfare reform, which has started to bear fruit as indicated by the reduction in unemployment and the increase in labor force participation, should be supported by further active labor market policies.** The recent strengthening of existing active labor market programs and the new pilot initiatives are encouraging. Yet, spending on active labor market policies, as a share of GDP, remains small in comparison to OECD countries and the absorption of new job seekers into the labor market could be improved by expanding vocational training and employment services in a carefully targeted way while enhancing their effectiveness.

42. **Israel has subscribed to the Special Data Dissemination Standard.** The periodicity, timeliness, coverage, and quality of Israel's economic data are generally adequate for Fund surveillance. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Israel: Real GDP and Demand, 1995–2004 1/
(year-on-year change)

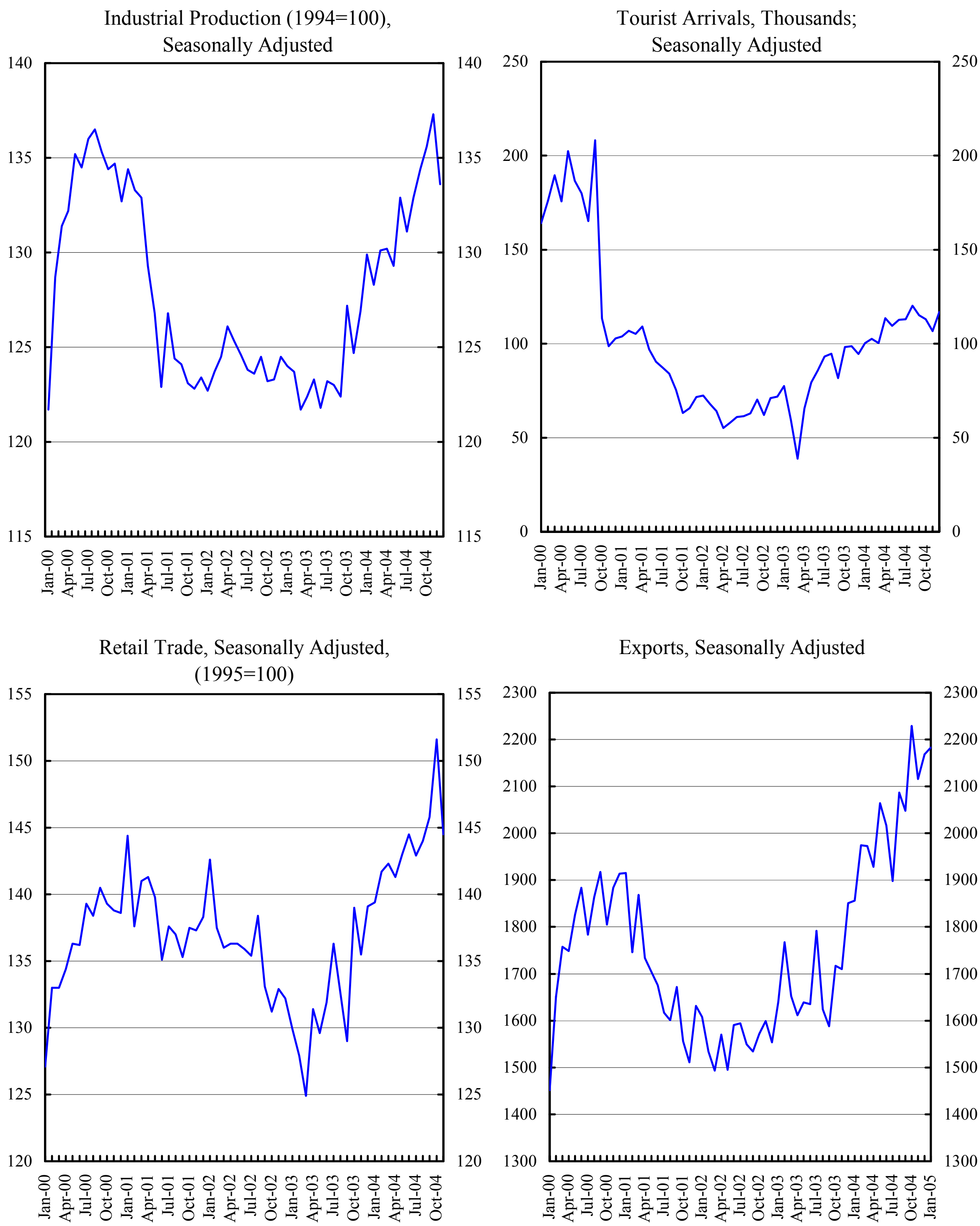



Sources: Central Bureau of Statistics; and Bank of Israel.

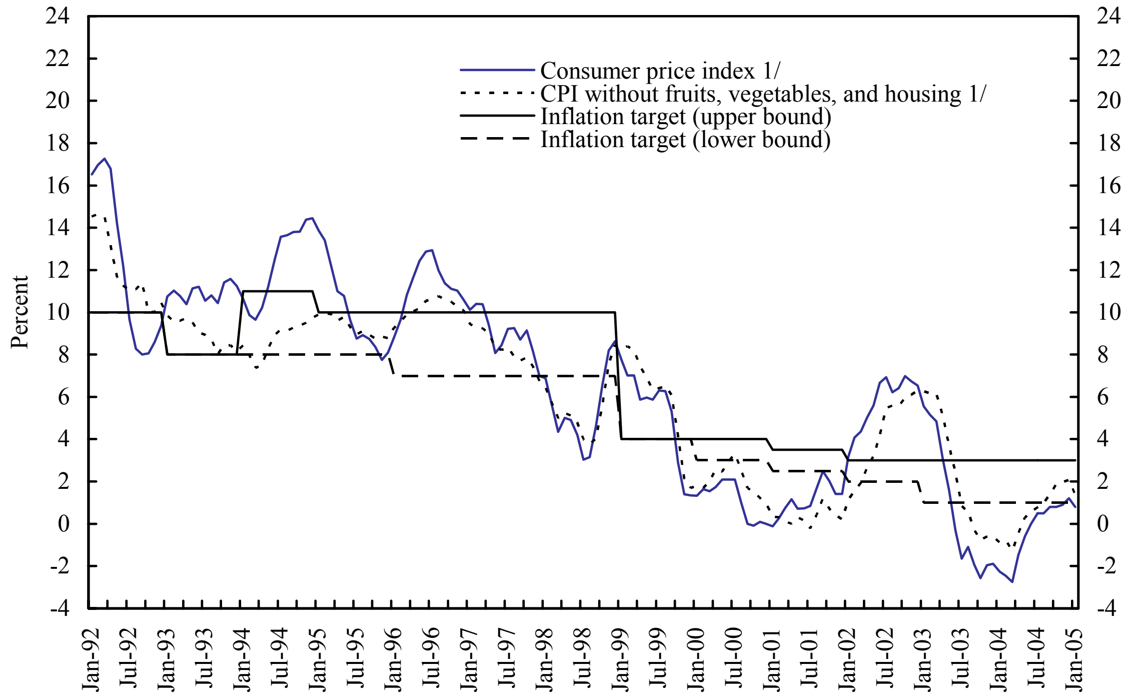
1/ Fund staff projections.

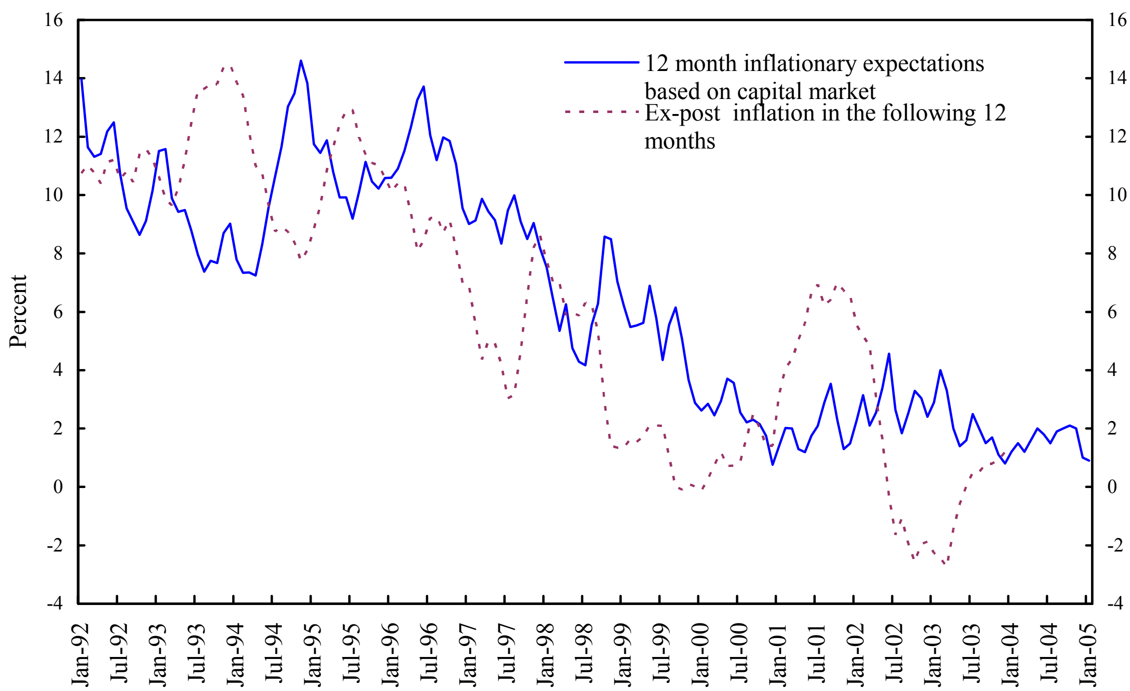
Figure 2. Israel: Recent Developments, 2000–05




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

Figure 3. Israel: Inflation, 1992–2005

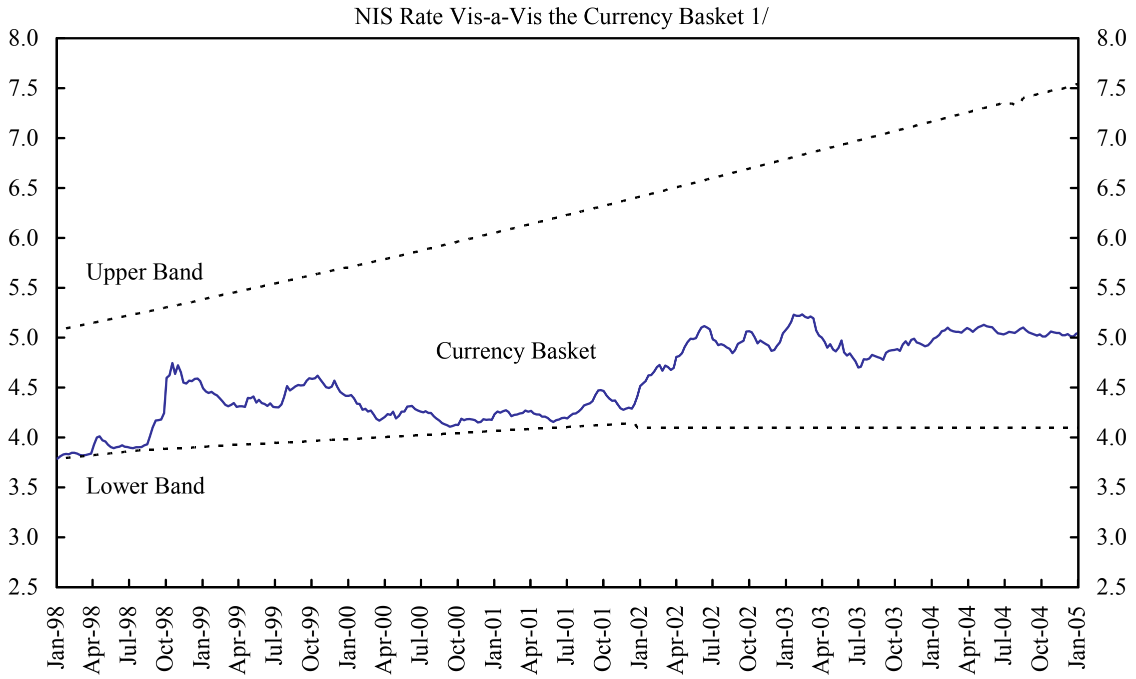


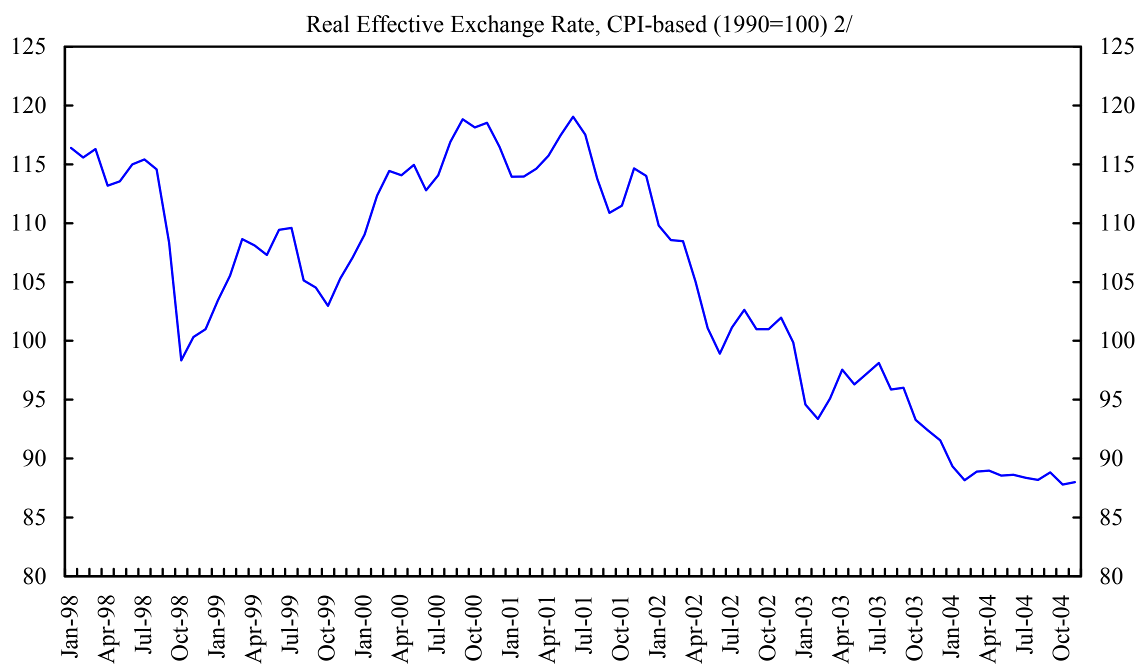




Sources: Central Bureau of Statistics; and Bank of Israel.

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

Figure 4. Israel: Exchange Rates, 1998–2005

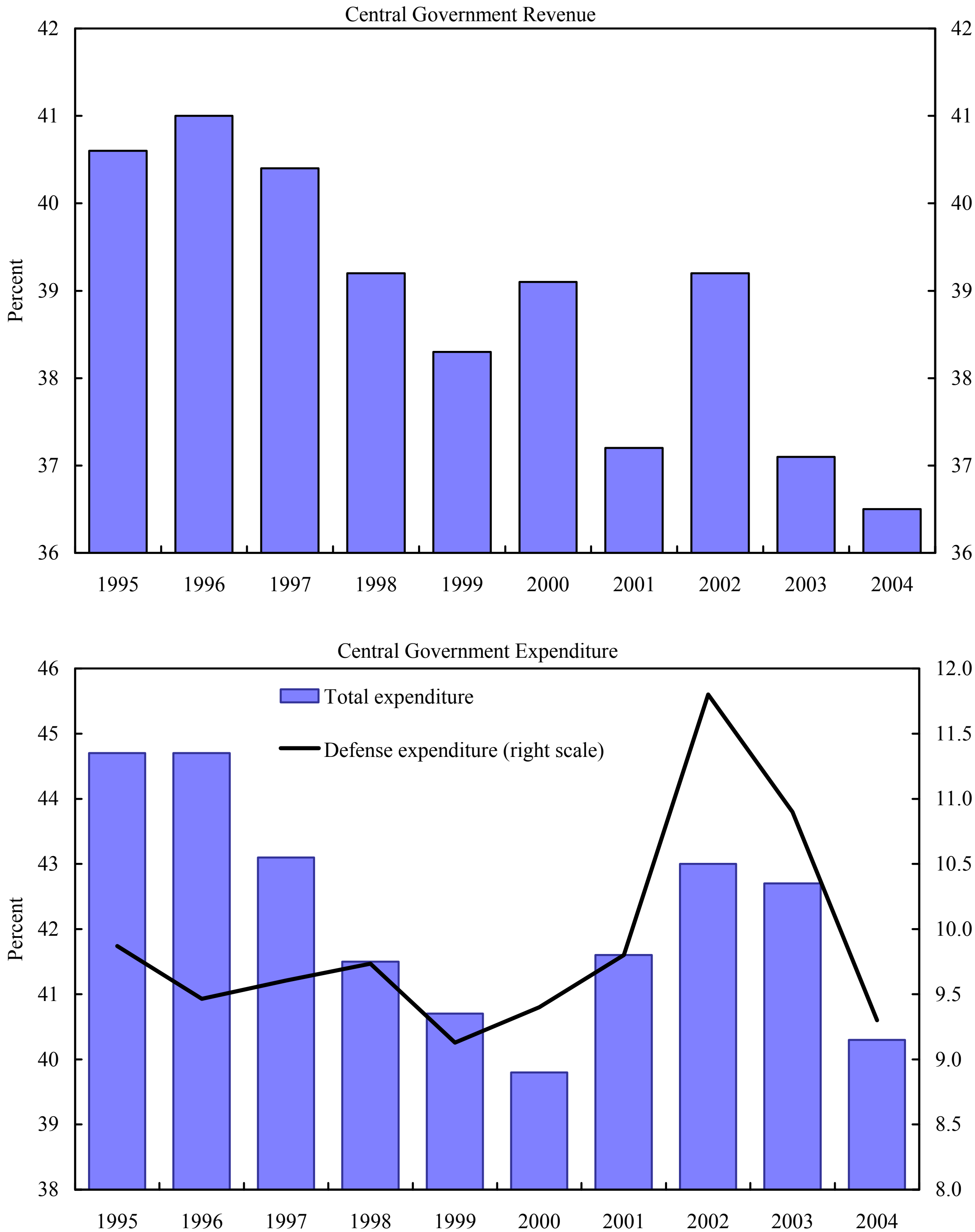



Sources: Bank of Israel; and IMF, *Information Notice System* .

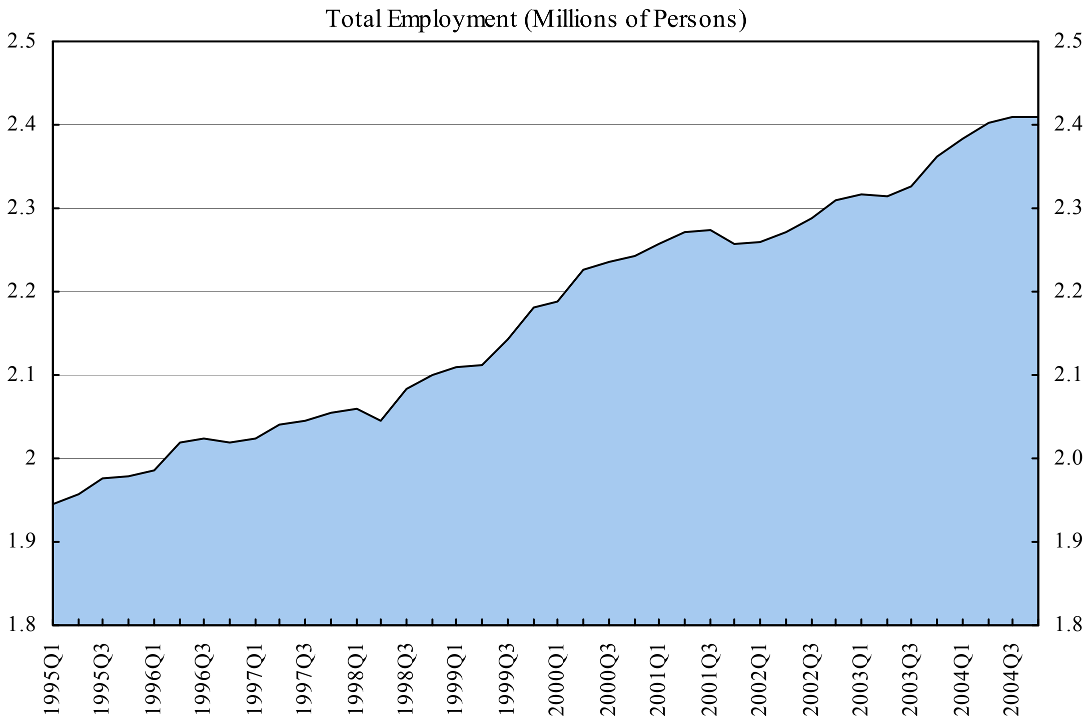
1/ Weekly average of daily rates. Updated to January 25, 2005.
2/ A decrease represents depreciation.

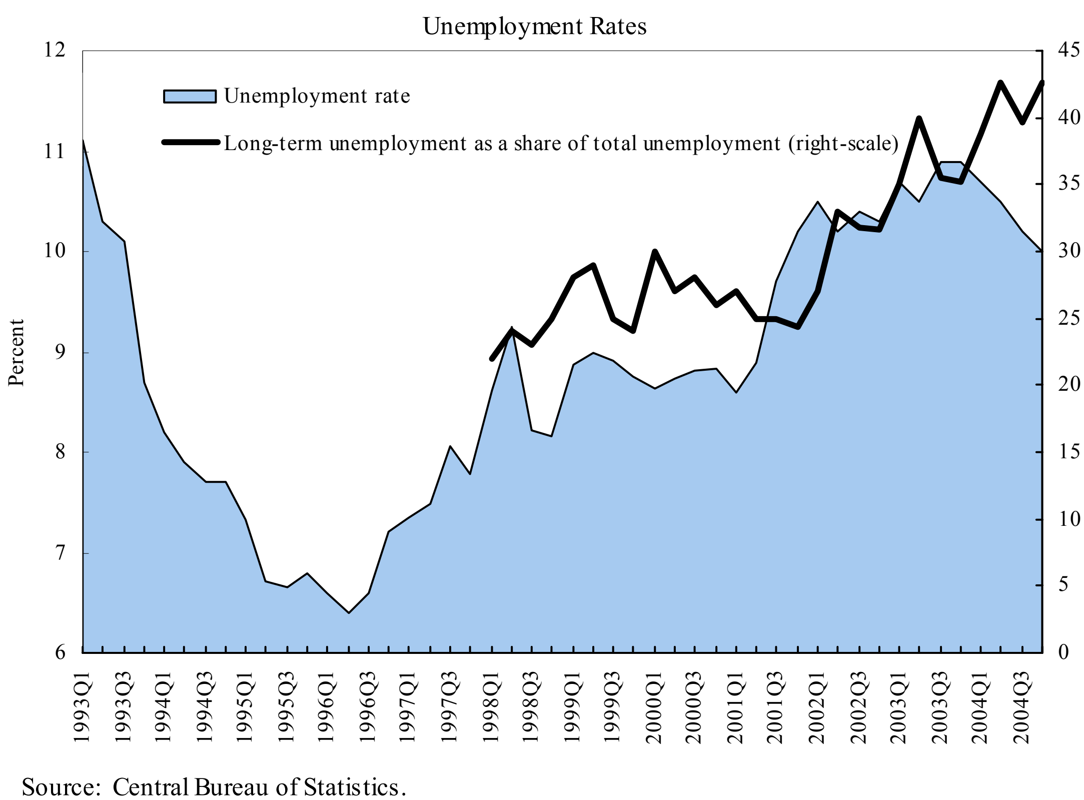
Figure 5. Israel: Selected Fiscal Indicators, 1995–2004
(In percent of GDP; unless otherwise stated)




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

Figure 6. Israel: Labor Market Indicators, 1993–2004




Source: Central Bureau of Statistics.

Table 1. Israel: Selected Economic and Financial Indicators, 1999–2005

**Demographic and other data:**

| | |
|---|---|
| Population (2002) | 6.3 million |
| GDP per capita (2002) | US$ 16,675 |
| Social indicators (1993-2002) | |
| Life expectancy at birth | |
| Male (2002) | 76.7 |
| Female (2002) | 80.7 |
| Infant mortality rate (2002) | 6 per 1,000 live births |
| Physicians per 1,000 people (2001) | 3.75 |
| Population per sq. km. (2002) | 318.4 |

| | 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 | 2004 1/ | 2005 1/ |
|---|---|---|---|---|---|---|---|
| | (Percent change unless otherwise indicated) | | | | | | |
| National account indicators (constant prices) | | | | | | | |
| Private consumption | 3.3 | 7.7 | 2.7 | 1.1 | 1.3 | 5.2 | 4.0 |
| Public consumption | 2.8 | 1.8 | 3.5 | 5.0 | -2.0 | -2.0 | 1.0 |
| Fixed capital formation | 0.2 | 1.8 | -3.3 | -7.0 | -4.9 | -2.1 | 3.8 |
| Exports of goods and services | 13.1 | 23.1 | -11.2 | -2.4 | 6.2 | 14.6 | 7.3 |
| Imports of goods and services | 14.9 | 12.2 | -4.7 | -2.1 | -1.8 | 12.3 | 5.5 |
| Real GDP | 2.5 | 8.0 | -0.9 | -0.7 | 1.3 | 4.3 | 3.8 |
| Labor market indicators | | | | | | | |
| Unemployment rate (in percent) | 8.9 | 8.7 | 9.3 | 10.3 | 10.8 | 10.4 | 9.8 |
| Real wages | 5.7 | 1.7 | -2.6 | 0.1 | -3.2 | ... | ... |
| Prices | | | | | | | |
| Overall CPI (end period) | 1.3 | 0.0 | 1.4 | 6.5 | -1.9 | 1.2 | 1.6 |
| Underlying CPI (excluding housing, fruit and vegetables, end period) | 1.7 | 0.9 | 0.2 | 6.3 | -0.6 | 2.1 | 1.1 |
| Interest rates (average, in percent) | | | | | | | |
| BoI policy rate 2/ | 12.1 | 9.3 | 6.8 | 6.8 | 7.5 | 4.2 | ... |
| Money and credit (period average) | | | | | | | |
| Non direct domestic credit 3/ | 8.9 | -1.5 | 3.1 | 12.7 | -4.0 | 2.4 | ... |
| Narrow money (M1) | 3.3 | 11.0 | 14.2 | 15.6 | 0.5 | 18.1 | ... |
| Broad money (M3) 3/ | 21.9 | 15.3 | 15.5 | 6.1 | 2.2 | 4.5 | ... |
| Public finance (percent of GDP) | | | | | | | |
| Central government revenue | 38.3 | 39.1 | 37.2 | 39.2 | 37.1 | 36.5 | 37.0 |
| Central government expenditure | 40.7 | 39.8 | 41.6 | 43.0 | 42.7 | 40.3 | 40.4 |
| Central government balance | -2.4 | -0.7 | -4.4 | -3.8 | -5.6 | -3.8 | -3.4 |
| General government balance | -4.2 | -2.1 | -4.1 | -4.5 | -6.4 | -4.3 | -3.6 |
| General government debt | 101.4 | 91.4 | 96.4 | 104.9 | 107.4 | 104.8 | 103.8 |
| Balance of payments | | | | | | | |
| Current account (percent of GDP) | -1.5 | -1.5 | -1.9 | -1.8 | 0.1 | -0.1 | 0.3 |
| Foreign reserves (e.o.p., in US$ billion) | 22.6 | 23.3 | 23.4 | 24.1 | 26.3 | 26.2 | 26.4 |
| Reserve cover (in months of imports) | 6.7 | 6.0 | 6.5 | 6.8 | 7.1 | 6.1 | 5.7 |
| Exchange rate and terms of trade indices | | | | | | | |
| NEER appreciation ( period average) 4/ | -7.7 | 9.1 | 0.7 | -13.5 | -7.0 | -3.4 | ... |
| REER appreciation (period average) 4/ | -3.8 | 8.1 | -0.2 | -10.0 | -7.9 | -4.8 | ... |
| Terms of trade (1990=100; index level) | 104.3 | 101.3 | 99.2 | 99.3 | 97.8 | ... | ... |

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/ As of December 2004. The Bank of Israel set the policy rate at 3.5 percent in February 2005.
3/ As of October 2004.
4/ As of November 2004.

**Table 2. Israel: State Budget, 1998–2005**

(In percent of GDP)

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Budget | est. | Budget Proposal /1 |
| **Revenue (excluding repayment of credit)** | **39.2** | **38.3** | **39.1** | **37.2** | **39.2** | **37.1** | **37.7** | **36.5** | **37.0** |
| Domestic | 34.8 | 34.5 | 36.3 | 34.7 | 34.2 | 33.2 | 34.1 | 33.1 | 33.9 |
| Tax | 29.4 | 29.5 | 30.9 | 30.6 | 29.8 | 28.6 | 29.1 | 28.8 | 29.2 |
| On income and profits | 16.2 | 16.2 | 18.0 | 17.8 | 16.2 | 15.2 | 15.4 | 15.1 | 15.2 |
| On domestic goods and services | 13.2 | 13.3 | 12.9 | 12.8 | 13.6 | 13.5 | 13.6 | 13.6 | 13.9 |
| Nontax domestic | 5.4 | 5.0 | 5.4 | 4.2 | 4.4 | 4.6 | 5.0 | 4.4 | 4.7 |
| Loans from NII | 1.4 | 1.4 | 1.5 | 0.9 | 1.6 | 1.8 | 2.2 | 2.0 | 2.1 |
| Other | 4.0 | 3.6 | 3.9 | 3.3 | 2.8 | 2.8 | 2.8 | 2.3 | 2.6 |
| Foreign | 4.5 | 3.8 | 2.8 | 2.5 | 5.0 | 3.9 | 3.6 | 3.4 | 3.1 |
| Grants | 3.2 | 2.6 | 2.5 | 2.0 | 3.0 | 2.1 | 2.3 | 2.1 | 2.1 |
| VAT on defense imports | 0.2 | 0.2 | 0.2 | 0.3 | 0.4 | 0.3 | 0.3 | 0.3 | 0.2 |
| Bank Israel 2/ | 1.0 | 0.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Interest foreign currency | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 |
| Other revenues abroad 3/ | 0.0 | 0.0 | 0.0 | 0.0 | 1.5 | 1.4 | 0.9 | 0.9 | 0.7 |
| **Expenditure (excluding lending and expenditure by public hospitals)** | **41.5** | **40.7** | **39.8** | **41.6** | **43.0** | **42.7** | **41.7** | **40.4** | **40.0** |
| Domestic | 37.6 | 37.3 | 36.8 | 38.3 | 37.7 | 38.6 | 37.4 | 36.4 | 36.3 |
| Of which: interest | 4.7 | 4.5 | 4.6 | 4.6 | 4.5 | 5.3 | 5.4 | 5.0 | 5.1 |
| Foreign | 3.9 | 3.4 | 2.9 | 3.3 | 5.3 | 4.1 | 4.2 | 3.9 | 3.7 |
| Of which: interest | 1.5 | 1.4 | 1.3 | 1.3 | 1.1 | 1.2 | 1.5 | 1.0 | 1.5 |
| **Budget deficit** | **2.2** | **2.4** | **0.7** | **4.4** | **3.8** | **5.6** | **4.0** | **3.9** | **3.0** |
| Net Lending | -0.3 | -0.3 | -0.4 | -0.1 | -0.4 | -0.4 | 0.1 | -0.5 | -0.3 |
| Domestic | -0.3 | -0.3 | -0.4 | -0.1 | -0.3 | -0.3 | 0.1 | -0.5 | -0.3 |
| Foreign | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Lending | 0.9 | 0.9 | 0.8 | 0.8 | 0.7 | 0.8 | 1.2 | 0.5 | 0.7 |
| Domestic | 0.9 | 0.9 | 0.8 | 0.8 | 0.7 | 0.8 | 1.2 | 0.5 | 0.7 |
| Foreign | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Repayment | 1.2 | 1.2 | 1.2 | 0.9 | 1.0 | 1.2 | 1.1 | 1.0 | 1.0 |
| Domestic | 1.2 | 1.2 | 1.2 | 0.8 | 1.0 | 1.1 | 1.1 | 1.0 | 1.0 |
| Foreign | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Revenue (including repayment) | 40.4 | 39.5 | 40.3 | 38.1 | 40.2 | 38.3 | 38.8 | 37.5 | 38.0 |
| Domestic | 35.9 | 35.7 | 37.4 | 35.6 | 35.2 | 34.4 | 35.2 | 34.1 | 34.9 |
| Foreign | 4.5 | 3.8 | 2.8 | 2.5 | 5.0 | 3.9 | 3.6 | 3.4 | 3.1 |
| Expenditure (including lending) | 42.4 | 41.6 | 40.5 | 42.4 | 43.6 | 43.5 | 42.8 | 40.9 | 40.7 |
| Domestic | 38.4 | 38.2 | 37.6 | 39.0 | 38.4 | 39.4 | 38.6 | 36.9 | 37.0 |
| Foreign | 3.9 | 3.4 | 2.9 | 3.3 | 5.3 | 4.1 | 4.2 | 3.9 | 3.7 |
| Budget deficit (including net lending) | 1.9 | 2.1 | 0.3 | 4.3 | 3.4 | 5.3 | 4.1 | 3.4 | 2.7 |
| Domestic | 2.5 | 2.5 | 0.2 | 3.5 | 3.2 | 5.0 | 3.5 | 2.8 | 2.1 |
| Foreign | -0.6 | -0.4 | 0.1 | 0.8 | 0.2 | 0.2 | 0.6 | 0.5 | 0.6 |
| Financing | 1.9 | 2.1 | 0.3 | 4.3 | 3.4 | 5.3 | 4.1 | 3.4 | 2.7 |
| Cash in banks (net) | 0.0 | -0.1 | -0.1 | 1.4 | -1.2 | -0.5 | 0.0 | -0.6 | 0.0 |
| Nonbank (net) | 1.0 | 1.7 | -0.1 | 3.5 | 4.9 | 4.4 | 1.9 | 2.3 | 1.5 |
| Sale of assets (net) | 1.3 | 0.5 | 0.6 | 0.0 | 0.1 | 0.1 | 0.5 | 0.2 | 0.7 |
| Foreign (net) | -0.4 | -0.1 | -0.2 | -0.6 | -0.4 | 1.3 | 1.7 | 1.5 | 0.5 |
| Memorandum items: | | | | | | | | | |
| Defense expenditure | 9.7 | 9.1 | 9.4 | 9.8 | 11.8 | 10.9 | 9.3 | | 8.4 |
| Current expenditure | 39.7 | 39.0 | 38.1 | 39.9 | 41.1 | 40.6 | 39.8 | | 40.0 |
| Wages | 8.3 | 5.9 | 8.8 | 8.6 | 8.8 | 8.7 | 8.5 | | 8.2 |
| Subsidies & transfers | 14.7 | 15.0 | 14.0 | 14.8 | 14.4 | 14.5 | 13.3 | | 13.1 |
| Interest | 6.2 | 5.8 | 5.9 | 5.8 | 5.6 | 6.5 | 6.9 | 6.0 | 6.6 |
| Other | 10.5 | 12.4 | 9.4 | 10.6 | 12.4 | 11.0 | 11.0 | | 12.1 |
| Capital expenditure | 1.8 | 1.7 | 1.7 | 1.7 | 1.8 | 2.1 | 1.9 | | 0.0 |
| Primary balance | 4.0 | 3.4 | 5.2 | 1.4 | 1.8 | 0.8 | 2.9 | 2.1 | 3.6 |

Source: Ministry of Finance.

1/ Does not include the 0.4 percent of GDP deviation from the 3.0 percent budget deficit target, reflecting the cost associated with the Gaza disengagement plan.

2/ Beginning in the year 2000, no "realized profits" of the Bank of Israel were transferred to the Government.

3/ These revenues were not classified as a separate item before 2002.

Table 3. Israel: Balance of Payments, 2000–09 1/
(in billions of U.S. dollars)

| | | | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| Current account balance | -1.7 | -2.1 | -1.8 | 0.2 | -0.1 | 0.3 | -0.1 | -0.2 | -0.2 | -0.5 |
| Merchandise | -3.0 | -3.2 | -3.9 | -2.2 | -3.2 | -4.5 | -4.1 | -3.9 | -3.6 | -3.2 |
| Exports, f.o.b. | 31.0 | 27.8 | 27.3 | 30.2 | 31.4 | 33.1 | 35.3 | 37.5 | 40.2 | 43.0 |
| Imports, f.o.b. | 34.0 | 31.0 | 31.2 | 32.3 | 34.6 | 37.6 | 39.4 | 41.5 | 43.8 | 46.2 |
| Civilian imports | 32.1 | 28.9 | 28.8 | 30.3 | 35.8 | 38.9 | 40.4 | 42.0 | 43.6 | 45.3 |
| Military imports | 1.9 | 2.1 | 2.4 | 2.1 | 2.1 | 2.3 | 2.5 | 2.7 | 2.9 | 3.1 |
| Services | 1.9 | -0.8 | -0.7 | 0.3 | 1.0 | 1.5 | 2.2 | 2.7 | 3.2 | 3.7 |
| Exports | 14.4 | 11.7 | 10.8 | 12.3 | 14.0 | 15.7 | 17.5 | 19.2 | 21.0 | 23.1 |
| Imports | -12.5 | -12.4 | -11.5 | -12.0 | -13.0 | -14.2 | -15.3 | -16.5 | -17.9 | -19.3 |
| Factor Income | -7.1 | -4.8 | -4.0 | -4.4 | -4.3 | -3.3 | -4.9 | -5.3 | -6.2 | -7.4 |
| Receipts | 3.7 | 2.7 | 2.5 | 2.2 | 2.7 | 3.2 | 3.0 | 3.2 | 2.8 | 3.0 |
| Payments | -10.7 | -7.6 | -6.5 | -6.6 | -7.0 | -6.5 | -7.9 | -8.5 | -9.0 | -10.4 |
| Net transfers | 6.5 | 6.7 | 6.8 | 6.4 | 6.4 | 6.6 | 6.6 | 6.4 | 6.4 | 6.4 |
| Capital and financial account balance 3/ | 4.2 | 1.5 | -1.1 | -0.2 | -0.1 | 0.2 | 0.0 | -0.2 | -0.3 | -0.8 |
| Capital account | 0.5 | 0.7 | 0.2 | 0.5 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Financial account | 3.8 | 0.8 | -1.2 | -0.6 | -0.4 | -0.1 | -0.3 | -0.5 | -0.6 | -1.1 |
| Direct investment, net | 1.5 | 2.9 | 0.6 | 1.9 | 2.8 | 3.0 | 3.0 | 3.0 | 2.9 | 2.8 |
| Foreign direct investment (in Israel) | 5.0 | 3.5 | 1.7 | 3.7 | 3.9 | 4.2 | 4.3 | 4.4 | 4.4 | 4.4 |
| Portfolio investment, net | 2.9 | -1.0 | -1.7 | -0.4 | -1.5 | -1.4 | -1.4 | -1.6 | -1.6 | -1.8 |
| Other investment | -0.6 | -1.1 | -0.1 | -2.1 | -1.7 | -1.7 | -1.9 | -1.9 | -1.9 | -2.1 |
| Errors and omissions | -1.6 | 0.5 | 2.3 | 1.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Change in reserves 4/ | -0.9 | 0.5 | 0.6 | -1.3 | 0.3 | -0.5 | 0.2 | 0.4 | 0.6 | 1.3 |
| Memorandum items (percentage of GDP): | | | | | | | | | | |
| Current account balance | -1.5 | -1.9 | -1.8 | 0.1 | -0.1 | 0.3 | -0.1 | -0.1 | -0.2 | -0.3 |
| Civilian trade balance | -1.0 | -1.0 | -1.4 | -0.1 | -3.8 | -4.7 | -3.9 | -3.2 | -2.4 | 0.0 |
| Gross external debt | 56.5 | 58.3 | 64.9 | 63.5 | 61.0 | 59.5 | 57.4 | 55.3 | 53.9 | 52.4 |
| Net external debt 5/ | 3.0 | 0.2 | -2.2 | -4.5 | -7.2 | -9.1 | -11.3 | -13.5 | -15.5 | -17.9 |
| Gross external debt (in US$ billions) | 64.0 | 64.8 | 67.4 | 70.6 | 71.5 | 73.1 | 74.7 | 76.3 | 78.9 | 81.6 |
| Net external debt (in US$ billions) | 3.4 | 0.2 | -2.3 | -5.0 | -8.5 | -11.1 | -14.6 | -18.6 | -22.7 | -28.0 |
| GDP (in US$ billions) | 113.3 | 111.2 | 103.8 | 111.2 | 117.2 | 122.9 | 130.1 | 137.9 | 146.5 | 155.9 |

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 4. Israel: Indicators of External and Banking Sector Vulnerability, 1998–2004
(In percent of GDP, unless otherwise indicated)

| | | | | | | | Latest Data | |
|---|---|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | Date |
| Financial indicators | | | | | | | | |
| General government debt | 106.7 | 101.4 | 91.4 | 96.4 | 104.9 | 107.4 | ... | Dec. 2003 |
| M1 | 5.3 | 5.1 | 5.2 | 5.8 | 6.4 | 6.3 | 7.3 | Dec. 2004 |
| M3 | 46.3 | 52.2 | 55.2 | 62.9 | 63.4 | 63.0 | 63.1 | Oct. 2004 |
| Private sector credit (percent change, 12 month basis) | ... | ... | ... | 13.1 | 7.2 | -5.5 | 4.8 | Oct. 2004 |
| External Indicators | | | | | | | | |
| Exports of G&NFS (percent change) | 4.4 | 15.6 | 21.2 | -13.1 | -3.3 | 11.2 | 11.7 | Sept. 2004 |
| Imports of G&NFS(percent change) | -3.5 | 13.6 | 14.2 | -6.7 | -1.6 | 3.7 | 9.0 | Sept. 2004 |
| Terms of trade (percent change, average) 1/ | -0.1 | -1.9 | 0.1 | -0.2 | 0.7 | 0.2 | ... | Dec. 2003 |
| Current account surplus | -1.4 | -1.5 | -1.5 | -1.9 | -1.8 | 0.1 | -2.4 | Sept. 2004 |
| Capital and financial account balance | 0.5 | 3.5 | 3.0 | 1.5 | -0.4 | -1.3 | -3.4 | Sept. 2004 |
| *Of which:* Inward portfolio investment (debt securities etc.) | 2.5 | 1.8 | 2.6 | -0.9 | -1.7 | -0.4 | 2.1 | Sept. 2004 |
| Other investment (loans, trade credits etc.) | 0.1 | -0.8 | -1.9 | -1.0 | -2.4 | -2.5 | -2.3 | Sept. 2004 |
| Inward foreign direct investment | 1.7 | 3.0 | 4.4 | 3.2 | 1.7 | 3.3 | -1.8 | Sept. 2004 |
| Gross official reserves (in US$ billions; e.o.p.) | 22.7 | 22.6 | 23.3 | 23.4 | 24.1 | 26.3 | 26.6 | Nov. 2004 |
| Short-term foreign assets of the financial sector (in US$ billions) | 13.2 | 14.3 | 15.7 | 15.6 | 15.4 | 18.3 | 19.0 | Jun. 2004 |
| Short-term foreign liabilities of the financial sector (in US$ billions) | 19.2 | 21.2 | 22.7 | 23.8 | 24.5 | 24.7 | 23.6 | Jun. 2004 |
| Official reserves in months of imports GNFS | 7.6 | 6.7 | 6.0 | 6.5 | 6.8 | 7.1 | 5.7 | Sept. 2004 |
| Ratio of foreign reserves to Broad Money | 16.4 | 12.0 | 0.7 | 10.7 | 7.0 | 7.5 | 0.3 | Oct. 2004 |
| Ratio of foreign reserves to short-term debt | 88.3 | 79.0 | 83.6 | 81.6 | 79.8 | 86.2 | 87.0 | Sept. 2004 |
| Total net external debt/GDP (in percent) | 11.0 | 7.0 | 3.0 | 0.2 | -2.2 | -4.5 | -8.3 | Sept. 2004 |
| Total gross external debt/GDP (in percent) | 57.4 | 60.6 | 56.5 | 58.3 | 64.9 | 63.5 | 59.4 | Sept. 2004 |
| *Of which:* Government debt/GDP (in percent) | 26.6 | 26.8 | 24.0 | 24.0 | 26.1 | 26.6 | 25.3 | Jun. 2004 |
| Total gross external debt to exports GNFS (in percent) | 182.3 | 165.4 | 140.9 | 164.1 | 176.6 | 166.3 | 142.3 | Sept. 2004 |
| Ratio of short-term debt to total debt (in percent) | 43.5 | 46.1 | 43.5 | 44.2 | 44.8 | 43.3 | 41.9 | Jun. 2004 |
| Country risk ratings (S. & P. / Moody's) | A- / A3 | A- / A3 | A- / A2 | 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 | 4.55 | 4.34 | Dec. 2004 |
| REER appreciation (+) (period average) | -3.0 | -3.8 | 8.1 | -0.2 | -10.0 | -7.9 | -4.8 | Nov. 2004 |
| Change in Stock Market Index (in percent) | 0.6 | 64.4 | 0.3 | -6.6 | -19.9 | 55.4 | 17.6 | Dec. 2004 |
| Banking sector indicators (largest 5 banks, all in percent) | | | | | | | | |
| Problem loans / total credit | 9.4 | 8.7 | 7.0 | 9.0 | 10.1 | 10.5 | ... | |
| Annual loan-loss provision/total credit | 0.6 | 0.5 | 0.5 | 0.9 | 1.3 | 1.1 | ... | |
| Risk-weighted capital asset ratio | 9.2 | 9.4 | 9.2 | 9.4 | 9.9 | 10.3 | ... | |
| Total credit growth | 14.5 | 12.1 | 12.5 | 9.8 | 1.7 | -1.3 | ... | |
| Rate of return to equity | 9.9 | 11.3 | 11.7 | 5.8 | 2.8 | 8.4 | ... | |
| Shares in total credit of those borrowing more than NIS 35 million | 44.7 | 46.4 | 47.1 | 47.5 | 47.5 | 46.3 | ... | |

Sources: Bank of Israel; Central Bureau of Statistics; International Monetary Fund; Fund staff estimates and projections.
1/ According to WEO GEE trade deflators.

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 | 3.7 | 2.5 | 8.0 | -0.9 | -0.7 | 1.3 | 4.3 | 3.8 | 3.7 | 3.9 |
| Inflation (end of period) | 8.6 | 1.3 | 0.0 | 1.4 | 6.5 | -1.9 | 1.2 | 1.6 | 2.0 | 2.0 |
| Fiscal deficit/GDP | | | | | | | | | | |
| Central government deficit | -1.9 | -2.4 | -0.7 | -4.4 | -3.8 | -5.6 | -3.8 | -3.4 | -3.0 | -3.0 |
| General government debt/GDP (end of period) | 106.7 | 101.4 | 91.4 | 96.4 | 104.9 | 107.4 | 104.8 | 103.8 | 101.8 | 100.0 |
| Current account/GDP | -1.4 | -1.5 | -1.5 | -1.9 | -1.8 | 0.1 | -0.1 | 0.3 | -0.1 | -0.1 |
| Foreign reserves (in billions of U.S. dollars) | 22.7 | 22.6 | 23.3 | 23.4 | 24.1 | 26.3 | 26.2 | 26.4 | 26.3 | 26.1 |
| Memorandum Items: | | | | | | (percentage changes) | | | | |
| Aggregate domestic demand | 2.3 | 3.9 | 4.7 | 1.4 | -0.7 | -1.6 | 3.9 | 3.2 | 2.9 | 3.3 |
| Private consumption | 4.3 | 3.3 | 7.7 | 2.7 | 1.1 | 1.3 | 5.2 | 4.0 | 4.0 | 4.0 |
| Public consumption | 2.7 | 2.8 | 1.8 | 3.5 | 5.0 | -2.0 | -2.0 | 1.0 | 1.0 | 1.0 |
| Gross fixed capital formation | -3.8 | 0.2 | 1.8 | -3.3 | -7.0 | -4.9 | -2.1 | 3.8 | 4.6 | 4.6 |
| Exports of Goods and Services | 6.3 | 13.1 | 23.1 | -11.2 | -2.4 | 6.2 | 14.6 | 7.3 | 7.7 | 6.3 |
| Imports of Goods and Services | 1.7 | 14.9 | 12.2 | -4.7 | -2.1 | -1.8 | 12.3 | 5.5 | 5.5 | 4.8 |

Source: Fund staff estimates and projections.

Table 6. Israel: Public Sector Debt Sustainability Framework, 1999–2009
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | | | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | |
| | | | | | | | | **I. Baseline Projections** | | | | | | **Debt-stabilizing primary balance 10/** |
| 1 **Public sector debt 1/** | 101.4 | 91.4 | 96.4 | 104.9 | 107.4 | | | **104.8** | **103.8** | **101.8** | **100.0** | **98.3** | **96.7** | **1.4** |
| o/w foreign-currency denominated | 26.4 | 23.8 | 25.1 | 27.3 | 27.9 | | | 27.3 | 27.0 | 26.5 | 26.0 | 25.6 | 25.1 | |
| 2 Change in public sector debt | -5.3 | -10.0 | 5.0 | 8.5 | 2.5 | | | -2.6 | -1.1 | -2.0 | -1.8 | -1.7 | -1.6 | |
| 3 Identified debt-creating flows (4+7+12) | -4.2 | -7.0 | 5.1 | 1.5 | 1.5 | | | 1.0 | -1.1 | -2.5 | -2.3 | -2.2 | -2.1 | |
| 4 Primary deficit | -1.9 | -3.9 | -1.9 | -0.9 | -0.1 | | | -2.5 | -3.2 | -3.6 | -3.6 | -3.6 | -3.6 | |
| 5 Revenue and grants | 47.9 | 48.9 | 49.7 | 50.7 | 48.4 | | | 48.1 | 49.0 | 49.3 | 49.4 | 49.6 | 49.9 | |
| 6 Primary (noninterest) expenditure | 46.0 | 45.0 | 47.9 | 49.8 | 48.3 | | | 45.6 | 45.8 | 45.7 | 45.8 | 46.0 | 46.3 | |
| 7 Automatic debt dynamics 2/ | -2.2 | -3.0 | 7.0 | 2.4 | 1.6 | | | 3.6 | 2.1 | 1.1 | 1.3 | 1.4 | 1.4 | |
| 8 Contribution from interest rate/growth differential 3/ | -2.1 | -2.4 | 4.8 | 0.7 | 3.6 | | | 3.6 | 2.1 | 1.1 | 1.3 | 1.4 | 1.4 | |
| 9 Of which contribution from real interest rate | 0.3 | 5.1 | 4.0 | 0.0 | 4.9 | | | 7.8 | 5.9 | 5.3 | 5.0 | 5.3 | 5.4 | |
| 10 Of which contribution from real GDP growth | -2.4 | -7.5 | 0.8 | 0.7 | -1.3 | | | -4.2 | -3.8 | -4.2 | -3.7 | -3.9 | -4.0 | |
| 11 Contribution from exchange rate depreciation 4/ | -0.1 | -0.7 | 2.2 | 1.7 | -2.0 | | | ... | ... | ... | ... | ... | ... | |
| 12 Other identified debt-creating flows | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | | | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 13 Privatization receipts (negative) | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | | | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 14 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 | |
| 15 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 | |
| 16 Residual, including asset changes (2-3) 5/ | -1.1 | -2.9 | -0.2 | 7.0 | 1.0 | | | -3.5 | 0.0 | 0.5 | 0.5 | 0.5 | 0.5 | |
| Public sector debt-to-revenue ratio 1/ | 211.6 | 186.9 | 193.8 | 206.9 | 222.0 | | | 218.0 | 211.9 | 206.6 | 202.5 | 198.3 | 193.8 | |
| **Gross financing need 6/** | 18.2 | 15.0 | 17.3 | 18.5 | 21.2 | | | 19.0 | 18.0 | 17.3 | 17.1 | 16.8 | 16.6 | |
| in billions of U.S. dollars | 18.6 | 17.0 | 19.2 | 19.2 | 23.6 | 10-Year Historical Average | 10-Year Standard Deviation | 22.0 | 21.9 | 22.3 | 23.3 | 24.3 | 25.4 | Projected Average |
| **Key Macroeconomic and Fiscal Assumptions** | | | | | | | | | | | | | | |
| Real GDP growth (in percent) | 2.5 | 8.0 | -0.9 | -0.7 | 1.3 | 3.8 | 3.3 | 4.1 | 3.8 | 4.3 | 3.9 | 4.1 | 4.3 | 4.1 |
| Average nominal interest rate on public debt (in percent) 7/ | 6.1 | 6.5 | 6.6 | 5.9 | 6.4 | 6.5 | 0.3 | 6.5 | 6.8 | 6.9 | 7.1 | 7.3 | 7.4 | 7.0 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | 5.9 | 6.0 | 6.0 | 6.4 | 5.0 | 6.0 | 0.5 | 7.4 | 5.9 | 5.5 | 5.3 | 5.7 | 5.9 | 6.0 |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | 0.2 | 2.8 | -8.5 | -6.8 | 8.2 | -3.6 | 6.5 | ... | ... | ... | ... | ... | ... | ... |
| Inflation rate (GDP deflator, in percent) | 5.7 | 1.0 | 2.2 | 5.9 | 1.5 | 6.5 | 4.1 | -0.9 | 0.9 | 1.5 | 1.8 | 1.6 | 1.5 | 1.0 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 1.2 | 5.7 | 5.4 | 3.3 | -1.7 | 3.7 | 3.1 | -1.8 | 4.3 | 4.0 | 4.0 | 4.6 | 5.0 | 3.4 |
| Primary deficit | -1.9 | -3.9 | -1.9 | -0.9 | -0.1 | -2.0 | 1.3 | -2.5 | -3.2 | -3.6 | -3.6 | -3.6 | -3.6 | -3.3 |
| | | | | | | | | **II. Stress Tests for Public Debt Ratio** | | | | | | **Debt-stabilizing primary balance 10/** |
| **A. Alternative Scenarios** | | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2005-09 8/ | | | | | | | | **104.8** | **105.0** | **105.7** | **106.4** | **107.1** | **107.8** | **2.2** |
| A2. No policy change (constant primary balance) in 2005-09 | | | | | | | | **104.8** | **104.4** | **103.6** | **102.9** | **102.4** | **101.9** | **1.5** |
| **B. Bound Tests** | | | | | | | | | | | | | | |
| B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006 | | | | | | | | **104.8** | **104.7** | **104.2** | **102.3** | **100.7** | **99.1** | **1.4** |
| B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **104.8** | **114.3** | **128.0** | **133.3** | **139.1** | **145.0** | **2.1** |
| B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **104.8** | **107.5** | **109.8** | **108.0** | **106.5** | **105.0** | **1.5** |
| B4. Combination of B1-B3 using one standard deviation shocks | | | | | | | | **104.8** | **110.4** | **116.7** | **115.1** | **113.7** | **112.3** | **1.6** |
| B5. One time 30 percent real depreciation in 2005 9/ | | | | | | | | **104.8** | **115.4** | **113.6** | **111.9** | **110.4** | **108.9** | **1.6** |
| B6. 10 percent of GDP increase in other debt-creating flows in 2005 | | | | | | | | **104.8** | **113.8** | **111.9** | **110.2** | **108.7** | **107.2** | **1.6** |

1/ Gross central government debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with $r$ = interest rate; $\pi$ = growth rate of GDP deflator; $g$ = real GDP growth rate; $\alpha$ = share of foreign-currency denominated debt; and $\varepsilon$ = 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 $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ 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, 1999–2009
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | | | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | |
| | | | | | | | | **I. Baseline Projections** | | | | | | **Debt-stabilizing non-interest current account 7/** |
| 1 **External debt** | 59.7 | 55.8 | 57.5 | 65.0 | 64.8 | | | **63.3** | **61.2** | **59.0** | **56.7** | **55.2** | **53.9** | **2.2** |
| 2 Change in external debt | 2.6 | -4.0 | 1.7 | 7.5 | -0.2 | | | -1.5 | -2.1 | -2.2 | -2.2 | -1.5 | -1.3 | |
| 3 Identified external debt-creating flows (4+8+9) | 0.4 | -6.8 | 5.9 | 9.4 | 0.6 | | | 2.7 | 2.6 | 2.5 | 2.0 | 2.5 | 2.4 | |
| 4 Current account deficit, excluding interest payments | 1.5 | 1.5 | 1.9 | 1.8 | -0.1 | | | 0.4 | 0.0 | 0.1 | -0.4 | -0.5 | -0.9 | |
| 5 Deficit in balance of goods and services | 3.2 | 0.7 | 3.3 | 4.0 | 1.8 | | | 2.3 | 2.8 | 1.5 | 0.5 | -0.3 | -1.1 | |
| 6 Exports | 36.1 | 39.8 | 35.3 | 37.1 | 38.9 | | | 42.7 | 43.4 | 44.2 | 45.0 | 45.3 | 45.8 | |
| 7 Imports | 39.3 | 40.5 | 38.5 | 41.2 | 40.6 | | | 45.1 | 46.2 | 45.8 | 45.4 | 45.0 | 44.7 | |
| 8 Net non-debt creating capital inflows (negative) | -3.2 | -6.4 | 0.4 | 1.3 | 0.1 | | | 1.1 | 1.0 | 1.0 | 1.2 | 2.0 | 2.0 | |
| 9 Automatic debt dynamics 1/ | 2.1 | -1.9 | 3.7 | 6.4 | 0.7 | | | 1.2 | 1.6 | 1.3 | 1.2 | 1.1 | 1.3 | |
| 10 Contribution from nominal interest rate | 3.6 | 3.6 | 3.2 | 3.2 | 3.2 | | | 3.5 | 3.7 | 3.5 | 3.4 | 3.3 | 3.2 | |
| 11 Contribution from real GDP growth | -1.4 | -4.3 | 0.5 | 0.5 | -0.8 | | | -2.3 | -2.1 | -2.2 | -2.2 | -2.3 | -1.9 | |
| 12 Contribution from price and exchange rate changes 2/ | -0.1 | -1.2 | 0.0 | 2.7 | -1.7 | | | ... | ... | ... | ... | ... | ... | |
| 13 Residual, incl. change in gross foreign assets (2-3) 3/ | 2.2 | 2.8 | -4.2 | -1.9 | -0.9 | | | -4.2 | -4.8 | -4.7 | -4.2 | -4.0 | -3.7 | |
| External debt-to-exports ratio (in percent) | 165.4 | 140.0 | 162.9 | 174.9 | 166.5 | | | 148.2 | 141.1 | 133.3 | 126.2 | 122.0 | 117.8 | |
| **Gross external financing need (in billions of US dollars) 4/** | 34.7 | 37.9 | 36.6 | 37.4 | 32.2 | | | 34.5 | 34.9 | 35.8 | 35.9 | 36.6 | 37.3 | |
| in percent of GDP | 33.5 | 33.0 | 32.5 | 36.1 | 29.6 | | | 30.5 | 29.2 | 28.3 | 26.7 | 25.6 | 24.6 | |
| **Key Macroeconomic Assumptions** | | | | | | 10-Year Historical Average | 10-Year Standard Deviation | | | | | | | Projected Average |
| Real GDP growth (in percent) | 2.5 | 8.0 | -0.9 | -0.7 | 1.3 | 3.8 | 3.4 | 3.6 | 3.5 | 3.9 | 4.0 | 4.2 | 3.7 | 3.8 |
| GDP deflator in US dollars (change in percent) | -2.1 | 2.4 | -0.9 | -7.3 | 3.7 | 1.3 | 4.9 | 0.1 | 2.2 | 2.0 | 2.0 | 2.0 | 2.0 | 1.7 |
| Nominal external interest rate (in percent) | 6.3 | 6.7 | 5.6 | 5.2 | 5.2 | 6.7 | 1.3 | 5.6 | 6.1 | 6.1 | 6.1 | 6.2 | 6.2 | 6.1 |
| Growth of exports (US dollar terms, in percent) | 15.6 | 22.0 | -13.1 | -3.1 | 10.0 | 7.9 | 10.1 | 14.0 | 7.4 | 8.1 | 7.9 | 7.1 | 7.1 | 8.6 |
| Growth of imports (US dollar terms, in percent) | 13.6 | 14.2 | -6.7 | -1.7 | 3.7 | 5.4 | 8.4 | 15.0 | 8.5 | 5.0 | 5.3 | 5.2 | 5.2 | 7.4 |
| Current account balance, excluding interest payments | -1.5 | -1.5 | -1.9 | -1.8 | 0.1 | -2.7 | 1.9 | -0.4 | 0.0 | -0.1 | 0.4 | 0.5 | 0.9 | 0.2 |
| Net non-debt creating capital inflows | 3.2 | 6.4 | -0.4 | -1.3 | -0.1 | 2.5 | 2.7 | -1.1 | -1.0 | -1.0 | -1.2 | -2.0 | -2.0 | -1.4 |
| | | | | | | | | **II. Stress Tests for External Debt Ratio** | | | | | | **Debt-stabilizing non-interest current account 7/** |
| **A. Alternative Scenarios** | | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2005-09 5/ | | | | | | | | **63.3** | **61.0** | **58.6** | **56.6** | **54.6** | **52.9** | **-1.7** |
| **B. Bound Tests** | | | | | | | | | | | | | | |
| B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006 | | | | | | | | **63.3** | **63.1** | **62.9** | **60.7** | **59.1** | **57.9** | **2.2** |
| B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **63.3** | **65.2** | **67.3** | **64.8** | **63.2** | **61.8** | **2.5** |
| B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **63.3** | **66.4** | **69.2** | **66.5** | **64.8** | **63.4** | **2.7** |
| B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **63.3** | **67.7** | **71.9** | **69.7** | **68.2** | **66.9** | **2.2** |
| B5. Combination of B1-B4 using one standard deviation shocks | | | | | | | | **63.3** | **72.8** | **83.0** | **80.4** | **78.5** | **77.0** | **2.6** |
| B6. One time 30 percent nominal depreciation in 2005 | | | | | | | | **63.3** | **80.6** | **77.4** | **74.4** | **72.4** | **70.9** | **3.1** |

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; $\rho$ = 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 $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. $\rho$ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of 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 projection year.

**Table 8. Israel: Monetary Survey (1999–2003)**
(In millions of new sheqels;end of period)

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Total assets in banks and government bonds | 600061 | 639008 | 699309 | 755688 | 792496 |
| Broad monetary assets | 426808 | 455863 | 490833 | 519491 | 506865 |
| Liquid financial assets (m3) | 236494 | 271942 | 309384 | 314907 | 322044 |
| Money supply (m1) | 23543 | 25307 | 29198 | 30628 | 32972 |
| Time deposits | 130722 | 160722 | 184878 | 182308 | 179724 |
| CD's | 24544 | 26365 | 28782 | 24835 | 29728 |
| Special deposits | 0 | 0 | 0 | 0 | 0 |
| Resident foreign currency | 43239 | 46766 | 52666 | 59967 | 61313 |
| Restitution deposits | 16997 | 15254 | 16403 | 20194 | 21246 |
| Long-term assets | | | | | |
| CPI-indexed saving schemes | 101805 | 93409 | 91499 | 108334 | 78978 |
| Foreign currency saving schemes | 6272 | 7578 | 6575 | 6779 | 5277 |
| Long-term CPI-indexed deposits | 58080 | 60223 | 60691 | 63248 | 72860 |
| Long-term denominated in and indexed deposits | 7158 | 7456 | 6280 | 6029 | 6459 |
| Earmarked deposits | ... | ... | ... | ... | ... |
| Short-term treasury bills | 18203 | 25866 | 26556 | 37967 | 51170 |
| Tradeable government bonds | 155050 | 157280 | 181920 | 198230 | 234460 |
| Stocks | 168227 | 161615 | 163834 | 116652 | 175877 |
| Total financial assets | 768288 | 800623 | 863143 | 872340 | 968373 |
| *of which* : nonindexed short-term assets | 197012 | 238259 | 269414 | 275737 | 293594 |
| | | | (In percent of total fin.a.ncial assets) | | |
| | 1999 | 2000 | 2001 | 2002 | 2003 |
| Total assets in banks and government bonds | 78.1 | 79.8 | 81.0 | 86.6 | 81.8 |
| Broad monetary assets | 55.6 | 56.9 | 56.9 | 59.6 | 52.3 |
| Liquid financial assets (m3) | 30.8 | 34.0 | 35.8 | 36.1 | 33.3 |
| Money supply (m1) | 3.1 | 3.2 | 3.4 | 3.5 | 3.4 |
| Time deposits | 17.0 | 20.1 | 21.4 | 20.9 | 18.6 |
| CD's | 3.2 | 3.3 | 3.3 | 2.8 | 3.1 |
| Special deposits | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Resident foreign currency | 5.6 | 5.8 | 6.1 | 6.9 | 6.3 |
| Restitution deposits | 2.2 | 1.9 | 1.9 | 2.3 | 2.2 |
| Long-term assets | | | | | |
| CPI-indexed saving schemes | 13.3 | 11.7 | 10.6 | 12.4 | 8.2 |
| Foreign currency saving schemes | 0.8 | 0.9 | 0.8 | 0.8 | 0.5 |
| Long-term CPI-indexed deposits | 7.6 | 7.5 | 7.0 | 7.3 | 7.5 |
| Long-term denominated in and indexed deposits | 0.9 | 0.9 | 0.7 | 0.7 | 0.7 |
| Earmarked deposits | ... | ... | ... | ... | ... |
| Short-term treasury bills | 2.4 | 3.2 | 3.1 | 4.4 | 5.3 |
| Tradeable government bonds | 20.2 | 19.6 | 21.1 | 22.7 | 24.2 |
| Stocks | 21.9 | 20.2 | 19.0 | 13.4 | 18.2 |
| Total financial assets | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| *of which* : nonindexed short-term assets | 25.6 | 29.8 | 31.2 | 31.6 | 30.3 |
| | | | (Real Annual Growth) | | |
| Total assets in banks and government bonds | ... | 6.5 | 7.9 | 1.5 | 4.9 |
| Broad monetary assets | ... | 6.8 | 6.2 | -0.6 | -2.4 |
| Liquid financial assets (m3) | ... | 15.0 | 12.2 | -4.4 | 2.3 |
| Money supply (m1) | ... | 7.5 | 13.8 | -1.5 | 7.7 |
| Time deposits | ... | 22.9 | 13.4 | -7.4 | -1.4 |
| CD's | ... | 7.4 | 7.6 | -19.0 | 19.7 |
| Special deposits | ... | | | | |
| Resident foreign currency | ... | 8.2 | 11.1 | 6.9 | 2.2 |
| Restitution deposits | ... | -10.3 | 6.0 | 15.6 | 5.2 |
| Long-term assets | ... | | | | |
| CPI-indexed saving schemes | ... | -8.2 | -3.4 | 11.2 | -27.1 |
| Foreign currency saving schemes | ... | 20.8 | -14.4 | -3.2 | -22.2 |
| Long-term CPI-indexed deposits | ... | 3.7 | -0.6 | -2.1 | 15.2 |
| Long-term denominated in and indexed deposits | ... | 4.2 | -16.9 | -9.9 | 7.1 |
| Earmarked deposits | ... | | | | |
| Short-term treasury bills | ... | 42.1 | 1.2 | 34.2 | 34.8 |
| Tradeable government bonds | ... | 1.4 | 14.1 | 2.3 | 18.3 |
| Stocks | ... | -3.9 | 0.0 | -33.1 | 50.8 |
| Total financial assets | ... | 4.2 | 6.3 | -5.1 | 11.0 |
| of which: nonindexed short-term assets | ... | 20.9 | 11.5 | -3.9 | 6.5 |

Source: Bank of Israel

## Fund Relations

(As of December 31, 2004)

I. **Membership Status**: Israel became a member of the Fund on July 12, 954, 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 | 629.95 | 67.87 |
| Reserve position in Fund | 298.26 | 32.13 |

III. **SDR Department**:

| | SDR Millions | % Allocation |
|---|---|---|
| Net cumulative allocation | 106.36 | 100.0 |
| Holdings | 9.77 | 9.19 |

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

V. **Financial Arrangements**: None

VI. **Projected Payments to Fund**:

| | Forthcoming | | | | |
|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 | 2009 |
| Principal | | | | | |
| Charges/Interest | 2.15 | 2.15 | 2.15 | 2.16 | 2.15 |
| Total | 2.15 | 2.15 | 2.15 | 2.16 | 2.15 |

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

VIII. **Safeguards Assessments**: Not applicable

IX. **Exchange Rate Arrangement**:

Israel has a *de facto* floating exchange rate regime. In principle, 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. But without intervention by the BOI during the past several years, the exchange rate has fluctuated freely 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 November 11, 2004, the width of the band, based on the average of the upper and lower limits, was about 60 percent.

X. **Article IV consultation**:

The last Article IV consultation was concluded on April 19, 2004. Israel is on the standard 12-month consultation cycle.

XI. **ROSCs**

Financial System Stability Assessment was conducted in 2000, issued in August 2001.

Fiscal Transparency ROSC was conducted in 2003, issued in March 2004.

XII. **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).

XIII. **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. Data submitted for the 2004 *Government Finance Statistics Yearbook* now present cash and accrual data for revenue and expense, following the *GFSM 2001* format. However, no data on transactions and stocks of financial assets and liabilities were submitted. Within-year monthly reports on central government operations cover only the main aggregates of budgetary accounts, not broken down by composition.

## Israel: Table of Common Indicators Required for Surveillance

As of February 15, 2005

| | Date of latest observation | Date received | Frequency of Data[6] | Frequency of Reporting[6] | Frequency of publication[6] |
|---|---|---|---|---|---|
| Exchange Rates | 1/31/2005 | 2/8/05 | D | D | D |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | | | | | |
| Reserve/Base Money | 11/2004 | 12/19/04 | M | M | M |
| Broad Money | 11/2004 | 2/1/05 | M | M | M |
| Central Bank Balance Sheet | 11/2004 | 12/19/04 | M | M | M |
| Consolidated Balance Sheet of the Banking System | | | | | |
| Interest Rates[2] | 11/2004 | 2/1/05 | D | D | D |
| Consumer Price Index | 1/31/05 | 2/1/05 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4] | | | | | |
| Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government | | | | | |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | | | | | |
| External Current Account Balance | Q2 2004 | 9/17/04 | Q | Q | Q |
| Exports and Imports of Goods and Services | | | | | |
| GDP/GNP | Q3 2004 | 12/15/04 | Q | Q | Q |
| Gross External Debt | Q3 2003 | 9/17/04 | Q | Q | Q |

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA)

**Statement by the IMF Staff Representative**
**March 21, 2005**

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 Bank of Israel (BoI) kept its policy rate unchanged for the month of March at 3.5 percent. The BoI in its press statement noted that the decision was based on the assessment that the current level of short-term interest is consistent with the inflation targeting range of 1-3 percent a year.

3. The latest reading of the consumer price index (CPI) showed that inflationary pressures remain subdued, with the January and February CPIs registering a decline of 0.6 percent m/m and a rise of 0.2 percent m/m, respectively. During the last 12 months, the CPI undershot the lower bound of the inflation targeting range, rising by 0.8 percent.

4. As of March 17, the 2005 budget has yet to be approved by the Knesset. Since the beginning of the year, the government has operated using the 2004 budget framework which allows 1/12 of that budget to be spent each month. If the Knesset fails to pass the budget by March 31, new elections must be held within 3 months.

5. The authorities initiated an investigation of Bank Hapoalim regarding money laundering activity amounting to several hundred million dollars and which involved certain customers and employees of a particular branch.

6. The government sold 6.5 percent of Bank Leumi to institutional investors. The government’s remaining holdings of Leumi stand at about 28 percent.

7. Following the completion of negotiations between the government and the ports’ labor unions, the authorities last month launched the separation of the two ports with the intention to privatize them in the future.

INTERNATIONAL MONETARY FUND

**Public Information Notice**

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/44
FOR IMMEDIATE RELEASE
March 29, 2005

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

# IMF Executive Board Concludes 2004 Article IV Consultation with Israel

On March 21, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Israel.[1]

**Background**

Economic recovery is underway after a prolonged recession. Growth is being supported by more favorable global economic conditions, an improvement in the security situation, and appropriate policies, which have included tightening the fiscal stance and easing monetary policy.

Real GDP grew by an estimated 4.3 percent in 2004, with exports and private consumption leading the way. The economy is expected to continue to strengthen, albeit at a slightly lower growth rate this year. Unemployment remains high, but is on a declining path. The exchange rate was stable throughout 2004, balanced by the drop in interest rates and the rebound in economic activity. The current account remained near balance.

The recovery has proceeded hand in hand with a consolidation of the fiscal stance, an easing of monetary policy, and the implementation of key structural reforms. The government is establishing a credible commitment to maintain future deficits below 3 percent of GDP and to limit government expenditure growth, in real terms, to no more than 1 percent a year. While such a deficit is still relatively high, particularly in light of the large public sector debt—105 percent of GDP—it represents a marked improvement compared to 2003.

Monetary policy loosened during the first few months of 2004, as inflationary pressures continued to ease. Subdued inflation amid sheqel appreciation against the U.S. dollar during the second half of the year prompted the Bank of Israel to lower its policy rate by 20 basis points in December 2004 and again in January and February of 2005 to 3.5 percent.

[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.

While rebalancing their macroeconomic policy mix, the authorities have also embarked on structural reform policies aimed at boosting competition and efficiency. These included privatization in key sectors as well as further labor market initiatives. The authorities are also considering a major capital market reform in addition to other measures designed to enhance capital market development already underway.

Most financial soundness indicators for the banking system have improved, albeit marginally, due to the strengthened macroeconomic environment. While the quality of banks' loan portfolios has yet to improve, it is expected to strengthen further as the recovery takes hold.

**Executive Board Assessment**

Executive Directors welcomed the improvements in policies that have helped strengthen Israel's economic performance. Economic growth has resumed, prices and the exchange rate are stable, and competitiveness has increased. While a favorable external environment and a better security situation have been important factors, prudent policies have been instrumental in this outcome. In particular, the authorities have rebalanced macro policies and undertaken an ambitious fiscal consolidation, while easing monetary policy. The government's commitment to boost competition and efficiency, including through welfare reforms and privatization, has enhanced market confidence and laid the foundations for future growth. Directors considered that the policy agenda ahead should continue to focus on strengthening the fiscal position, reducing the high level of public debt, and implementing key structural reforms.

Directors welcomed the authorities' commitment to limit the growth of public expenditure. To that end, they urged the authorities to adopt a multi-year budgetary framework and a detailed spending plan to enhance credibility, and to help ensure that future budgets are more insulated from political pressures and reflect long-term priorities.

Directors emphasized the importance of accelerating debt reduction by abstaining from further unplanned tax cuts and broadening the tax base through the elimination of various tax exemptions. They encouraged the authorities to implement steadfastly their fiscal deficit target and respect the expenditure growth limit for the years ahead. Some Directors felt that the fiscal deficit and expenditure rules should be more ambitious in order to achieve a more pronounced decline in the stock of public debt than presently planned that would underpin lower interest rates, greater private investment, lower future taxes, and faster medium-term growth. Accordingly, the automatic stabilizers ought to be allowed to operate fully should revenues overperform, and should be reined in partially should revenues underperform.

Directors commended the Bank of Israel's (BoI) success in maintaining low inflation, and welcomed the reductions in interest rates last year. Given that inflationary pressures are subdued and the inflation outlook is well within the BoI target range, the current policy rate appears appropriate, provided the external environment remains stable.

Directors recommended that the authorities update the Bank of Israel Law to reflect international best practices, in order to reinforce the central bank's independence and enhance its transparency and accountability. The updated law should specify that the primary function of the central bank is to ensure price stability. It should also provide for instrument independence and the establishment of a committee to set monetary policy.

Directors considered that the BoI’s current practice of using market-based indicators for implementing inflation targeting is broadly appropriate, but they saw scope for further enhancing inflation targeting tools and procedures. A few Directors cautioned that overreliance on market expectations of long-term real interest rates and inflation could contribute to price volatility. Directors welcomed the BoI’s intention to strengthen its statistical forecasting models for assessing the inflationary outlook.

Directors welcomed the authorities’ commitment to strengthen competition in the financial sector and the steps being taken to remove obstacles to capital market development. Regarding the authorities’ plan to require banks to divest themselves of their mutual and provident funds, a number of Directors understood the authorities’ preference for such a strong measure given Israel’s highly concentrated financial system. Other Directors, however, recommended that the risks of the divestiture strategy be carefully weighed. These Directors noted that the plan might go against trends elsewhere toward universal banking and that other more conventional measures being undertaken to open up the sector could meet the same objective. In any case, it was broadly agreed that if the authorities proceed with the plan, the regulations already on the books should be vigorously enforced and the supervisory and regulatory functions enhanced, in order to mitigate systemic risk from the transfer of mutual and provident funds to the non-bank sector. It will also be important to proceed rapidly with the other capital market reform measures under way or planned.

Directors welcomed the strengthening of Israel’s regime to counter money laundering and the financing of terrorism to a level comparable to best international practices. They noted the heightened cooperation between the relevant Israeli supervisory authorities and their counterparts in other countries.

Directors took note of the progress made in structural reforms, in particular the successful privatization of the national airline and the shipping entity in 2004. They concurred with the authorities’ plans for privatization of the ports, utilities, and oil refineries in the period ahead.

Directors agreed that welfare reform has started to bear fruit, as indicated by the reduction in unemployment and the increase in labor force participation. They welcomed the recent strengthening of existing active labor market programs and new pilot initiatives, but noted the scope for increasing spending in this area, which remains low in comparison to that in OECD countries. Directors considered that expanded and well-targeted vocational training and employment services could further assist new job seekers in entering the labor market.

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

## Israel: Selected Economic and Financial Indicators, 1999–2005

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 1/ | 2005 1/ |
|---|---|---|---|---|---|---|---|
| | (annual percent change; unless otherwise indicated) | | | | | | |
| **National account indicators** (constant prices) | | | | | | | |
| Private consumption | 3.3 | 7.7 | 2.7 | 1.1 | 1.3 | 5.2 | 4.0 |
| Public consumption | 2.8 | 1.8 | 3.5 | 5.0 | -2.0 | -2.0 | 1.0 |
| Fixed capital formation | 0.2 | 1.8 | -3.3 | -7.0 | -4.9 | -2.1 | 3.8 |
| Exports of goods and services | 13.1 | 23.1 | -11.2 | -2.4 | 6.2 | 14.6 | 7.3 |
| Imports of goods and services | 14.9 | 12.2 | -4.7 | -2.1 | -1.8 | 12.3 | 5.5 |
| Real GDP | 2.5 | 8.0 | -0.9 | -0.7 | 1.3 | 4.3 | 3.7 |
| **Labor market indicators** | | | | | | | |
| Unemployment rate (in percent) | 8.9 | 8.7 | 9.3 | 10.3 | 10.8 | 10.4 | 9.8 |
| Real wages | 5.7 | 1.7 | -2.6 | 0.1 | -3.2 | ... | ... |
| **Prices** | | | | | | | |
| Overall CPI (end period) | 1.3 | 0.0 | 1.4 | 6.5 | -1.9 | 1.2 | 1.6 |
| Underlying CPI (excluding housing, fruit and vegetables, end period) | 1.7 | 0.9 | 0.2 | 6.3 | -0.6 | 2.1 | 1.1 |
| **Interest rates** (average, in percent) | | | | | | | |
| BoI policy rate 2/ | 12.1 | 9.3 | 6.8 | 6.8 | 7.5 | 4.2 | ... |
| **Money and credit** (period average) | | | | | | | |
| Non direct domestic credit 3/ | 8.9 | -1.5 | 3.1 | 12.7 | -4.0 | 2.4 | ... |
| Narrow money (M1) | 3.3 | 11.0 | 14.2 | 15.6 | 0.5 | 18.1 | ... |
| Broad money (M3) 3/ | 21.9 | 15.3 | 15.5 | 6.1 | 2.2 | 4.5 | ... |
| | (in percent of GDP, unless otherwise indicated) | | | | | | |
| **Public finance** (percent of GDP) | | | | | | | |
| Central government revenue | 38.3 | 39.1 | 37.2 | 39.2 | 37.1 | 36.5 | 37.0 |
| Central government expenditure | 40.7 | 39.8 | 41.6 | 43.0 | 42.7 | 40.4 | 40.4 |
| Central government balance | -2.4 | -0.7 | -4.4 | -3.8 | -5.6 | -3.9 | -3.4 |
| General government balance | -4.2 | -2.1 | -4.1 | -4.5 | -6.4 | -4.3 | -3.6 |
| General government debt | 101.4 | 91.4 | 96.4 | 104.9 | 107.4 | 104.8 | 103.8 |
| **Balance of payments** | | | | | | | |
| Current account (percent of GDP) | -1.5 | -1.5 | -1.9 | -1.8 | 0.1 | -0.1 | 0.3 |
| Foreign reserves (e.o.p., in US$ billion) | 22.6 | 23.3 | 23.4 | 24.1 | 26.3 | 26.2 | 26.4 |
| Reserve cover (in months of imports) | 6.7 | 6.0 | 6.5 | 6.8 | 7.1 | 6.1 | 5.7 |
| | (annual percent change, unless otherwise indicated) | | | | | | |
| **Exchange rate and terms of trade indices** | | | | | | | |
| Nominal effective exchange rate (period average; depreciation -) 4/ | -7.7 | 9.1 | 0.7 | -13.5 | -7.0 | -3.4 | ... |
| Real effective exchange rate (period average; depreciation -) 4/ | -3.8 | 8.1 | -0.2 | -10.0 | -7.9 | -4.8 | ... |
| Terms of trade (1990=100; index level) | 104.3 | 101.3 | 99.2 | 99.3 | 97.8 | ... | ... |

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

1/ IMF staff estimates and projections.
2/ As of December 2004. The Bank of Israel set the policy rate at 3.5 percent in February 2005.
3/ As of October 2004.
4/ As of November 2004.

**Statement by Jeroen Kremers, Executive Director for Israel**
**and Herman Litman, Advisor to Executive Director**
**March 21, 2005**

***General remarks***

The authorities believe in "expansionary fiscal contraction" within the current Israeli economic circumstances, i.e. that tax cuts and curbs on public spending stimulate private sector effort via supply, given that spending and taxes are high and supply thus constrained. The authorities clearly signaled to the markets a break with the past. A fiscal adjustment has been realized of almost 3 percent of GDP from 2002 to 2004. The fiscal effort has been accompanied by easing monetary policy. The key policy interest rate has been cut from 8.9 percent in March 2003 to 3.5 percent in February 2005. To strengthen a virtuous circle, the authorities have reduced distortionary taxes and strengthened fiscal transparency and accountability to bolster confidence in the authorities' fiscal program. Furthermore, the authorities laid down the basis for sustainable noninflationary growth through privatization and other structural reforms.

By demonstration of credibility and commitment, the authorities have succeeded in changing market expectations. The public perception of the authorities' policies is that they are prudent, and that the government is committed to structural reforms. The change in market expectations is visible in the favorable responses of stock, foreign exchange and long-term bond markets, and in the reduction of the country risk premium.

***GDP***

After negative growth in 2001-02 and timid growth in 2003, GDP grew 4.3 percent in 2004. The security situation which has improved markedly, renewed US demand for technological products[1], prudent fiscal policy and the easing of monetary policy have spurred growth. As the public sector is shrinking due to structural reforms and the intentional policy of the government, business-sector product is a better indication of economic performance. Business-sector product grew 6.1 percent. Exports (excluding diamonds and start-ups) which rose 16.3 percent, domestic private consumption, which rose 5.7 percent, and investment, which rose 6.4 percent, all contributed to robust GDP growth. The 12.3 percent growth of imports provided an additional indication that domestic demand has picked up. The State of Economy Index (which combines leading economic indicators) rose 5.2 percent in 2004, the highest rise in 10 years.

Almost 70,000 new jobs have been created in the private sector, an increase of 4.5 percent. As a consequence of government policies, the government is no longer perceived as "an employer of the last resort" and the number of jobs in the public sector declined. In 2004 unemployment fell from 10.9 percent to 10.0 percent.

***Monetary issues***

[1] Electronic communication equipment, scientific equipment, control and supervision equipment, and electronic components.

Staff commends the BoI for maintaining low inflation and finds the recent cuts of its key policy rate appropriate. In February 2005 the interest rate stood at 3.5 percent, a record low in the history of Israel, after it had been cut three times, each by 20bp, since November 2004. Only in March 2003 it stood at 8.9 percent. Nevertheless staff finds models and communication policy, which underpin monetary policy, wanting.

The BoI conducts simulations of two policy-oriented macro econometric models for briefing materials, which are presented at monthly interest rate meetings. The reason for basing decisions more heavily on market-based expectations is not for lack of models, but because the simulation results do not always seem reasonable. The available models developed at the BoI reflect state-of-the-art methodology as well as the difficulties of modeling an economy as noisy as Israel's. Therefore, there is a fundamental problem with available models and they should be *underweighted* relative to market-based information and informed judgment. The BoI is actively seeking, devoting considerable resources, to produce an improved forecasting framework, and hopes to benefit from the lessons to be drawn from the Fund's survey of all countries that have adopted inflation targeting. Until such a framework is available, the current use of market-based measures and, especially, informed judgment seems appropriate.

As regards communication policy, transparency is not an end in itself but a means to enhance credibility of the central bank. Concerning the issue of publication of forecasts, there is the logical difficulty of publishing an inflation forecast that is potentially different from the target. The publication of forecasts for a relevant horizon that are different from the target would damage credibility. Logical consistency is likely to be as important as transparency in promoting credibility of policies. Based in large part on the recommendations of the previous mission, the BoI did publish in its mid-2004 *Inflation Report* a general direction of interest rates for the half year till the next *Report* and it turned out to be wrong. Such forecasts would be wrong about as often as they are right.

***Fiscal issues***

The cap on government spending growth of 1 percent (in real terms) together with the growing economy, downsize the weight of the public sector in the economy: the public sector expenditure-to-GDP ratio has declined from 54.3 in 2002 to 51.6 percent in 2004, and the authorities plan to reach 40 percent in 2010. This way, Israel will move from one of the highest ratios in OECD to around average OECD level. The authorities not only capped the total expenses, but also conducted a minute examination of all expenditures in order to cut waste and inefficiencies, especially in wages, which amount to 27 percent of total expenditures. The departments of direct and indirect taxations have been unified. The unified procurement department, which started operation in 2005, is projected to save, in the medium term, between 10 to 20 percent on the procurement bill of NIS 30 billion. In late 2004, monitoring of transfers was unified. A better discipline of payments for goods and services should also cut costs. The authorities continue to broaden the tax base. The 2005 budget includes elimination of various tax exemptions.

The 1 percent cap on public expenditure growth allowed the authorities to fulfill their commitment to decrease the general government debt ratio, and to continue with gradual implementation of tax reform, in order to reduce distortionary taxes. The debt decreased from 106.5 percent of GDP in 2003 to 104.9 percent in 2004. Within the framework of the tax reform, the maximum tax rate on wages has been cut from 60 to 49 percent, and the corporate tax will be gradually cut from 36 to 30 percent.

The 2004 fiscal deficit was 3.9 percent of GDP, lower than the target of 4 percent, compared to 5.6 percent in 2003. Without the disengagement cost, the 2005 fiscal deficit is targeted at 3 percent of GDP. The cost of the disengagement plan, to be implemented in 2005 -07, amounts to 1 percent of GDP.

***Capital market reform***

The concentration of the Israeli capital markets is unique not only by its level, but also by its characteristics. It is dominated by two large banks. The Israeli banks almost completely dominate the country's provident funds (providing management), which comprise a significant component of pension savings in Israel. Non-bank intermediaries which provide a viable alternative to banking services are virtually absent in Israel. The Israeli banks do not face competitive “threats” from abroad. Therefore, the concentration of the Israeli capital markets has much greater adverse effect on their competitiveness.

The authorities believe that development of the capital markets should be promoted by a wide range of measures, and they are convinced that the divesture of provident and mutual funds from the banks is a condition for all the additional measures to achieve effect.

There is no evidence to substantiate staff’s hesitation that the reform may deter potential players from entering the Israeli capital markets. On the contrary, evidence supports the view that the reform will prompt new players to join the markets. This is based, *inter alia*, on the outcome of the decision from 1996 to restrict banks from holding substantial interests in insurance companies. This decision has prompted foreign insurance companies to enter the insurance sector. In addition, following the proposed reform (which is now in the public domain), there has been a rise in foreign interest in the Israeli financial markets: e.g. the recent sale of the controlling share in the Israel Discount Bank and of 6.5 percent of Bank Leumi’s shares to a foreign institutional investor. Therefore, the authorities believe that the sale of provident and mutual funds by the banks will present opportunities for foreign financial institutions. Such institutions, that are not attracted by direct investment in banking activity, *per se*, can realize their competitive advantage in the asset management field. From discussions held with foreign financial institutions, it is clear that such parties do not fear the authorities’ regulative intervention, as long as it is clear and consistent. There is no uncertainty about the authorities’ future intentions: once competition is established, the restrictions will be lifted.

The reform will not “radically restrict” banking activity. The banks will be allowed to continue to sell provident and mutual funds, and will, for the first time, be allowed to sell pension and life insurance products in their branches. Therefore, the authorities believe that it is possible that the volume of activity of the banks will even broaden.

The authorities intend to proceed to legislate the divestiture of mutual and provident funds. The authorities are aware of risks but think they are containable. Having in mind that the proposed reform constitutes a major change, they will implement it in a controlled, cautious and gradual way, and will strengthen regulation (among others, through the adoption of a new provident law) and improve enforcement.

***Labor markets and structural reforms***

As economic growth is not yet sufficient for substantially reducing unemployment – many of the new jobs were created in the high-tech sector, and many of other new jobs were part-time jobs - the authorities have improved the existing and launched new active labor market policies. One of the new programs aims at increasing employment in the periphery which suffers from higher than average unemployment rates. The program subsidizes the creation of new, better-paid jobs, through one-stop employment centers, operated by foreign companies. The centers will cover 14,000 households in the first stage. There was also a significant improvement in the existing employment service: the employment placement rose 30 percent compared to 2003.

The authorities have continued with implementation of their ambitious agenda of boosting competition and efficiency. The shipping company ZIM, the national airline El-AL, the new pension funds, and the third largest bank, the Israel Discount Bank, have been privatized. The authorities launched the gradual opening of mail services to competition, privatization of the refineries, and the separation and privatization of the two sea ports. The authorities sold 6.5 percent of shares of Bank Leumi, the last publicly owned bank, to an international institutional investor, and they consider various ways to dispose of the remaining 28.5 percent of the shares.

***ALM/CFT***

In June 2002, Israel was removed from FATF's list of "noncooperative countries", and following further examination, also from its "monitoring list". Israel's progress in strengthening its ALM/CFT regime had been confirmed by the MFD-led mission, which visited Israel at the end of 2002. The ALM/CFT regime has been further strengthened by implementation of the mission's recommendations, including, *inter alia*, cooperation among the relevant supervisory authorities and information exchange between domestic and overseas supervisors.

The authorities carried out inspections in the last few years in order to ensure that all tools were put in place to implement the Prohibition on Money Laundering Law. The joint efforts of the authorities and the financial institutions over the last few years brought the Israeli AML/CFT regime to a level comparable to best international practice. In parallel, the enforcement authorities carry out investigations and inspections of specific centers of activity in order to identify breaches of the law, law-breakers and exceptional activities.

The recent widely publicized police investigation is part of this fight against money laundering. The authorities' investigation in one branch of Bank Hapoalim and Bank Hapoalim's subsidiary, the Bank Hapoalim Trust Company, brought to light findings that appeared to constitute exceptional activity that bypassed the management team and the controls practiced by the Bank Hapoalim. It is suspected that the sums involved in this activity amounted to several hundred million dollars and involved certain customers and employees of the branch and the Trust Company. The relevant overseas supervisors were also notified.