© 2009 International Monetary Fund

February 2009
IMF Country Report No. 09/57

Israel: 2008 Article IV Consultation—Staff Report; 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 2008 Article IV consultation with Israel, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 16, 2008, 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 January 27, 2009. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 13, 2009 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Israel.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 2008 Article IV Consultation

Prepared by the European Department

Approved by Anne-Marie Gulde-Wolf and Anthony Boote

January 27, 2009

Consultation discussions were held in Jerusalem and Tel Aviv during December 3–16, 2008. The staff team—Messrs. Doyle (head), Lundback, Mehrez, and Tang (all EUR)—met with Minister of Finance Bar-On, Bank of Israel Governor Fischer, and other senior officials of the government, the Bank of Israel, and the Israeli Securities Authority. It also met with academics, and representatives of the private sector, including financial institutions, the manufacturing association, and the labor union. Mr. Friedmann (OED) participated in the meetings.

Contents Page

I. Summary and Appraisal....3
II. The Context....6
III. Near Term Outlook and Risks....18
IV. Implications for Policies and Policy Frameworks, 2009–10....20
A. Financial Sector Policy and Framework....20
B. Fiscal Policy and Framework....22
C. Monetary Policy and Framework....27
V. The Authorities' Views....29

Boxes
1. Competitiveness and the Equilibrium Real Exchange Rate....10
2. Implementation of IMF Recommendations....12
3. Why was Israel's Financial Sector not More Affected by the Global Financial Crisis?....15
4. Is Israel Ready to Address Financial Instability, if it Occurs?....21

Figures
1. The Long View, 1996–2008....7
2. External Indicators, 2001–08....8
3. Recent Economic Indicators, 2001–08....9
4. Selected Monetary and Financial Indicators, 2006–08....11

5. Indicators of Competitiveness....13
6. Public Debt Sustainability: Bound Tests 24

Tables

1. Selected Economic and Social Indicators, 2001–08 31
2. Financial Soundness Indicators, 2001–07....32
3. Balance of Payments, 2005–13....33
4. Indicators of External and Financial Sector Vulnerability, 2001–08 34
5. Medium-Term Scenarios, 2008–13 35
6. Central Government Accounts, 2003–09....36

Attachments

I. Financial Sector Reform: Diversification and credit crunch 37
II. Global Spillovers to Israel 43
III. External Vulnerability....49
IV. Fiscal Sustainability....57

I. Summary and Appraisal

Israel was well situated when the global financial turmoil began in the fall of 2007

1. Fiscal and monetary credentials were established in markets; banks and their supervisory arrangement were robust; and growth was strong, sustained, and balanced. Though public debt is much reduced, to around 80 percent of GDP, it remains a vulnerability.

2. That set the stage for a relatively strong performance into the third quarter of 2008. As conditions deteriorated abroad, economic growth continued. And although domestic securities prices tracked those abroad downwards, prompting outflows from provident funds, flows in domestic credit markets remained largely undisturbed. In this context, capital inflows and the Shekel strengthened.

Since the fall of 2008, challenges facing policymakers have deepened profoundly

3. With the intensification of financial strains internationally, global demand, prospects, and securities markets slumped, and the Israeli real sector showed the first signs of strain. Declines in commodities prices, inflationary pressures, policy interest rates and the Shekel provided some respite. With elections due in February, the 2009 budget will not be adopted until well into the new year.

4. There is little sign that global difficulties will ease soon. Recessions in the U.S. and Euro areas are anticipated through the first half of 2009, but their length and depth is highly uncertain

5. With Israeli investment and exports weak, the staff central scenario anticipates a decline in economic growth to ½ percent in 2009, with average inflation around 1½ percent. A modest recovery is projected for 2010. However, financial sector vulnerabilities abroad imply that risks are firmly to the downside, notwithstanding strong profiles for external amortization and short term external debt.

Despite the global origins of present challenges, strong domestic policy can help

6. Policy needs to be well coordinated, with steps to strengthen long-run credibility increasing scope for flexibility in addressing immediate exigencies. In summary, we recommend, in the central scenario context, key steps to support credit flows and stability, a flexible near term budget stance backed by enhanced commitments to public debt reduction in the medium-term, and further monetary relaxation. These recommendations are subject to review should significant downside risks materialize.

Progress—notably concerning stability and credit flows—has already begun

7. Policymakers' immediate attention has rightly turned to the nexus of concerns regarding credit flows and financial stability.

8. The recently approved public-private fund to purchase corporate bonds is welcome. It should be established promptly and tasked primarily to support new credit flows for large solvent firms. Alongside, the initiative to streamline procedures to reorganize corporate bonds is welcome.

9. Given these steps to support credit flows, other financial sector initiatives should focus on further strengthening bulwarks against extreme strains on banks. This includes the proposed guarantee for bond issues by banks, which is an appropriately pre-emptive step to increase bank capital. Restrictions on dividend payments by participating banks would maximize its effect.

10. In addition, the technical review of legal provisions concerning troubled banks is welcome. The mandated rapid publication of lender-of-last-resort actions for publicly traded companies should also be reviewed to ensure that this policy instrument is fully effective in a crisis context.

11. The package of initiatives outlined above constitutes a first step. If downside risks materialize, abroad or domestically, more may be needed.

On the fiscal side, flexibility is required

12. There is a clear case to allow automatic stabilizers to operate fully given the degree of fiscal credibility. But the likely relatively moderate extent of the economic slowdown in 2009 and the still high debt ratio counsels against going much further than that.

13. Accordingly, the structural fiscal balance in 2009 should be unchanged from 2008, excluding the financial sector support initiatives described above and any already-committed investment and infrastructure projects which are brought forward. This stance leaves essential "fiscal firepower" in reserve should downside risks materialize, and it underscores commitment to fiscal sustainability. All these desiderata are implicit in the deficit outturns likely to emerge from implementation of the draft 2009 budget, which is therefore appropriate.

But flexibility requires enhanced credibility

14. The draft 2009 budget, the policy initiatives described above, and the fiscal outlook for 2010 could imply headline budget deficits for consolidated general government well in excess of 4 percent of GDP in 2009 and 2010. These are large numbers and public debt ratios

will rise. This underscores need to reinforce confidence in long run fiscal sustainability. Adjustments to the framework of fiscal rules will help to address these concerns.

Credibility might best be secured through adjustments to the fiscal rules

15. The one-year ceiling on the deficit of 1 percent of GDP needs to adjust to allow the operation of automatic stabilizers in 2009. Building on recent proposals from the Ministry of Finance, one alternative could be to replace it with a formal commitment to reduce public debt to well below 60 percent of GDP during the middle years of the next decade. This objective would be backed by new budget procedures laying out annually and in detail how and when the ultimate debt objective would be realized.

16. This flexible framework would also allow an effective fiscal response in the event that significant output downside risks materialize immediately during 2009, which a monetary response cannot fully address.

17. And the other fiscal rule—the annual cap of 1.7 percent on real spending growth—may also need to be amended. Instead, adoption of caps for three years ahead on annual nominal spending, excluding emergency outlays, has merit. This framework would be highly transparent, would improve the operation of fiscal stabilizers, and would buttress monetary responses to inflation surprises.

In this context, monetary policy can take the lead

18. On the monetary side, the advantages of the inflation targeting and flexible exchange rate frameworks are now more apparent than ever. Furthermore, the credit-supporting and financial stability initiatives outlined above will help to maintain the effectiveness of the domestic monetary transmission mechanism, while the suggested fiscal policy and framework steps reduce need for the Bank of Israel (BoI) to weigh upside risks as it pursues the inflation target. Both will allow monetary policy to play its maximum role in addressing external weakness and uncertainties.

19. Even after the most recent monetary easing, inflation is still set to fall below the target range for much of 2009 with indicators of inflation expectations remaining very subdued. If the outlook for output continues to deteriorate, with policies as outlined above, scope therefore remains for further reductions in policy rates.

Strong reserves and planned adjustments in the BoI law will boost credibility further

20. Increased international reserves—now over 100 percent of short-term debt—have attenuated external vulnerabilities. Purchase modalities under the program appropriately avoided any discretionary intervention.

21. Preparations for a new BoI law are welcome. In particular, provision in the draft law for establishment of a monetary policy committee of well qualified experts to determine the policy rate is appropriate.

Nonetheless, the outlook remains uncertain

22. Even with policies thus calibrated to address the coming slowdown and downside risks, prospects are challenging. While much has been done, planning for contingencies needs to proceed further and urgently.

23. Israel should remain on the standard 12–month consultation cycle.

II. THE CONTEXT—2004–08 [1]

Israel has enjoyed sustained balanced growth (Figure 1)

24. Real GDP growth rebounded strongly from the 2001–03 slump, averaging over 5 percent since then (Table 1, Figure 1). Export of goods and services supported employment and incomes, spurring private consumption and investment (Figures 2 & 3). Despite the deteriorating merchandise trade balance, strong transfers kept the current account in surplus. Inflation has been subdued and inflation expectations were well-anchored by the Inflation Targeting (IT) regime. These assessments are shared by the authorities (¶68).

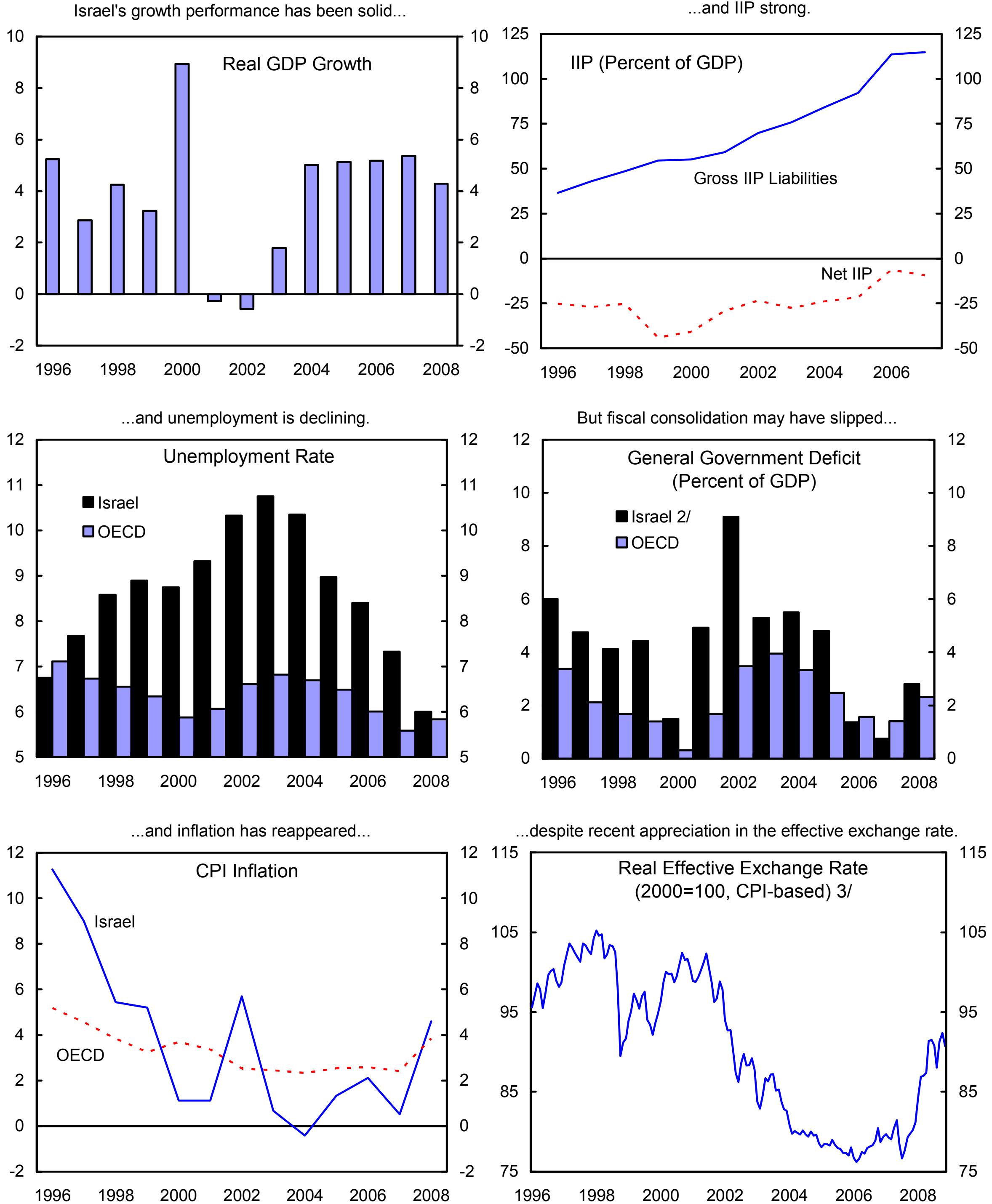
This has reflected and supported strong fiscal and financial sector policies

25. In this context, public debt was lowered from 100 percent of GDP in 2003. This was secured by adoption and adherence to fiscal rules—a cap of 1.7 percent on annual real expenditure growth (excluding emergency security-related items) and deficit ceilings for central government. The general government structural primary balance strengthened steadily from 1½ percent of GDP in 2004 to 2¼ percent in 2007, and public debt fell to just under 80 percent of GDP in 2007.

26. Far reaching financial sector reforms proceeded alongside (Table 2, Attachment I). These have significantly diversified financial markets, reflected in a switch from bank towards nonbank credit—including corporate bond issuance—to the business sector.

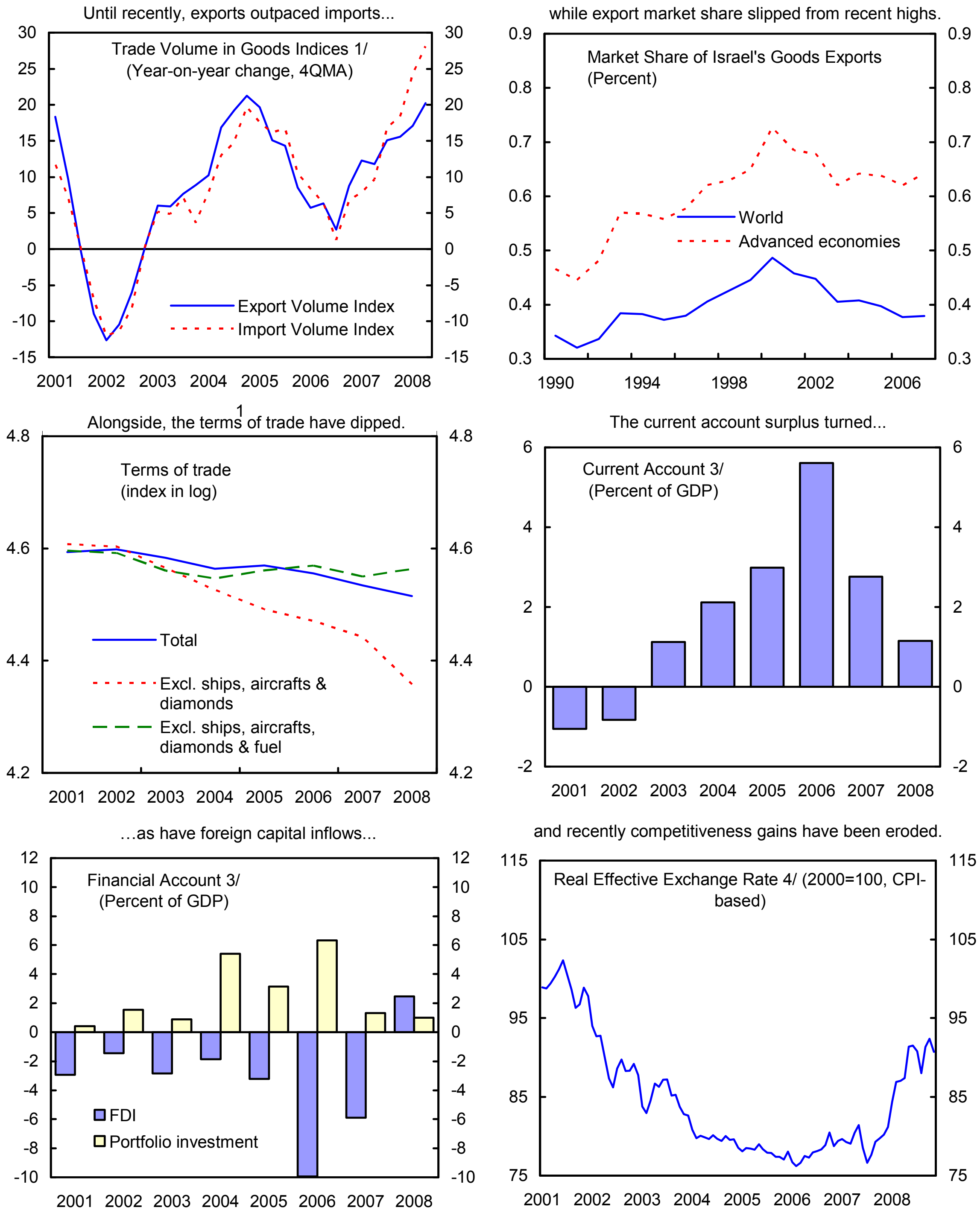
[1] Paragraph references in sections II-IV refer to the paragraphs reporting the authorities' views on the relevant topic.

Figure 1. Israel: The Long View, 1996−2008 1/
(Percent, unless otherwise indicated)



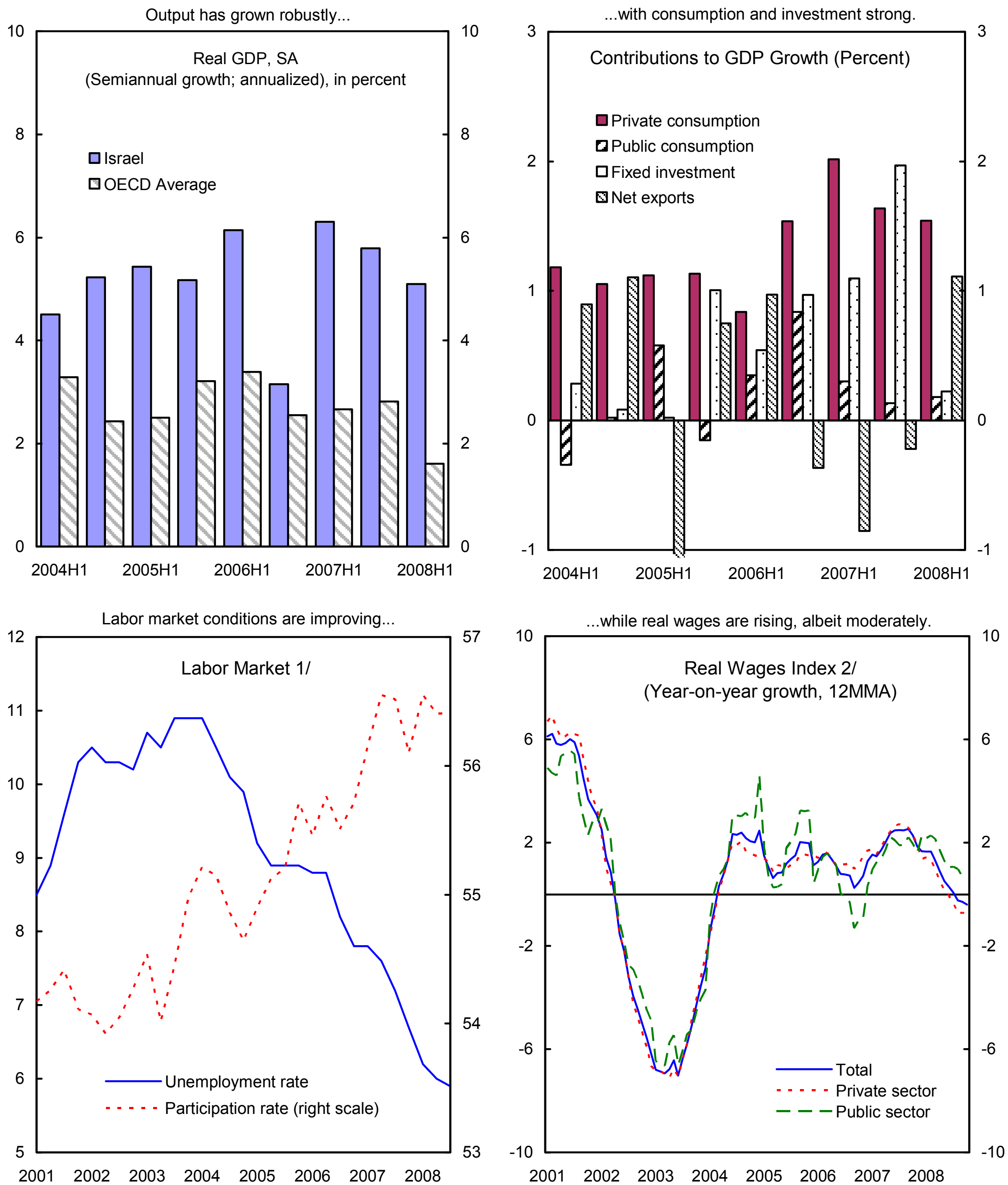
Sources: IMF, *World Economic Outlook;* and IMF, *Information Notice System.*
1/ Projections for 2008.
2/ From 1999 onward, international definition, accrual basis.
3/ Data for 2008 as of June.

Figure 2. Israel: External Indicators, 2001−08



Sources: Central Bureau of Statistics; Bank of Israel; and IMF staff projections.
1/ Inclusive of goods and services; data for 2008 as of April.
2/ Projection for 2008.
3/ A decrease represents depreciation. Data for 2008 as of October.

Figure 3. Israel: Recent Economic Indicators, 2001−08
(Percent, unless otherwise indicated)



Sources: Central Bureau of Statistics; Bank of Israel; IMF, *World Economic Outlook;* and IMF staff calculations.
1/ Seasonally adjusted; data for 2008 as of July.
2/ Data for 2008 as of September.

External vulnerabilities are contained, and competitiveness remains firm

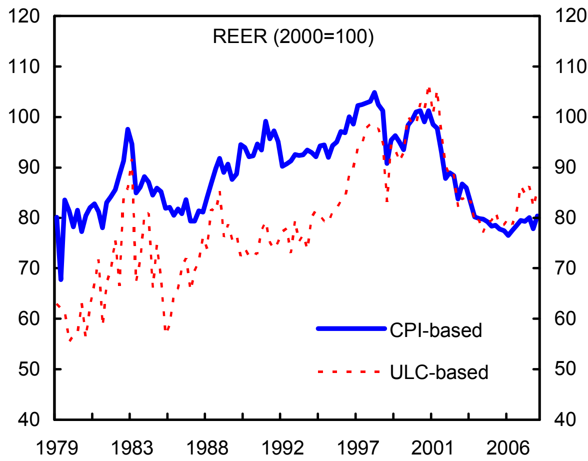
27. Strong policies have supported resilience and competitiveness (Box 1). Accordingly, despite gross external debt of some 43 percent of GDP, the net International Investment Position (IIP) has also strengthened further, with overall liabilities only modestly exceeding assets currently, and gross debt liabilities less than gross debt assets in the short-term and overall. Alongside, although indicators are mixed, competitiveness appears comfortable. The recent Shekel appreciation provided an opportunity, in the authorities' view, to implement a program of reserve accumulation to attenuate external vulnerability further (¶75).

Box 1. Competitiveness and the Equilibrium Real Exchange Rate

After a six year period of weakness, the Shekel appreciated about 20 percent in real terms in 2007, returning to its long-term average (See Figure 4). The trend current account balance was the mirror image of this pattern—relatively strong in the period of six year shekel weakness, and deteriorating more recently (though remaining positive through the third quarter of 2008).

On balance, the Shekel appears to be around its equilibrium, in light of various indicators. Abstracting from the temporary boost from the dot.com bubble to Israel's high tech exports and hence its overall export market share, penetration of global markets has remained broadly stable, Export growth remained firm until late 2008 when the weakening of the global economy began to be felt. Also, (i) some of the weakening in the merchandise trade balance reflects strong—and likely sustainable—income and net transfers from abroad (even if both weaken in the immediate period ahead); (ii) there are few signs of loss of labor competitiveness, either from relative unit labor cost measures or unemployment; (iii) and trade in services is still in surplus. These assessments are supported by the CGER estimates.

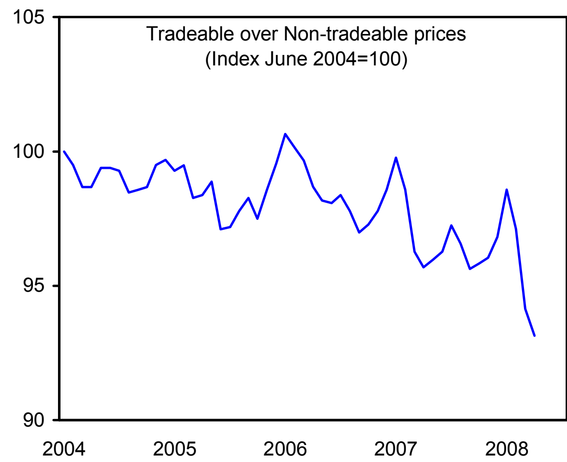
Figure 4. Indicators of Competitiveness



Real Exchamge Rate
Fall 2008 CGER Assessment

Approach	RER Valuation Conclusion
MB	2 % over
ES	3 % under
ERER	8 % over
Average	2 % over

MB: Macro Balance
ES: External Sustainability
ERER: Reduced form Equlibrium REF



Sources: Bank of Israel; *Direction of Trade Statistics;* Haver Analytics; IMF, Information Notice System; and IMF staff calculations.

28. Strong macroeconomic developments reflect policies consistent with past staff recommendations (Box 2).

Box 2. Implementation of IMF Recommendations

Fiscal policy and framework. As recommended, a sustained program of fiscal consolidation and debt reduction has been implemented, secured in part by adoption and adherence to a home-grown medium-term fiscal deficit target framework. Recommendations to strengthen fiscal transparency and governance remain outstanding.

Monetary policy: In the context of a strong inflation targeting framework, the BoI has enhanced its communications with the markets, including through regular publication of fan-chart projections.

Financial sector: Given ambitious financial sector reforms, the authorities have been fostering their capacity to supervise the increasingly complex domestic financial firms and markets.

In 2008, however, external shocks brought new challenges

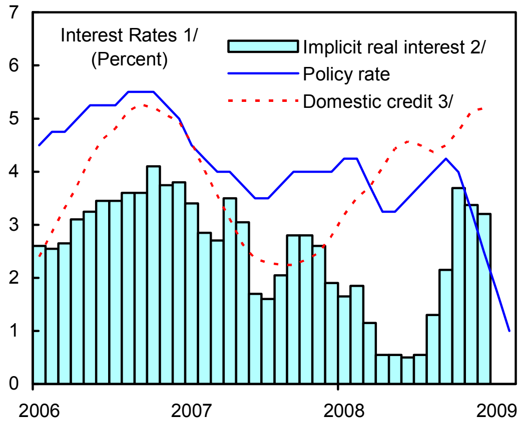
29. Soaring global food and fuel prices first raised inflation concerns. Thereafter, as global financial turmoil deepened, output prospects weakened even as global commodity prices fell back. In this context, S&P downgraded its rating for Israeli sovereign foreign currency credit one notch to stable in late October 2008.

Monetary policy adjusted swiftly

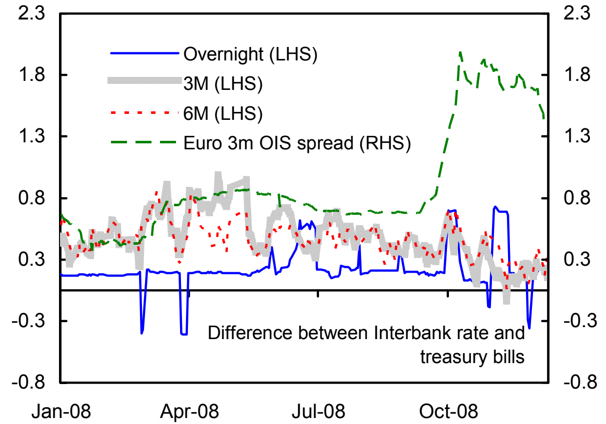
30. Under the IT regime, monetary policy adjusted nimbly to this shifting environment (Figure 5). When external price shocks—compounded by diminishing economic slack—pushed headline inflation substantially above target, policy rates were raised gradually by 75 bps in the five months to February 2008 to 4¼ percent. With inflation expectations apparently anchored, rates were then lowered in light of global and domestic output concerns, albeit with a temporary reversal in this trend when high CPI outturns from April suggested residual inflationary challenges. But as the global financial crisis deepened later in the year, interest rates have been reduced appropriately since 2008 September, in six steps to 1 percent (¶70). Indicators of medium-term inflation expectations slumped, albeit rising modestly in recent weeks. Inflation nevertheless remained above target at end–2008.

Figure 5. Israel: Selected Monetary and Financial Indicators, 2006–08

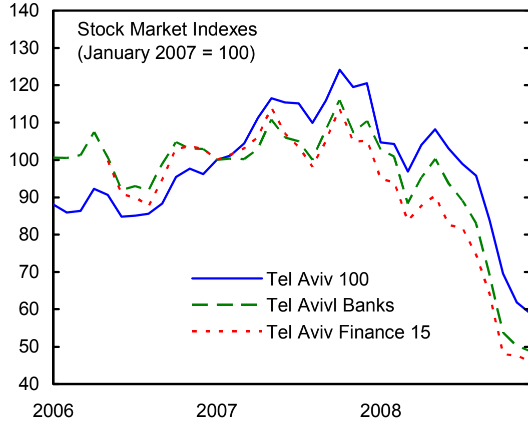
Policy rate has has responded to uncertain global conditions in the context of moderate credit growth.



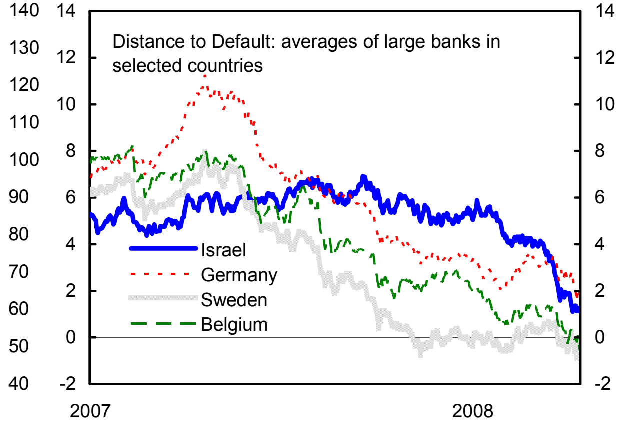
Recent money market strains have been limited...



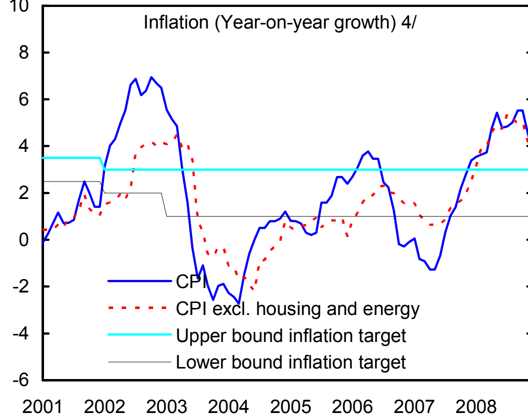
…while equity markets plunged.



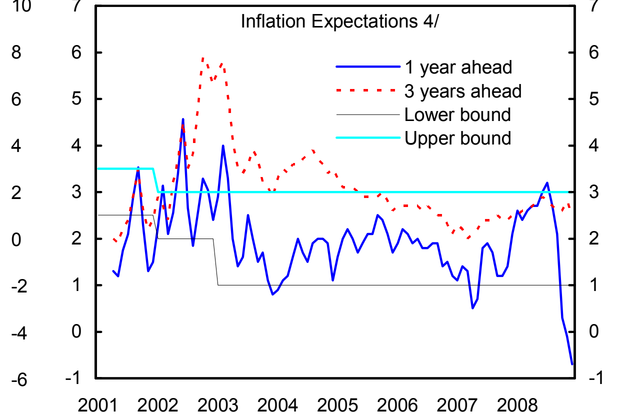
And bank default risks rose.



Inflation has risen above the band...



…but inflation expectations have recently dropped sharply.



Sources: Bank of Israel; IMF, *International Financial Statistics;* and Bloomberg.
1/ Data for 2008 as of November.
2/ Defined as the Bank of Israel policy rate minus inflation expectations.
3/ Data for 2008 as of October.
4/ Data for 2008 as of November.

And overt banking sector strains have been relatively few

31. Banking vulnerabilities appeared to have been contained, so far. Bank losses due to ABS exposures were minimized as they were sold early in 2008, leaving marginal remaining exposures.[2] Banks remain profitable, largely deposit-funded, and strongly capitalized (significantly above the legally required ratio of 9 percent), despite some exposure to failed international institutions (See Text table and Table 2). There is little sign of stress in money markets, notwithstanding sharp falls in banks' share prices and the associated distance-to-default measures—mirroring similar falls for other domestic and global financial firms (Figure 5). The only sign of a change is the increase in non performing loans (Box 3).

Summary of Banks Balance Sheet

	Bank Hapoalim		Bank Leumi		Mizrahi Bank		Discount Bank		First Int. Bank	
	Sep-08	2007	Sep-08	2007	Sep-08	2007	Sep-08	2007	Sep-08	2007
Credit/ asset	72.1	67.7	70.6	65.7	78.4	78.0	66.7	60.4	66.1	60.1
Securities/asset	10.0	15.9	14.1	15.6	7.0	6.4	17.5	22.1	16.9	23.2
Depoit/ liability	77.2	81.8	82.5	84.3	106.1	83.9	78.5	81.9	86.4	87.4
Bonds and subordinated notes/lliability	7.4	6.6	8.1	6.8	6.8	6.9	5.9	4.7	4.6	4.3
Equity/Assets	6.4	6.2	6.7	6.5	5.5	5.8	5.1	5.5	5.7	5.9
Equity/Risk Assets ratios	11.5	10.3	12.1	11.5	11.4	11.3	10.6	10.9	11.4	11.4
Return on Equity	-3.8	14.1	8.5	17.4	12.1	17.2	5.3	14.7	5.8	14.6
Assets (million, NIS)	297854	302991	293811	302151	107015	95317	170573	168719	96977	92516

Source: Bank of Israel.

[2] Bank Hapoalim (with 30 percent of total banks' assets) wrote off NIS 3 ½ billion in Q1 2008, leaving exposure of NIS 1½ billion and yielding overall loss for the quarter of some NIS 1½ billion, returning to profit in Q2. Bank Leumi (the second largest bank) reported ABS exposures of about NIS 6 billion, largely guaranteed by FNMA. ABS exposures of other banks appear small.

Box 3. Why was Israel's financial sector not more affected by the global financial crisis ?

Although Israel is highly integrated in the global economy with free capital mobility and extensive international trade and financial flows, financial markets held up relatively well compared with other small open economies (Figure 6). The shekel has strengthened until recently despite foreign exchange purchases by the BoI, and has been less volatile than many other currencies. Although the drop in equity prices was similar to other markets, the volatility has been smaller. Furthermore, bank share price falls have been in line with non-bank declines, a much better performance than elsewhere. The drop in corporate bonds has been similar to the global drop in corporate bonds with similar volatility. Finally, while global money markets came under severe stress, the overnight inter bank market in Israel has continued to operate calmly, albeit that it comprises only inter bank overnight lending.

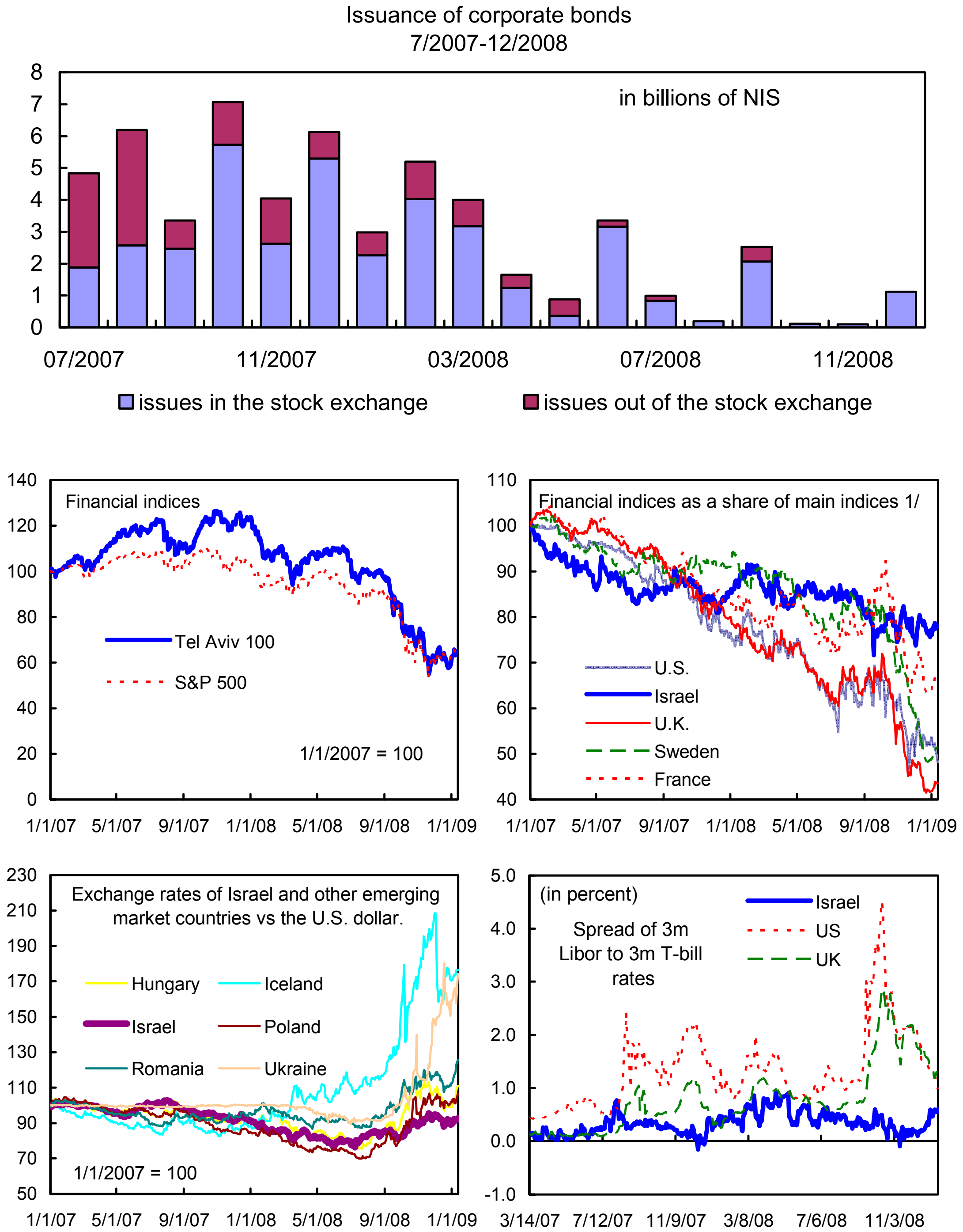
The relative strength of the financial sector is a result of conservative banking practices, transparency, and the longstanding implicit government guarantees that anchored confidence. Until the reforms of the last few years, banks benefited from strong market power, which provided little incentive to develop sophisticated financial instruments and move away from relatively conservative practices (See attachment I). The recent reforms increased competition and banks started to explore new markets abroad as well as new lines of businesses. However, for lack of time since reform was initiated, when the global crisis commenced, Israeli banks' exposures remained limited.

In addition, transparency has been high. The small and intimate size of the banking system, and the enhanced regulations that required more detailed reporting helped maintain confidence in the integrity of available information. This was boosted further by enhanced transparency rules adopted over the past year.

Finally, confidence in the ability of banks to meet their obligations was enhanced by the implicit government guarantee to support the banks and guarantee deposits. Indeed, the Minister of Finance issued a statement supporting this presumption, and the government has a track record of intervening to save banks and guaranteeing deposits.

Yet, stability may have come at a price. While the implicit government guarantees may have successfully avoided overt stress, the implicit transfer of risk to the public sector may have been reflected in increased yields on government bonds.

Figure 6. Indicators of Financial Market Stress



Source: Bank of Israel, Bloomberg.
1/ Israel: Tel Aviv Banks / Tel Aviv 100
US: S&P Financials / S&P 500
UK: FTSE 300 Financials / FTSE 100
Sweden: OMX Nordic Banks / OMX Stockholm 30
France: ENEXT CAC Financials / CAC 40

Non bank financial institutions have suffered, however.

32. The value of provident funds declined by about 20 percent in 2008, while some mutual funds lost even more. More importantly, withdrawals from provident funds amounted to NIS 8 billion (or about 5 percent of their total assets) in 2008. The corporate bond market, which was the main source of new corporate credit in the previous year has de facto closed. Yields in the secondary market rose significantly and new bond issues have halted since September.

The overall banking sector resilience may have buoyed net capital inflows during 2008

33. The robustness of the banking sector and the supportive policies may also account for the strength of the currency during most of 2008. Israel has been something of a safe haven, with residents repatriating capital from more hostile global environments. In the context of the consequent upward pressure that the BoI in late March announced its intention to increase foreign exchange reserves by $10 billion during a two year period, taking reserves to between $35–40 billion. In July, the announced pace of accumulation was raised, reflecting the absorptive capacity of the market, and in November the target range was raised to $40–44 billion. By end–December the reserves had reached $41½ billion.

Signs of strains in the real sector and the budget have emerged, however

34. Since September, global financial conditions have deteriorated further. The unfavorable asset market and export developments have impaired private consumption and investment, with merchandise imports also reflecting the strong shekel. Activity thus cooled significantly in the second half of 2008, with consumer and business confidence weakening along with global prospects. This is expected to bring the overall 2008 growth to 4¼ percent.

35. In this context, notwithstanding an over performance in the first half of 2008 and tight expenditure control by the authorities, significant revenue shortfalls in recent months are expected to bring the full-year budget deficit for central government to 2 percent of GDP (Table 6), with the structural primary balance weakening to ¾ percent of GDP. Public debt stands at little below 80 percent of GDP at end-2008.

And political and geopolitical uncertainties have recently mounted

36. General elections are now scheduled for early February 2009 after negotiations to reconstitute the coalition government broke down. With adoption of the 2009 budget therefore delayed until at least the Spring, spending will be capped each month until adoption of the full budget at 1/12 of the 2008 budgeted levels. Further, if the conflict in Gaza resumes, that would pose risks to real activity and public spending, though the economic and fiscal implications have been modest, so far.

III. Near Term Outlook and Risks

External factors continue to weigh on near term prospects

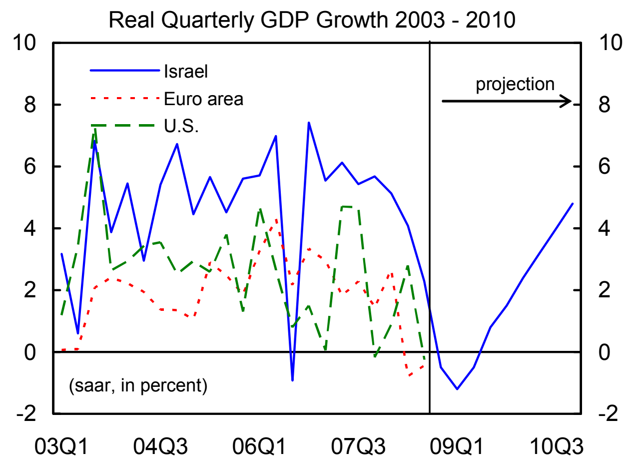
37. As the authorities envisage, assuming that the Gaza conflict does not resume, the outlook is likely to be dominated by the ongoing consequences of sustained global financial turmoil, with corresponding weakness in commodity prices only a partial offset (¶69). Growth in the imports of Israel's trading partners, averaging 7 percent annually in recent years, is projected at -1½ percent in 2009. Activity is anticipated to recover only in 2010.

Spillovers from the U.S. seem particularly pronounced

38. Staff work indicates strong spillovers from the U.S. to Israel (see Attachment II). Possibly reflecting close trade linkages—including through exports of intermediate inputs through third countries—a 1 percentage point increase in the U.S. quarterly economic growth is statistically associated with as much as ½ percentage point rise in Israel's GDP over two quarters. On the other hand, neither global stock markets nor oil prices appear to be major determinants of Israeli activity.

So Israeli output trends are set to follow those in the U.S. closely

39. In this light, domestic demand is projected to weaken further in 2009 reflecting the global slowdown, the impact on net trade of past shekel appreciation, and tight credit conditions. Activity weakness is cushioned however by past monetary easing and fiscal automatic stabilizers. Thus, in broad accord with the authorities, staff project growth to slow to ½ percent in 2009, before gradually regaining momentum in 2010 as the external environment turns (¶69) Declining commodity prices and slowing activity should rapidly bring inflation—now at 4½ percent—back to the 2 percent range by mid-2009.



Various downside risks are associated with this outlook

- Global risks are to the downside of the WEO central forecast, and the Gaza conflict could resume.

- Israeli government debt is high, at some 80 percent of GDP and is associated with needs to finance significant roll-overs and current fiscal positions.

- If major defaults in the domestic corporate bond market occur, this could compound constraints on access by healthy corporations to refinancing.

- Though direct bank exposure to ABS is limited, economic slowdown could impair credit quality and prices of securities held by banks could continue to fall. Thus, although banks' total risk-adjusted capital-asset ratio is relatively high at 11 ½ percent, raw equity is some 6 percent of assets and both major banks issued profits warnings for the latter part of 2008.

- Furthermore, risk of disorderly withdrawals from nonbank financial institutions remains, and insurance companies have suffered losses on their assets as financial markets have fallen.

- As elsewhere, tail risks, including in the financial sector, may materialize with little warning.

But these are mitigated by various factors

- On the external side, banks' short-term external debt is more than matched by deposits abroad; private sector short-term assets are more than twice the size of short-term debt; and only a small portion of public external debt matures within one year.
- External public debt rollover needs are modest. US$3.4 billion (NIS 12 billion) of the total US$30 billion in external debt was due in one year from end-September, 2008.

- Public financing for the next several months has largely been secured.

- Almost half of all external public debt is guaranteed by the U.S. government. In 2003, the United States approved a new loan guarantee program for up to US$9 billion, subject to certain understandings and deductions. That program has been extended until 2011. Another third of the external debt is comprised of State of Israel Bonds, where the Diaspora constitute the major and hitherto stable source of demand.

- The economy has shown a capacity for rapid adjustment, as in its resilience during the 2006 war and its sharp rebound from dotcom bubble, and as reflected in the rapid response of inflation expectations and monetary policy to global developments since October 2008.

- Several stimulating policy measures—including advancing infrastructure investment, extending credits to small enterprises, establishing public-private corporate bond funds, and guaranteeing new capital raised by banks—have been approved (see Attachment I).

- The economy was cyclically strongly placed to face these challenges.

- Though banks' expansion into new domestic and global markets—the fruit of earlier financial sector reform—has had, as yet, uncertain effects on their credit risk exposures, the fact that this expansion has been only recent may, fortuitously, have limited their direct exposure to the ongoing global turmoil.

IV. Implications for Policies and Policy Frameworks: 2009–10

40. The economy has proven comparatively resilient so far, even in the face of heightened global financial sector turmoil since September 2008. But a growth slowdown is underway and, following global trends, is set to continue through 2009 even if domestic banking sector stability continues. And continued economic stability is not certain, not least with external risks firmly to the downside.

41. In that context, the immediate priority is to ensure that the financial stability framework is ready to address downside tail risks should those materialize. Alongside, the medium-term focus of fiscal policy should strengthen so as to continue steady reduction in debt and the associated vulnerability. But this should not impede operation of automatic stabilizers during the downturn. In this fiscal context, with the monetary transmission mechanism relatively undisturbed by recent global financial turmoil and inflation pressures diminished, monetary rather than fiscal policy should remain the instrument of first recourse to support activity, with the interest rate remaining the primary instrument used to achieve that goal. This stance would leave fiscal resources available to cope with possible materializations of downside risks.

A. Financial Sector Policy and Framework

Downside tail risks should constitute the immediate focus for policy

42. Frameworks for crisis preparedness are needed for the support and resolution of both banks and non-banks. These should address liquidity and capital adequacy issues, and corresponding public interventions. As the authorities agreed, although the legal framework is in general adequate to address banking crisis and has worked formerly when banks failed, some aspects might need to be further reviewed. These include the framework for dealing with failures of large banks and non bank institution, notably the legal recourse for affected shareholders, and the mandated transparency of use of lender-of-last-resort facilities by publicly traded companies (see Box 4) (¶72).

Box 4. Is Israel Ready to Address Financial Instability, if it occurs?

1. Market liquidity, and ELA facilities. The Governor appropriately enjoys wide discretion to determine the instruments, pricing, and collateral arrangements for emergency liquidity operations to support individual banks and the banking system. Thus, any shortfalls can be rapidly addressed. Nonetheless, a particular concern warranting review is the mandate under stock exchange listing requirements for financial firms to rapidly announce any LOLR facilities they receive.

2. Bank resolution framework. The banking ordinance gives the Governor the power to takeover a bank. In particular, if the Governor, after consultation with the Supervisor, is of the opinion that a particular banking corporation is unable to meet its obligations, he may with the approval of the Government, appoint, without delay, an administrator to manage the banking corporation. It will be key to ensure legal capacity to complete such operations speedily, should they become necessary. In this regard, it will be important to strengthen provision for preemptive bank resolution by the regulator, notably via restriction of legal recourse for affected stakeholders to financial compensation only.

3. Coordination amongst the authorities. Given the more complex financial system that has emerged due to recent reforms and the need for close cooperation between supervisors, the central bank, and the Government, strong technical capacity to manage and resolve financial stress is needed. A recent Memorandum of Understanding among the supervisors, as well as exercises that test responses to crisis scenarios are welcome.

4. Non-banks. Readiness to handle weakness in a large non-bank financial institution is unclear. While forms of appropriate support will vary from case to case, early consideration of options and risks that may arise is needed.

43. The corporate bond market has been under strain. Accordingly, the authorities have temporarily suspended mark-to-market rules for institutional investors, up to a maximum of 3 percent of their assets and only if the institutions commit to holding the bonds to maturity. This has brought a measure of relief to the corporate bond market, while retaining the principle of transparency for the bulk of institutions' accounts. And the Israeli security authority has proposed a detailed and flexible blueprint for procedures to reorganize corporate bonds.

44. Furthermore, the authorities have approved the establishment of a NIS 10–20 billion fund to purchase corporate bonds (see Attachment I). NIS 5 billion of this will come from public sources which bear most of the risk. While the authorities preferred to consider the options for the specific objectives of this fund further, staff suggest that the prime functions

of the fund would be to refinance bond installments as they fall due and to support new bond issues, because these directly support credit to firms (¶71). In this light, purchases by the fund on the secondary market would generally be avoided as these will not provide new credit, and they risk implicitly transferring accrued institutional investor or corporate losses to the budget. While plans should be prepared to address priorities in the corporate bond market other than credit flows, the tasks for this fund should not be extended lest its effectiveness and accountability is diluted. Given these terms of reference, the anticipated size of the fund is sufficient at least through 2009.

45. Against the backdrop of continuing initiatives to buttress supervision of all financial firms during 2008—enhancing capital, reporting, monitoring, transparency, and regulatory coordination—the steps above could help maintain orderly financial market conditions under conditions of duress.

Alongside, more deep-seated reforms should remain under review

46. The ongoing process of financial sector reform continues to require corresponding review of the supervisory regulations and structures. However, as noted by the authorities, given that the immediate priority is management of tail risks, implementation of organizational reforms which might cause a temporary loss of focus on tail risks should be avoided, even if those changes are aimed at better supervisory arrangements in the long run (¶72).

47. In particular, whatever the best long run allocation of bank and non-bank supervisory tasks between the Central Bank and other agencies, the immediate priority is to ensure that the flow of information from banks to the central bank remains uninterrupted.

48. Similarly, consideration of action to implement a deposit insurance scheme would best await the easing of global financial market tensions lest such action call into question the meaning of the authorities' commitment to financial market stability. Eventual implementation of formal deposit insurance could provide an appropriate opportunity to exit from the current implicit deposit guarantee.[3]

B. Fiscal Policy and Framework

A strong medium-term budget framework would underpin fiscal credibility, and so facilitate accommodation of stabilizers in 2009

[3] In 2008, an international committee of experts (MONEYVAL) noted that Israel is considerably exposed to organized criminal activity and related money laundering. The authorities are strongly encouraged to address the highlighted deficiencies.

49. The ongoing progress towards debt reduction over the medium term needs to continue to reduce the associated vulnerability (See Figure 7 & Attachment III). Accordingly, staff have earlier suggested—and reiterate—that the government endorse the Minister of Finance's proposal of an objective of debt of below 60 percent of GDP in the medium term. This goal reflects the EU ceiling as expressed in the Maastricht criteria. But it should be a minimum objective; Israel's unique vulnerabilities—including those arising from geopolitical considerations—call for a more ambitious debt goal over the longer term than may be appropriate for EU countries.

50. But with a further growth slowdown in prospect, macroeconomic policies should provide appropriate support, while maintaining confidence.

51. Accordingly, adjustment of the fiscal framework needs to weigh two considerations.

- On the one hand, there is need for a flexible framework given uncertainties about the economic outlook.
- On the other hand, adjustment of the strong rules and procedures that have delivered strong fiscal outcomes in recent years, raises risks that budget discipline may be lost.

The revenue and deficit estimates in the draft 2009 budget have been overtaken by events

52. The draft 2009 budget envisages full implementation of the programmed tax cuts of about ½ percent of GDP, and observes the pre-set deficit target of 1 percent of GDP by anticipating a marked reduction in expenditure growth (Text Table). On the authorities' fiscal projections, the structural primary surplus implied by the draft budget is roughly 1 percent of GDP, representing a modest improvement from 2008, and public debt is expected to fall to 77 percent of GDP.

Israel: Budget and Macroeconomic Outlook

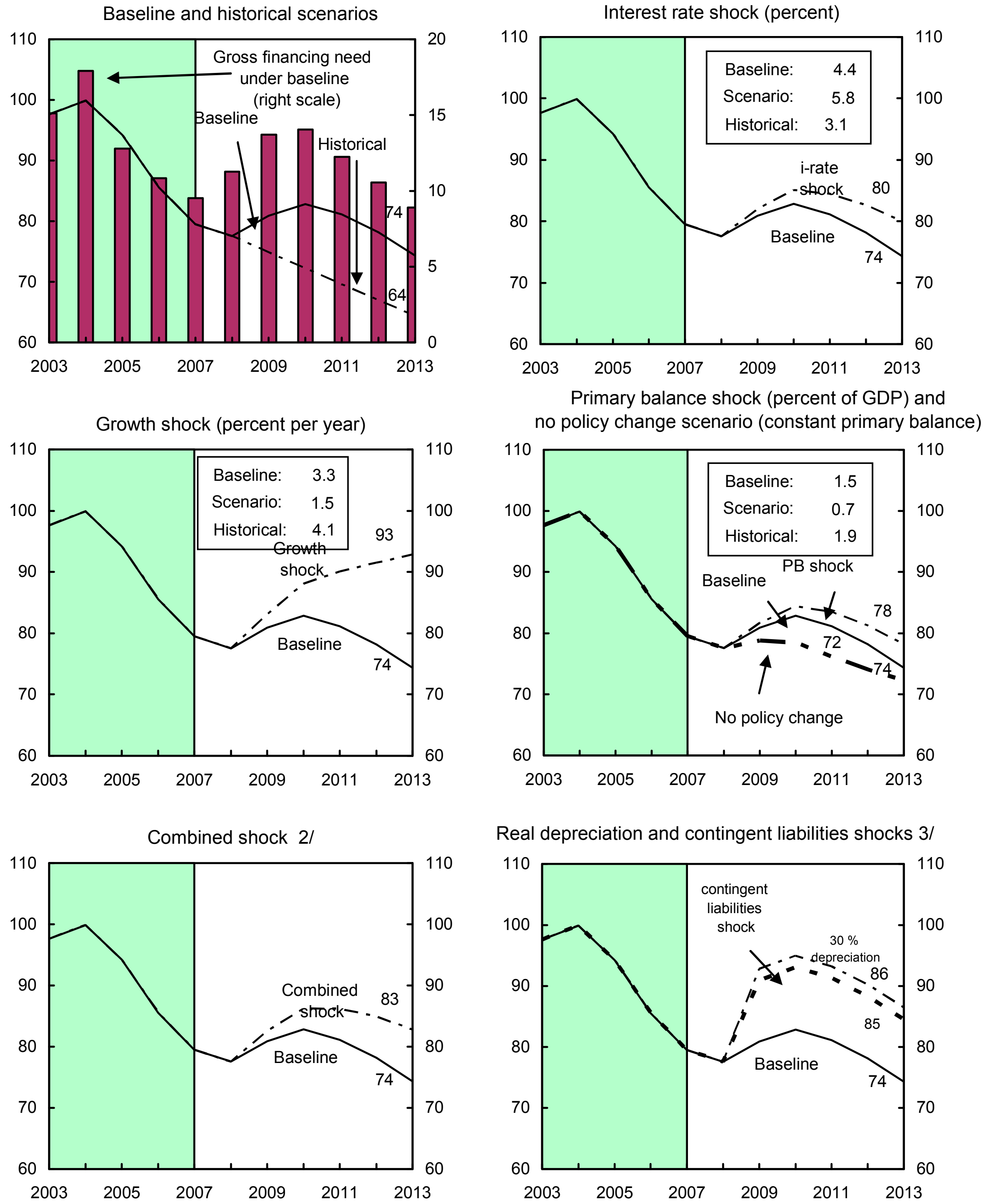
(Percent of GDP)

	2008	2009			2010	2015 2/
		Draft budget	Staff projected	Staff recommended	Staff projected	Staff projected
Central Govt 1/						
Revenue (excluding repayment of credit)	30	33 1/4	30	…	30 1/4	32
Expenditure 2/ 3/	32	34 1/4	34 1/4	…	34 1/2	30 3/4
Budget balance	-2	-1	-4 1/4	…	-4 1/4	1 1/4
Budget balance target	-1.6	-1	…	…	…	…
General Govt						
Structural primary balance 3/	3/4	1	1	3/4	3/4	3 3/4
Gross public debt 3/	77 1/2	77	81	81 1/4	82 3/4	68
Memorandum items:						
GDP growth 4/	4 1/4	3 1/2	1/2	…	2 1/2	3 3/4
Current account	1 1/4	…	2 1/2	…	1 1/4	1 3/4
CPI inflation 5/	4 1/2	…	1 1/2	…	1 1/2	2

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

1/ Excludes net credit.
2/ Assumes adherence to the annual real expenditure growth ceiling of 1.7 percent, excluding emergency security-related spending.
3/ Excludes proposed govt initiatives to support the financial sector and infrastructure investment brought forward.
4/ In percent. For 2009 Budget, it is the growth assumption by the Ministry of Finance.
5/ In percent, period average.

Figure 7. Israel: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

53. Four factors are of concern, however.

- First, the draft budget's growth and therefore revenue estimates may prove optimistic as real GDP growth appears unlikely to reach the assumed 3½ percent for 2009. If growth is closer to ½ percent, fiscal revenue would likely be much weaker than projected by the draft budget—especially since the size of automatic stabilizers tends to be larger during downturns. In such scenarios, either the operation of automatic stabilizers will have to be constrained, or the headline 1 percent deficit ceiling would be breached.

- Second, the structural primary surplus implied by the 2009 draft budget falls short of the steady-state structural surplus of 3¾ percent of GDP needed to lower debt to 60 percent of GDP within the next decade. While this stance may be appropriate given the cycle, it also underscores need for a strong medium-term framework to deliver the necessary primary balances to realize the debt objective.

- Third, the technical estimation of the structural primary surplus should reflect a cautious assessment of the automatic stabilizers. In particular, past buoyancy in fiscal revenue in part reflected the excesses in the global financial markets before the outbreak of the current crisis. In that light, future tax collection ratios may be unlikely to return to the levels seen in recent years, even after the global crisis passes.

- Fourth, ongoing political and geopolitical uncertainties are inevitably reflected in risks to budget prospects.

Accordingly the 2009 budget deficit target should be modified and the medium-term framework strengthened

54. In this context, as agreed with the authorities, the cap on the headline budget deficit ceiling for 2009 should be adjusted to accommodate full operations of automatic stabilizers (¶73). It should also accommodate, without offsets, the fiscal and financial-sector initiatives recently approved by parliament, and any already-planned investments which are brought forward investments as these leave the NPV of anticipated government spending over the medium-term unchanged. Implementation of the expenditure estimates in the planned 2009 budget would be consistent with these recommendations (see Text Table). Nevertheless, the headline deficit outturns will be large relative to the recent past, underscoring need to sustain confidence by elaborating a formal framework to deliver ambitious medium-term debt objectives.

Key characteristics of the current fiscal framework should be retained

55. The current targets, established in 2006, cap real expenditure growth at 1.7 percent beginning in 2007 and set ceilings on the headline deficit. Excluding emergency security

spending, they have been adhered to, so far. The key elements of this framework that would best be retained include simplicity, robustness, and compliance.

A new framework could formally be anchored by debt reduction, with scope for appropriate fiscal flexibility

56. The authorities share the view that reforms to the current fiscal framework are needed. They recognize—and staff agree—that any new framework should reflect six principles:

- Fiscal policy in Israel should be guided by rules
- Those rules should have a medium-term focus, targeting debt reduction
- Automatic stabilizers should be allowed to operate unimpeded
- The key instrument to deliver the debt objective is expenditure caps
- Spending caps should exclude emergency allocations for security.
- In this context, the deficit target of 1 percent of GDP for 2009 should be relaxed

57. In this light, the authorities have proposed a new framework that entails elements of an "error correction" mechanism. The proposed framework would automatically constrain (loosen) real expenditure should debt rise above (drop below) the envisaged adjustment path due to breaches.[4] The explicit link between spending and debt is a clear advantage in the system.

Actual debt-to-GDP ratio	*Ceiling on real expenditure growth*
Over 82%	1%
76 – 82%	1.7%
70 – 76%	2.1%
64 – 70%	2.5%

58. There may be scope to increase the flexibility of the framework in three dimensions, however. First, establishment of a range of dates—e.g., the middle years of the next decade—rather than a single year for the debt target may improve the flexibility of policy in the face of a highly uncertain global outlook. Second, adoption of caps on spending in nominal rather than real terms may better accommodate automatic stabilizers—with cumulative errors in inflation projections corrected only after three years, rather than all

[4] For a general discussion of error correction mechanisms for Israel, see IMF Country Report No. 08/63, February 2008, Chapter IV "Towards a New Fiscal Rule: What might work well for Israel?"

inflation errors corrected after one year. This more extended correction mechanism would also help monetary policy to reduce inflation volatility. Third, rather than an automatic error correction mechanism tied to debt, a less formal link has merit to accommodate output surprises. It could be based on adoption of new budget procedures mandating publication of full medium-term budget projections as part of each budget, showing exactly how and when, and in accord with the predetermined caps on nominal spending, the debt objective was expected to be met. These projections would take into account, each year, new information on output prospects, allowing annual policy on fiscal deficits to respond flexibly to developments, while maintaining the credibility of the medium-term anchor. In the context of agreement with staff on the six principles outlined above, the authorities were inclined to a less flexible framework, notwithstanding global uncertainties (¶74).

C. Monetary Policy and Framework

Inflationary pressures have abruptly eased

59. Given global and domestic developments, inflationary pressures have eased markedly since the fall of 2008 and remain contained, even after the late January policy rate cut. Monthly inflation peaked in August with core inflation measures continuing subdued.

And an undershoot of the 2009 inflation target is now anticipated

60. Markets still anticipate a further modest reduction in the policy rate—some 25bp in coming months—and, associated with that, evidence from surveys and financial market instruments suggests that the inflation target will be undershot by end–2009. Given the expected policy rate, the recommended fiscal stance, and WEO projections for commodity prices and Israeli output in 2009 and beyond, such an undershoot indeed still appears likely.

On balance, the bank rate could be lowered further

61. In these circumstances, and in the context of the staff recommended fiscal policy, both for 2009 and beyond, several considerations should guide whether, and to what extent, the policy rate should be lowered further.

- Even if indicators of inflation expectations understate likely outturns, falling commodity prices and activity, long-contained nominal wage behavior, and recent sharp reductions in international central bank interest rates underscore that the domestic and global inflationary concerns even of a few months ago have substantially dissipated.

- In balancing risks, a case to err on the side of caution is not persuasive. Indicators of inflation expectations for 2009 and beyond are now below target, with liquidity-premia distortions to such indicators likely minimal (given similar liquidity for indexed and non-indexed Israel government bonds). With inflation expectations so

low, output concerns remain considerable even with fiscal stabilizers operating (as recommended) and domestic financial sector strains continuing to be limited.

62. On balance, therefore, further early policy relaxation seems appropriate (¶76). Concerns not to surprise markets with large steps may be attenuated with prior guidance and by the increased market familiarity with large steps globally. And as policy rates approach zero, options for quantitive easing should be considered in case that is needed.

The IT framework serves well, and appropriate strengthening is anticipated

63. As the authorities noted, although inflation has frequently been outside the 1–3 percent target range, inflation, inflation expectations, and nominal wages remain contained, and indexation has declined (¶75).

64. In this broad context, the proposed new draft BoI Law appears appropriate. The proposal to increase the BoI independence, establish a committee with power to set monetary policy, and a separate management committee to manage the bank's administration. However, provisions for BoI capital, staff remuneration, and legal protections for staff may need to be strengthened.

Foreign exchange intervention should play at most a limited role in the framework

65. As the authorities agreed, sizeable foreign currency reserves can provide a useful signal of resilience to markets (¶75). Accordingly, a level equal to short-term debt has merit. This ratio was realized by end-December as the reserves reached the target range of $40–44 billion. Such a target should, however, also be set in light of the associated sterilization costs (estimated at less than 0.1 percent of GDP so far).

66. However, the bank rate should remain clearly the central instrument in the inflation targeting regime. This requires, first, preannouncement of the schedule of purchases and the targets for foreign exchange purchases, as reflected in the authorities' actions in 2008. Once the announced target has been reached, there may be a case to maintain the ratio relative to short term debt. If so, this objective and the schedule of purchases to realize it over time, should be preannounced. Second, maintenance of the pre-eminence of the bank rate also requires restriction of discretionary intervention to combat disorderly conditions. And if flows persist in either direction, the policy response should focus on the bank rate (¶75).

V. THE AUTHORITIES' VIEWS [5]

67. There was broad agreement with staff that the recent intensification of global financial stresses required policy responses in various areas, with many still yet to be finalized. There was common ground on diagnosis and broad principles for the policy response, with fiscal rules a particular focus of debate with staff.

68. Sustained strong policies meant that Israel had been well prepared on the eve of global financial turmoil, with public debt falling, low inflation and stable monetary conditions, conservative and healthy banks, and a significantly improved international investment position.

The immediate outlook has weakened

69. Given global conditions, however, the near-term macroeconomic outlook was challenging, including significant downside risks. The BoI's latest growth forecast for 2009—at -0.2 percent—is a little below that of staff, but the BoI and staff were in close agreement on the pace of recovery in 2010. And while the Ministry of Finance concurred broadly that real activity in 2009 would slow sharply, it had not updated its macroeconomic framework since submission of the draft 2009 budget. The macro assumptions underlying that draft would be substantially marked down (¶37).

70. Given the deteriorating outlook and associated declines in inflationary pressure, the first response to intensified turmoil had been significant reductions in the Bank of Israel rate. Thereafter, focus had turned to concerns with stabilization of the corporate bond market, securing continued credit supply, and fiscal support for activity (¶30 &41).

Financial sector stabilization policy has been strengthened

71. With the terms of reference for the proposed private investment fund with public capital for the corporate bond market still in development, its purpose was broadly to support liquidity, credit to solvent corporates whose main activity is in Israel and which face difficulties in recycling their credit, and restoration of confidence in the market. Potential conflicts of interest should be addressed and secondary market purchases may be warranted on some occasions, for example as part of broader debt workouts. The relative importance of raising capital ratios versus increased credit supply as the objective for the guarantee for bond issues by banks was similarly under consideration. But pre-emptive action was warranted in either case (¶44).

[5] Paragraph references in this section refer to the paragraphs reporting staff's views on the relevant topic.

72. Extensive arrangements have been made to strengthen information-sharing and coordination amongst the regulatory authorities in the context of stresses in financial markets since the fall of 2007. In that context, the review of readiness for contingencies undertaken by the mission was welcome, and legal provisions guiding the resolution of troubled banks and transparency of lender-of-last-resort would both be considered further. And hitherto lively domestic debate on the appropriate organizational structures of financial regulation had been largely suspended while policymakers and regulators' focus remained on the immediate challenges in markets (¶45–48).

Fiscal policy needs to be more flexible

73. Turning to budget matters, the authorities agreed that the essential issue was how to accommodate greater flexibility in the context of a downturn without losing momentum in debt reduction and fiscal sustainability. In striking this balance, they concurred with staff that to accommodate fiscal stabilizers, the 2009 deficit should exceed its ceiling under the prevailing fiscal rules. And they agreed that some framework of firm fiscal rules was needed nevertheless. While revenue would be lower than the estimates in the draft 2009 budget, the Ministry envisaged that total nominal spending in 2009 would conform to the draft budget ceilings. In this way, fiscal discipline would be maintained in 2009 and in the medium-term (¶52–54).

74. The Ministry of Finance's preferred approach to reform of the fiscal rules was to target public debt below 60 percent of GDP by 2015, underpinned by a ceiling on real expenditure growth, adjusted downwards if debt overshoots its path towards the 2015 goal. This framework constrains automatic stabilizers but aids the credibility of the medium-term goal. And, in contrast to a ceiling on nominal spending, it implied lower volatility in annual real spending. Finally, a framework with caps on nominal spending might be susceptible to pressures to raise the ceilings should the inflation outturn be higher than expected (¶58).

Monetary policy options would remain under review

75. On the monetary side, the IT framework remained appropriate and the accumulation of reserves had been prudent according to a variety of metrics, and had been secured without disturbance to the market. Further reserve accumulation seemed warranted by the continuing buoyant market conditions, reflected in the strength of the Shekel, and by a desire to build up resilience to further shocks. Going forward, proactive financial sector and prudent fiscal policies would support monetary policies (¶27, 65 & 66).

76. Sizeable interest rate cuts had been necessary to avoid undershooting the 2009 target and strengthen the economy's ability to cope with the effects of the global economic crisis. While indicators remained mixed, the case for further rate reductions would remain under review. However, reductions would have to be consistent with maintenance of market confidence (¶61–62).

Table 1. Israel: Selected Economic and Social Indicators, 2001–08

(Percent change, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008 1/
Real economy								
Real GDP	-0.3	-0.6	1.8	5.0	5.1	5.2	5.4	4.3
Private consumption	3.1	0.7	0.3	5.4	3.9	4.0	6.7	4.6
Public consumption	3.4	5.1	-2.7	-1.8	1.7	2.7	2.9	0.1
Gross capital formation	-3.5	-10.9	-5.0	3.1	12.7	6.5	12.0	2.8
Fixed capital formation	-3.8	-6.8	-4.7	0.9	2.9	9.9	15.5	3.8
Unemployment rate (percent)	9.3	10.3	10.8	10.4	9.0	8.4	7.3	6.0
GDP deflator	1.7	4.1	-0.5	0.0	0.9	1.9	-0.2	3.2
Overall CPI (end period)	1.4	6.5	-1.9	1.2	2.4	-0.1	3.4	4.8
Money and credit (period average)								
Narrow money (M1) 2/	14.1	15.6	0.5	18.0	17.5	13.7	15.3	15.2
Broad money (M3) 3/	15.5	6.1	2.2	4.6	7.9	7.4	12.9	5.3
Interest rates (average, percent)								
Bank of Israel policy rate 4/	6.8	6.8	7.5	4.2	3.7	5.1	3.9	2.5
Public finance (percent of GDP)								
Central government revenue	35.6	37.4	35.4	35.1	35.3	35.2	35.4	30.0
Central government expenditure	39.8	41.0	40.8	38.7	37.1	36.2	35.4	32.1
Central government balance	-4.2	-3.6	-5.4	-3.6	-1.9	-1.0	0.0	-2.1
General government balance	-4.3	-4.6	-7.0	-4.3	-2.5	-1.4	-0.8	-2.8
General government debt	89.9	97.6	99.9	98.2	94.2	85.6	79.5	77.6
Of which: foreign currency external debt	23.7	24.9	24.6	24.2	24.4	22.3	19.6	15.9
Balance of payments (percent of GDP, unless otherwise noted)								
Exports of goods and services	33.3	35.3	36.9	41.6	42.9	43.4	43.2	41.9
Real growth rate (percent)	-11.1	-2.0	8.0	17.5	4.3	6.1	8.5	5.3
Imports of goods and services	35.8	38.3	37.7	41.6	43.2	43.1	44.9	43.9
Real growth rate (percent)	-5.1	-1.1	-1.3	11.8	3.5	3.6	11.7	2.8
Trade balance	-2.5	-3.1	-0.8	0.0	-0.3	0.4	-1.7	-2.1
Oil Imports (billions of U.S. dollars)	3.1	3.1	3.7	4.5	6.8	7.5	8.4	9.5
Net Imports (billions of U.S. dollars)	3.1	3.1	3.7	4.5	6.8	7.5	8.4	9.5
Current account	-1.1	-0.8	1.1	2.1	3.0	5.6	2.8	1.2
Foreign direct investment	2.9	1.4	2.8	1.9	3.2	9.9	5.9	2.5
Foreign reserves (end period, billions of U.S. dollars)	23.5	24.2	26.6	27.2	28.5	29.6	29.0	36.3
Exchange rate								
Exchange rate regime							Floating	
Present rate per U.S. dollar (January 26, 2009)							4.0	
NEER annual percent change (period average) 5/	1.0	-12.6	-3.7	-3.3	-0.8	0.4	3.9	11.0
REER annual percent change (period average) 5/	-0.9	-9.6	-5.3	-6.0	-2.2	0.0	1.8	11.7

Social Indicators

GDP per capita (current U.S. dollars, 2005): 25,875; Life expectancy at birth (2005): 77.7 (male) and 81.8 (female); Infant mortality rate (2005): 5 per 1,000 births; Physicians (2003): 3.8 per 1,000 people; Automobile ownership (2003): 284 per thousand; CO_2 emissions (tons per capita, 2003): 10.2; Population density (2006): 325 inhabitants per square kilometer; Poverty rate: 18.5 percent 6/.

Sources: Bank of Israel, *Annual Report*; Central Bureau of Statistics; IMF, *World Economic Outlook;* World Bank, *World Development Indicators;* and IMF staff estimates and projections.

1/ IMF staff estimates and projections.
2/ Data for 2008 as of October.
3/ Data for 2008 as of September.
4/ Data for 2008 as of November.
5/ Data for 2008 as of October.
6/ Poverty rate from National Insurance Institute of Israel.

Table 2. Israel: Financial Soundness Indicators, 2001–08 1/

(Percent)

	2001	2002	2003	2004	2005	2006	2007	2008
								June
Core Set								
Deposit Takers								
Regulatory capital to risk-weighted assets	9.4	9.9	10.3	10.8	10.7	10.8	11.0	11.6
Regulatory Tier 1 capital to risk-weighted assets	6.4	6.6	6.9	7.3	7.1	7.4	7.6	7.8
Problem loans to total credit	...	...	10.5	10.5	9.5	8.4	...	...
Nonperforming loans net of provisions to capital	...	35.1	33.3	31.0	27.2	21.2	15.8	14.1
Nonperforming loans to total gross loans	...	2.4	2.6	2.5	2.3	1.9	1.5	1.3
Of which:								
Other financial corporations (OFCs)	7.2	7.6	7.2	7.9	8.7	8.7	10.2	10.5
General government	3.6	3.5	3.3	2.7	2.5	2.2	2.0	2.2
Nonfinancial corporations (NFCs)	50.2	49.7	48.1	44.7	43.4	41.9	41.5	42.6
Other domestic sectors	24.5	24.7	26.0	28.4	28.5	29.3	28.4	29.6
Nonresidents	14.4	14.5	15.4	16.2	16.9	17.8	17.9	15.1
Return on assets	0.6	0.3	0.7	1.0	1.1	1.0	1.2	0.7
Return on equity	12.3	6.1	14.1	17.9	19.4	17.6	20.0	10.7
Interest margin to gross income	63.5	63.5	64.1	63.1	62.6	61.9	61.0	55.3
Noninterest expenses to gross income	65.5	64.6	60.2	59.7	61.7	66.2	54.5	84.5
Net open position in foreign exchange to capital	-0.5	4.3	2.1	4.1	-0.5	1.8	-8.9	-7.7
Encouraged Set								
Deposit Takers								
Capital to assets	4.9	4.9	5.3	5.5	5.6	5.9	6.1	6.3
Gross asset position in financial derivatives to capital	...	...	36.0	32.5	28.7	24.6	29.2	34.4
Gross liability position in financial derivatives to capital	...	...	32.4	31.6	29.3	21.3	27.7	39.5
Trading income to total income	36.4	19.4	12.3	17.9	23.7	8.8	6.9	...
Personnel expenses to noninterest expenses	61.8	62.8	61.0	60.3	59.7	62.4	59.9	60.2
Spread between reference lending and deposit rates (basis points)	1.5	2.3	2.0	2.7	3.0	3.5	4.1	...
Customer deposits to total (non interbank) loans	118.7	115.3	115.6	117.7	119.5	118.2	113.0	105.5
Foreign-currency-denominated loans to total loans	34.8	36.0	35.4	34.5	31.4	28.1	27.0	23.5
Foreign-currency-denominated liabilities to total liabilities	38.0	40.6	40.1	41.5	42.5	40.7	39.8	35.2
Net open position in equities to capital	7.2	5.4	11.4	12.8	11.5	16.2	17.6	...
Other Financial Corporations (OFCs)								
OFCs' assets to total financial system assets	35.4	35.5	38.1	40.0	42.3	42.4	43.5	...
OFCs' assets to Gross Domestic Product (GDP)	86.0	87.8	94.7	98.7	104.0	103.8	111.7	...
Nonfinancial Corporations								
Total debt to equity	201.0	230.1	208.4	197.2	184.5	185.0	...	...
Return on equity	-8.6	-3.2	5.2	11.6	16.6	13.1	...	...
Earnings to interest and principal expenses	61.3	73.9	96.5	128.3	139.1	138.1	...	...
Households								
Household debt to GDP	27.1	28.1	28.3	27.7	27.9	30.7	39.5	...
Market Liquidity								
Average bid-ask spread in the securities markets (percentage of mid-point price)	...	...	...	...	0.0	0.0	0.0	0.0
Average daily turnover ratio in the securities markets	0.6	0.9	0.9	0.9	0.8	0.9	2.3	...
Real Estate Markets								
Residential real estate prices (annual percentage increase)	0.2	2.5	-6.1	-1.3	4.4	-4.3	3.2	7.3
Residential real estate loans to total loans	10.9	11.8	11.9	12.4	13.1	13.9	12.5	13.1
Commercial real estate loans to total loans	18.2	18.2	17.9	16.6	16.1	16.0	16.4	16.8

Source: Bank of Israel.

1/ Problem loans include non-performing loans, rescheduled loans, loans designated for rescheduling, loans in temporary arrears and loans under special supervision.

Table 3. Israel: Balance of Payments, 2005−13

(Billions of U.S. dollars)

	2005	2006	2007	2008 1/	2009 1/	2010 1/	2011 1/	2012 1/	2013 1/
Current account balance	4.0	8.1	4.5	2.3	5.2	2.7	3.1	3.5	3.7
Merchandise	-4.1	-3.8	-6.0	-8.0	-4.8	-6.9	-7.5	-8.4	-9.3
Exports, f.o.b.	39.7	43.3	49.8	59.5	54.0	56.3	62.1	67.5	72.8
Imports, f.o.b.	43.9	47.1	55.8	67.5	58.8	63.2	69.6	75.8	82.1
Civilian imports	41.7	44.6	53.4	60.0	51.1	55.3	61.5	67.5	73.6
Military imports	2.2	2.5	2.4	7.5	7.7	7.9	8.1	8.3	8.5
Services	3.7	4.4	3.3	3.8	2.8	2.7	3.7	5.0	6.1
Exports	17.5	19.3	21.1	25.3	24.8	26.2	28.9	32.0	35.1
Imports	13.7	14.9	17.8	21.5	22.0	23.5	25.2	27.0	29.0
Factor Income	-1.6	0.1	0.0	-1.9	-1.2	-1.5	-1.5	-1.5	-1.5
Receipts	5.6	8.4	10.5	8.3	9.0	10.5	10.5	10.5	10.5
Payments	7.2	8.3	10.5	10.2	10.2	12.0	12.0	12.0	12.0
Net transfers	6.0	7.5	7.3	8.4	8.4	8.4	8.4	8.4	8.4
Public	3.2	4.4	3.9	4.0	4.0	4.0	4.0	4.0	4.0
Private	2.8	3.0	3.4	4.4	4.4	4.4	4.4	4.4	4.4
Capital and financial account balance 2/	-7.8	-7.8	-1.6	-2.3	-5.2	-2.7	-3.1	-3.5	-3.7
Capital account	0.7	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7
Financial account	-8.5	-8.6	-2.4	-3.0	-5.9	-3.4	-3.8	-4.2	-4.4
Direct investment, net	1.3	-0.8	2.6	1.0	1.0	1.0	3.0	3.0	3.0
Foreign direct investment (in Israel)	4.3	14.3	9.7	5.0	5.0	5.0	7.0	7.0	7.0
Portfolio investment, net	-3.8	1.1	-1.9	-4.0	-4.0	-4.0	-4.0	-4.0	-4.0
Other investment	-4.0	-8.5	-4.8	-1.5	-1.7	-1.7	-1.7	-1.7	-1.7
Change in reserves 3/	-2.0	-0.4	1.7	1.4	-1.2	1.3	-1.2	-1.6	-1.7
Errors and omissions	3.8	-0.2	-2.9	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items (percent of GDP, unless otherwise indicated):									
Current account balance	3.0	5.6	2.8	1.2	2.5	1.3	1.4	1.5	1.4
Civilian trade balance	-1.5	-0.9	-2.2	-0.2	1.4	0.5	0.3	0.0	-0.3
Gross external debt	57.1	58.8	53.1	42.3	41.2	39.1	36.2	33.5	31.1
GDP (billions of U.S. dollars)	133.3	144.0	164.1	202.5	204.7	212.5	225.6	239.4	253.2

Source: Central Bureau of Statistics, *Monthly Bulletin of Statistics.*

1/ IMF staff estimates and projections.

2/ Excludes reserve assets.

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

Table 4. Israel: Indicators of External and Financial Sector Vulnerability, 2001−08

(Percent of GDP, unless otherwise indicated)

							Latest Data		
	2001	2002	2003	2004	2005	2006	2007	2008	Date
Financial indicators									
Broad money (percent change, 12-month basis)	15.5	6.1	2.2	4.6	7.9	7.4	12.9	5.3	Sep-08
Private sector credit (percent change, 12 month basis)	14.3	11.7	-3.1	3.9	7.1	4.3	6.7	10.0	Sep-08
External Indicators									
Terms of trade (average, percent change) 1/	-1.2	0.5	-1.5	-1.9	0.6	-1.4	-2.1	...	Proj.
Current account balance	-1.1	-0.8	1.1	2.1	3.0	5.6	2.8	1.2	Proj.
Capital and financial account balance	0.0	-1.2	-0.2	11.4	14.5	22.2	7.7	1.4	Jun-08
Gross official reserves (end period, billions of U.S. dollars)	23.5	23.7	25.8	26.6	27.9	29.1	28.5	36.8	Nov-08
Official reserves in months of imports of goods and nonfactor services	6.5	6.8	7.2	6.2	5.9	5.7	4.7	4.9	Proj.
Total gross external debt/GDP (percent)	53.5	62.0	61.0	61.1	57.2	59.0	53.4	42.6	Proj.
Total net external debt/GDP (percent)	0.1	-0.7	-4.3	-8.1	-15.3	-23.0	-27.2	-24.1	Jun-08
Country risk ratings (S. & P. / Moody's) 2/	A- / A2	A- / A2	A- / A2	A- / A2	A- / A2	A- / A2	A / A2	A / A1	Oct-08
Exchange rate (per U.S. dollar, period average)	4.20	4.74	1.00	4.48	4.48	4.45	4.10	3.89	Nov-08
Change in Stock Market Index (percent)	-20.9	-6.0	15.7	35.3	21.0	20.0	23.2	-42.7	Nov-08

Sources: Bank of Israel; Central Bureau of Statistics; and IMF staff estimates and projections.
1/ According to WEO GEE trade deflators.
2/ On foreign currency long-term debt

Table 5. Israel: Medium-Term Scenarios, 2008−13

(Percent, unless indicated otherwise)

	2008	2009 4/	2010	2011	2012	2013
GDP growth rate	4 1/4	1/2	2 1/2	4 1/2	4 1/2	4 1/4
Inflation (average)	4 3/4	1 1/2	1 1/2	2	2	2
Fiscal balance/GDP 1/						
Central gov't balance 2/	-2	…	-4 1/4	-2 3/4	-1 1/4	0
General gov't structural primary balance 2/	3/4	3/4	3/4	1 1/4	2	2 1/2
Central gov't expenditure/GDP 2/	32	…	34 1/2	33 3/4	32 3/4	32
Public debt/GDP (end of period) 2/	77 1/2	81	82 3/4	81	78	74 1/4
Current account/GDP	1 1/4	2 1/2	1 1/4	1 1/2	1 1/2	1 1/2
Foreign reserves (billions of U.S. dollars) 3/	41 1/2	43	42 1/4	42 3/4	43 3/4	44 1/2
			(Percent changes)			
Memorandum Items:						
Aggregate domestic demand	3 1/4	3/4	2 3/4	4 1/4	4 1/4	4 1/4
Private consumption	4 1/2	1 1/4	3 1/4	5	5	5
Public consumption	0	- 3/4	1 3/4	1 3/4	1 3/4	1 3/4
Gross capital formation	2 3/4	1/2	2 3/4	5 1/4	5	4 1/2
Exports of goods and services	5 1/4	-1	4	7 3/4	7 3/4	6 3/4
Imports of goods and services	2 3/4	- 3/4	4 1/2	7 1/4	7	7

Source: IMF staff estimates and projections.
1/ For the purpose of its budget deficit targets, the central government excludes net credit.
2/ Assumes the government adheres to the 1.7 percent growth in real expenditure, excluding emergency security spending.
3/ End of period.
4/ Macro projections for 2009 are based on staff recommended fiscal policy.

Table 6. Israel: Central Government Accounts, 2003−09

(Percent of GDP)

	2003	2004	2005	2006	2007	2008		2009	
						Budget	Actual 1/	Draft budget	Staff proj.
Revenue (excluding repayment of credit)	35.3	35.0	35.3	35.2	36.1	32.7	30.0	33 1/4	30
Domestic	31.7	32.1	32.6	33.0	34.2	30.7			
Tax	27.3	27.3	27.4	27.8	29.3	26.2			
Of which: On income and profits	14.5	14.4	14.9	15.6	16.5	14.3			
On domestic goods and services	12.8	12.9	12.6	12.1	12.8	11.9			
Nontax	4.4	4.8	5.2	5.2	4.9	4.5			
Of which: Loans from the National Insurance Inst	1.7	1.9	2.1	2.1	2.1	2.0			
Other	2.6	2.8	3.1	3.1	2.8	2.5			
Foreign	3.7	2.9	2.6	2.2	1.9	2.0			
Of which: Grants	2.0	1.9	1.9	2.0	1.6	1.4			
Vat on defense imports	0.3	0.2	0.3	0.2	0.2	0.3			
Other	1.4	0.7	0.4	0.1	0.0	0.3			
Expenditure (excluding lending and expenditure by public hospitals)	40.7	38.6	37.1	36.2	36.1	34.3	32.1	34 1/4	34 1/4
Current expenditure	38.7	36.3	35.1	34.3	34.1	32.5			
Wages	8.3	8.1	8.1	8.0	7.7	7.3			
Subsidies & transfers	13.8	13.1	12.5	14.2	12.2	11.4			
Interest	6.2	5.8	5.6	5.5	5.2	4.8			
Other	10.4	9.3	8.9	6.6	9.0	9.0			
Capital expenditure	2.0	2.3	2.0	1.9	2.0	1.8			
Budget balance	-5.4	-3.6	-1.9	-1.0	0.0	-1.6	-2.1	-1	-4 1/4
Budget balance ceiling 2/	…	…	…	…	-2.0	-1.6		-1	
Financing	5.4	3.6	1.9	1.0	0.0	1.6			
Domestic (net)	4.2	2.2	-0.4	-0.7	-0.7	0.9			
Foreign (net)	1.2	1.4	-0.4	-0.3	0.9	0.7			
Sale of assets (net)	0.1	0.2	1.5	0.7	0.0	0.6			
Change in cash balances and other financing (net)	-0.1	-0.1	1.2	1.2	-0.2	-0.6			
Memorandum item:									
GDP growth 3/	1.8	5.0	5.1	5.2	5.4	4.3		3 1/2	1/2

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

1/ Based on staff projection of 2008 GDP.

2/ Set in 2006.

of GDP to expenditures in 2006-08, respectively.

3/ In percent. For 2008, staff projection. For 2009 "Draft budget" column, MoF growth assumption behind the draft budget.

ATTACHMENT I. FINANCIAL SECTOR REFORM: DIVERSIFICATION AND CREDIT CRUNCH[1]

1. **The Israeli financial system has undergone a comprehensive transformation over the past few years.** Reforms were significantly accelerated in 2005 with the introduction of various legislative measures and changes in regulatory coverage and taxation.[2] Though these steps were contraversial and some mid course corrections were necessary, they led to a rapid diversification of the financial sector towards non-bank financial institutions and expanded the choice of financial products and providers. In the process, new challenges have emerged for managing risks.

2. **The key pillar of the financial sector reform was the Bachar Legislation.** Implemented in July 2005, the legislation's main objective was to enhance the development of capital markets by

- Increasing competition and reducing concentration of financial institutions: This was achieved mainly through decentralization of the financial system whereby banks were required to sell their holdings of mutual funds and provident funds.
- Reducing conflicts of interest in the capital market: The Bachar legislation also stipulated separation between advice on financial assets and their marketing through changes in rules for employment in financial consultancy and marketing.
- Increasing foreign participation: Foreign-owned firms were encouraged to acquire stakes in the fund management businesses being disposed by the banks. In addition, government bond market reforms allowed entry of foreign-owned banks in the capital markets.

3. **Along with the Bachar legislation, reforms in taxation and regulatory coverage were also introduced in 2005–06.** These reforms sought to increase market efficiency, encourage competition between players and enhance supervision of financial institutions and services. Specifically, reform measures were implemented to:

- Widen investment choices of institutional investors: Tax provisions favoring domestic investment were removed for private and institutional investors, which encouraged foreign investment.
- Strengthen investor's choice and rights: Regulations governing long-term savings were revised, beginning in 2006, to ease mobility of savings between provident funds and insurance plans. In April 2005, institutional investors were also required to provide a more accurate fair value assessment of investor's rights.

---

[1] Prepared by Anita Tuladhar and Gil Mehrez.

[2] See Appendix 1 for a list of the key measures of legislative and regulatory changes. Prior to the 2005 reforms, measures ranging from pension and foreign exchange reform to government bond and capital market reforms had been implemented.

- Improve supervision of institutional investors: In line with the change in the institutional structure, supervision of the activities of the provident funds were initiated, while regulatory coverage of insurance companies was expanded.

4. **The authorities have continued to consolidate the reforms with the goal of deepening the capital markets and improving market infrastructure.** To facilitate the development of competitive and liquid markets, market makers were introduced in the trading of government bonds in 2006. Repo auctions were introduced by the Bank of Israel at end-2007. Repo trading in te Tel Aviv Stock Exchange is expected to start by the end of 2009 Q1. A new underwriting law was implemented in July 2007 allowing allocation of securities at the underwriter's discretion without an auction. Market infrastructure has been strengthened with the introduction in June 2007 of the RTGS system for settling intraday payments.

5. **Mobilizing long term savings in an efficient manner remains a key priority**. In December 2007, pension benefit coverage was expanded to employees without occupational pension plans. Effective 2008, changes in regulatory coverage were introduced that subjected a wide range of institutional investors to a uniform regulatory directive thereby equalizing the terms of savings on all forms of long-term savings, both domestic and foreign. It has also enabled banks to engage in pension advice and allowed a wide range of institutional investors to offer a basket of alternative products.

Outcome

6. **These reform measures have resulted in a fundamental restructuring of the financial sector towards non-bank institutions and non bank credit.** A private long-term saving industry separate from the banking system emerged. By 2007, the dominance of the banks was significantly reduced in the areas of credit to businesses and management of long-term savings. The share of bank deposits to the public's total assets declined from 46 percent at end-2002 to 30 percent at end-2007. Moreover, the control of banks over long term saving declined from 52 percent in 2003 to 11 percent at end-2007.

Market Share of the LT Savings and Mutual Funds Industry

Total LT Savings	Largest 5 banks	Largest 5 insurance companies	Others	o.w. foreign
2003	52	21	27	0
2007	11	55	34	7
Mutual Funds				
2003	84	2	13	0
2007	1	39	59	30

Source: Bank of Israel.

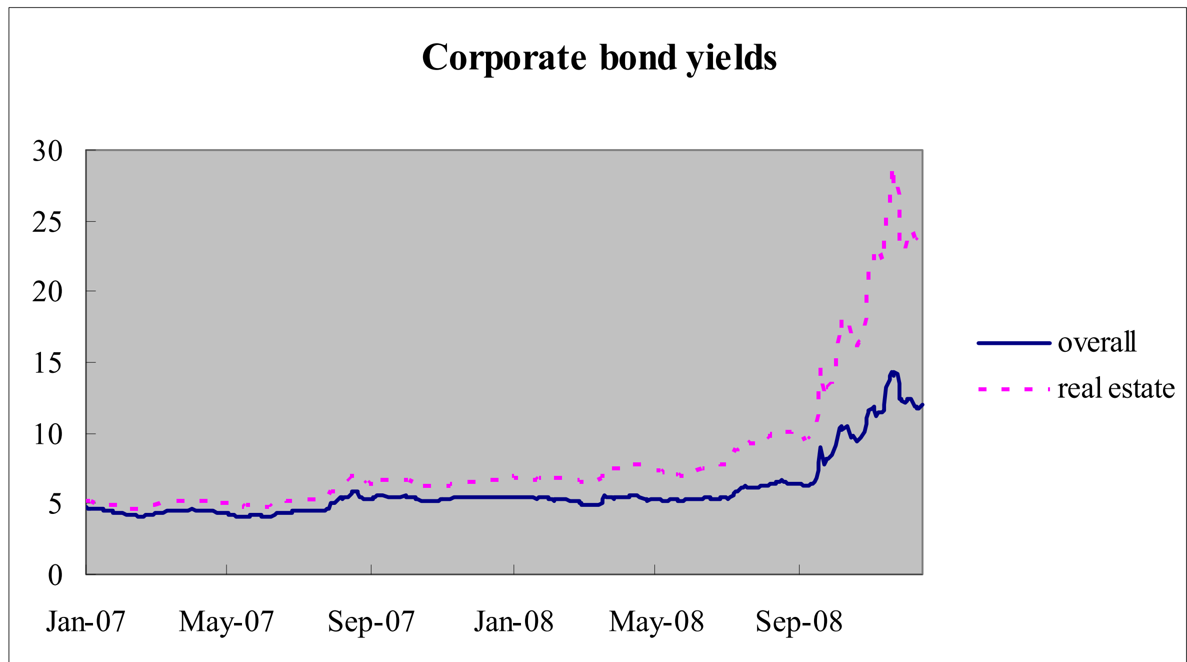
7. **The reforms also shifted the source of credit, in particular of new credit from banks toward non-bank financial institutions.** By end 2007, non-bank financial institutions provided nearly 50 percent of the business sector's outstanding credit, and most of new credit in 2007. In particular, corporate bonds issuance surged in recent years reaching about NIS 80 billion in 2007, and turnover in the financial market rose significantly. Most of

the bonds issued during 2003–08 were by real-estate companies (32 percent), and holding companies (21 percent).

8. **However, since the beginning of 2008, the capital market came under stress.** Bond prices declined significantly, particularly since September of 2008 and withdrawals from provident funds amounted to about NIS 5 billion in 2008. The surge in yields on corporate bonds has been particularly high in bonds in the real estate sector, mainly in those companies that invested in real estate projects abroad. In light of these developments, concerns emerged that some bonds had been systematically over-valued and that investors, notably provident funds were substantially exposed .

9. **Thus, overall credit—from banks and non-banks consolidated—declined since September 2008, while bank credit has continued to expand at a normal rate.** Bank credit to the private sector expanded at an annual rate of about 10 percent, but the collapse of the non bank credit caused overall sources of new credit to falter, despite the expansionary monetary stance. Issuance of new bonds, which declined in the first half of 2008 compared with 2007, stopped altogether from September.

10. **Looking ahead, credit conditions are likely to remain tight, with sizeable bond amortization due.** In 2009, bond repayments and interest will amount to almost NIS 25 billion. Most of it is by companies and financial institutions with high ratings, but about NIS 3 billion is by real estate companies—many of which were downgraded recently.



11. **On the other hand, although banks are sound and liquid, they are unable to meet the additional demand for credit.** First, although banks are well capitalized, the

capital ratio of most banks is still below the 12 percent ratio which the bank supervisor has encouraged them to achieve. Second, the slowdown in economic activity has raised credit risks and will raise non performing loans, reducing the banks appetite for additional risks. Finally, because banks' role in overall credit has declined significantly, their influence on overall credit is constrained.

Policy response

12. The authorities have taken several specific steps to address strains in capital and financial markets (See Box 1). These are anticipated to take effect during 2009.

13. **In addition, bank supervisors have intensified monitoring of banks exposures, enhanced regulatory requirements, required additional public disclosure, and have enhanced internal preparedness.** In addition to increasing the frequency of reporting, monitoring was intensified particularly in the areas of large credit and sensitive exposures, provisioning for credit losses, exposures to foreign financial institutions, Nostro securities exposures, and liquidity positions.

14. **At the same time the supervisor has issued various regulations.** These include instructing banks to review their business strategy and risk management policies, improved reporting on exposure to foreign financial institutions, guidelines regarding effective control over foreign offices, instructing banks to map their material exposures according to relevant risk parameters, improving reporting on liquidity positions, and guidelines regarding fair value evaluations. They also required additional disclosure with regards to investments in complex instruments, enhanced risk disclosures in quarterly reports, and additional reporting on country risk.

15. **Finally, the bank supervisor reviewed internal procedures regarding the handling of banks in difficulties**, analyzed closely options to enhance financial stability (e.g. alternatives regarding capital injection, limiting capital distributions). And overall coordination and information sharing between regulators--BoI, the MoF and the ISA—was enhanced.

16. **The ISA responded to the global financial crisis in several dimensions.** They proposed establishment of new regulatory infrastructure to ease refinancing of bond obligation in the capital market, and disclosure and transparency requirements were increased. Examples of the latter include reporting on cash sources, value of collateral, and exposure to the exchange rate, commodity prices and complex financial products. In addition, it increased supervision of rating agencies and auditors.

Box 1. Policies to support capital and financial markets

1. **Purchasing of corporate bonds.** The authorities plan to establish several funds to purchase corporate bonds, with the board objective to support liquidity and credit to solvent corporations whose main activity is in Israel and which face difficulties in recycling their debt. The government's overall investment will be up to NIS 5 billion, matched by about NIS 5-15 billion from institutional investors. Each fund will be set for 7 years with an option to extend it for an additional 3 years. To encourage private-sector participation in the fund, the government will provide the following incentives. If at the termination of the fund, the average real return is below 4 percent, the government will pay the intuitional investors 90 percent of the amount needed to raise their return to 4 percent as long as the amount is below the government revenues from the fund. If, on the other hand, the average real return is above 4 percent, the government will pay the institutional investors half of its profits above 4 percent return.

2. **Increasing banks' capital.** The government plans to provide guarantee of about NIS 6 billion for capital raised by banks to fortify banks' capital and increase their lending.

3. **Providing a safety net for long-term investors close to retirement.** Savers who will retire within the next 10 years, and who have less then NIS 1.5 million in retirement saving at the time of retirement, can choose upon retirement whether to withdraw their retirement savings or receive an annuity according to the amount (up to NIS 750 thousands) they had at November 30, 2008.

4. **Guaranteeing credit to small- and medium-sized firms.** The government set up a fund of NIS 1.3 billion ─ NIS 260 million of public money and NIS 1 billion from three banks who won the tender to provide loans. To encourage banks' participation, the government extends a 70 percent guarantee on the loans.

5. **Reducing constraints on reaching agreements on the refinancing of payment obligations to corporate bondholders.** According to new measures by Israel Security Authority, the trustees of bonds will be required in certain circumstances (or if demanded by a party holding substantial portion of bonds) to convene a forum of bond holders. Such a forum will require the presence of the three biggest holders of bond, who can delegate representatives to negotiate with the issuer. The bond issuer is allowed to withhold disclosure about the refinancing negotiation.

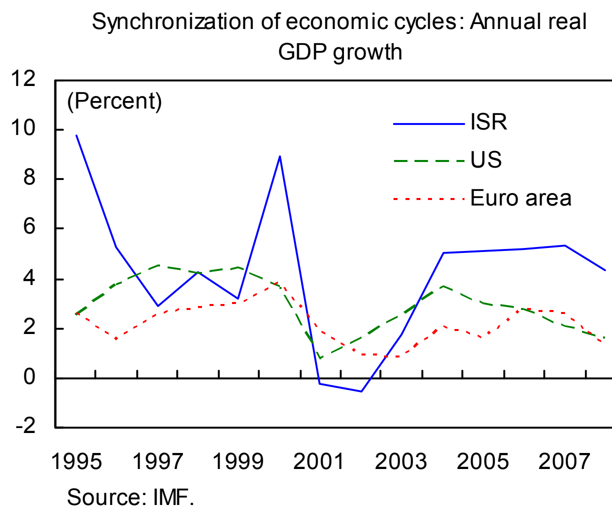
17. **The supervisor of insurance, pension and providence funds at the Ministry of Finance responded to the crisis in the financial market mainly by increasing monitoring.** It increased monitoring of the insurance companies' exposures to structured financial instruments and investments abroad. It raised the monitoring of the institutions' exposure to financial market and various instruments, their liquidity and withdrawal.

Conclusion

18. **The financial market reform achieved the goal of developing the capital market and reducing the banks' share in providing credit and managing long term saving.** However, the pace of the reform may have led to increased exposure to risks—more than the risks that, ex ante, savers might have appreciated. It also raised significantly and rapidly the importance of non bank credit. The collapse of this source of credit is thus a significant blow to the economy—a clear instance of a "credit crunch."

ATTACHMENT II. EXTERNAL SPILLOVERS TO ISRAEL [1]

1. **As a small open economy, Israel is susceptible to spillovers from the global economy.** Indeed, Israel's latest economic cycle (since 2000) has to a large extent mirrored that globally. The burst of the dotcom bubble in the early 2000s—compounded by the intifada—pushed the Israeli economy into a recession. Subsequently, notwithstanding security concerns in the mid-2000s, Israel enjoyed a period of strong economic performance alongside robust global growth and low risk aversion.



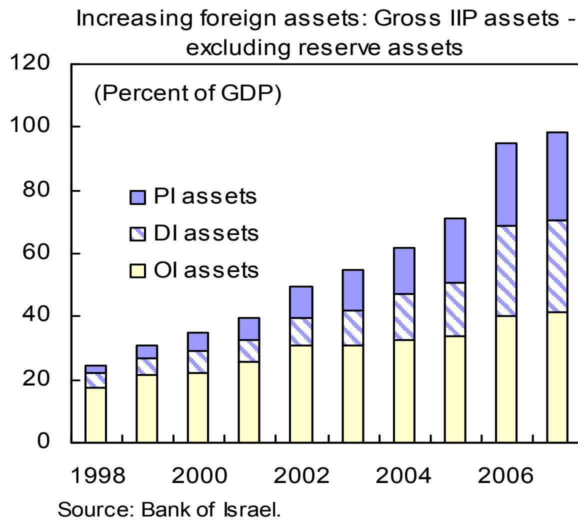
Potential Channels

2. **Trade linkages are likely to constitute the main channel transmitting external shocks to the Israeli economy.** The share of exports in GDP rose rapidly—from 20 to 33 percent of GDP—between 1995 and 2007. The U.S. and EU together account for about 2/3 of these exports. While some diversification into the developing-country markets (especially Asia) has been taking place slowly, and many of these are intermediate goods ultimately shipped to the U.S. and EU.

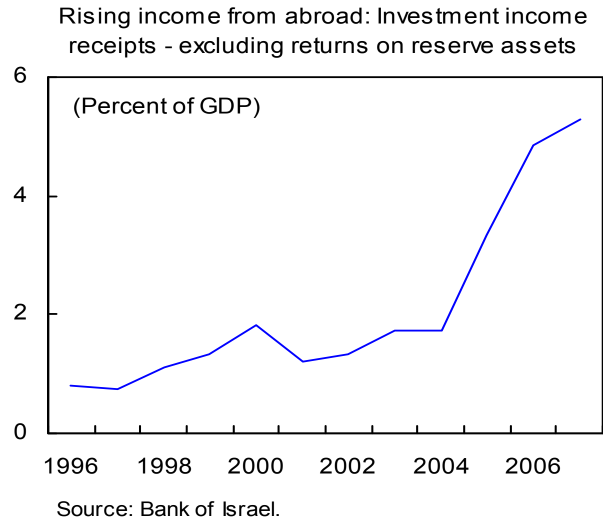
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Industrial co	72.3	73.1	71.4	73.9	73.4	70.4	71.3	71.5	71.8	70.2	70.8	70.6	68.8
US	29.9	30.8	32.1	35.6	35.5	36.8	38.2	40.2	38.4	36.8	36.5	38.4	35.0
EU	32.6	34.0	31.9	32.5	32.1	28.5	28.0	26.3	28.4	27.9	28.8	27.3	29.0
UK	6.0	6.7	6.2	5.7	5.5	4.3	4.2	3.9	3.9	3.8	3.9	3.5	3.6
France	3.6	3.3	2.7	2.9	2.7	2.3	2.5	2.2	2.2	2.0	2.1	2.4	2.4
Germany	5.0	5.1	4.3	4.7	4.5	4.8	4.4	3.5	3.6	3.5	3.2	3.8	3.5
Italy	2.9	2.7	2.8	3.1	2.8	2.5	2.6	2.4	2.5	2.2	2.1	2.3	2.4
Japan	6.9	6.0	4.5	3.2	3.3	2.6	2.8	2.2	2.0	2.0	1.9	1.7	1.4
Developing co	21.8	23.1	24.1	20.8	21.1	23.5	24.1	23.5	23.4	25.9	25.8	26.9	27.4
developing co Europe	4.5	4.7	4.7	4.4	3.7	3.5	3.8	4.0	4.4	5.1	5.3	5.6	6.0
developing co Asia	12.7	13.5	13.7	10.4	12.4	15.3	14.8	14.3	14.0	15.6	15.5	15.9	15.6
China (incl HK)	5.5	5.6	5.6	4.0	4.8	5.2	5.5	6.1	6.7	7.0	7.3	7.9	7.7
India	1.5	1.5	1.6	1.4	2.1	1.7	1.6	2.1	2.3	2.7	2.9	2.7	3.0
Memo item:													
Exports/GDP	19.8	19.4	20.9	21.3	23.4	25.8	23.9	26.4	26.5	30.6	31.9	32.3	32.9

[1] Prepared by Man-Keung Tang.

3. **Meanwhile, Israel's foreign assets have also grown rapidly**, even though on net basis IIP remains modest at -10 percent of GDP. This followed the completion of capital account liberalization in 2003 and subsequent extensive financial sector reform—including the 2005 tax code change that reduced capital gains tax on foreign investment to the same level as on domestic investment. Consequently, foreign investment income has become an increasingly important element in the current account. The substantial increase in foreign portfolio (PI) and direct investment (DI) exposures has likely increased spillovers via the wealth and cash-flow effects.[2]

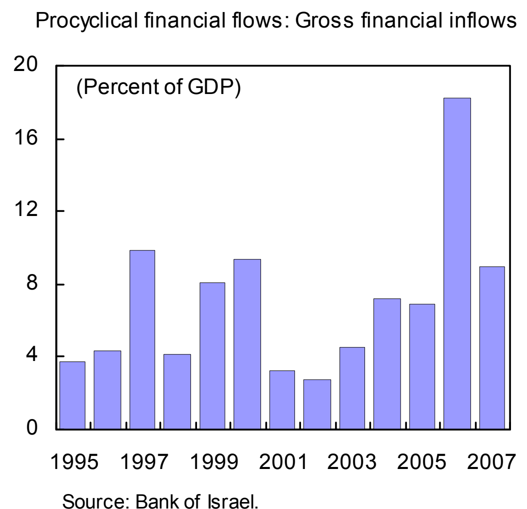


Source: Bank of Israel.



Source: Bank of Israel.

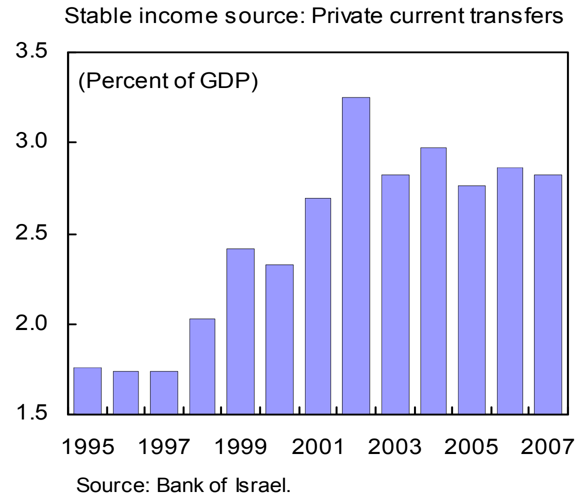
4. **International financial flows might also have considerable effects on the Israeli economy.** The size of Israel's gross financial inflows does not show any strong secular upward trend, and they remain relatively modest by international standards. However, the financial inflows are volatile and—with their dip in 2001–03 coinciding with the economic downturn—appear to be closely associated with strains in the global and Israeli economies.



Source: Bank of Israel.

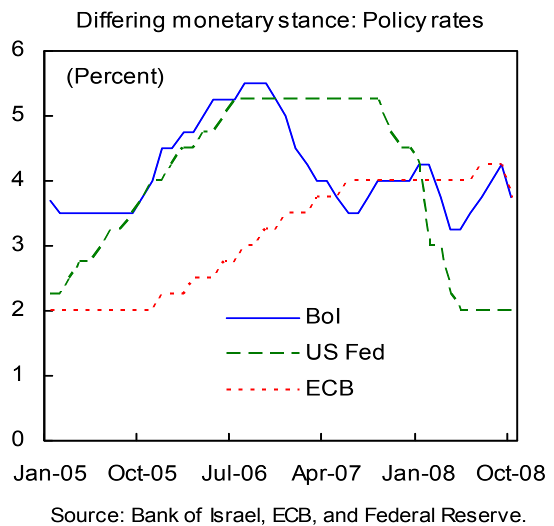
[2] Individually, PI exposure may have limited cash-flow effect (as bond coupons and stock dividends tend to be relatively stable), and DI exposure may not produce strong wealth effect (as DI is largely evaluated on book-value basis).

5. **Labor flows and current transfers, however, did not appear to be important channels in recent years**. After the massive migrant inflows in the early 1990s following the collapse of the former Soviet Union, Israel's net labor flows have been relatively small and steady. And while private current transfers have risen and become sizable (about 3 percent of GDP), they appear to be stable during the current cycle—indeed they might even have provided the Israeli residents with some insurance as they rose slightly during Israel's 2001–02 economic contraction.

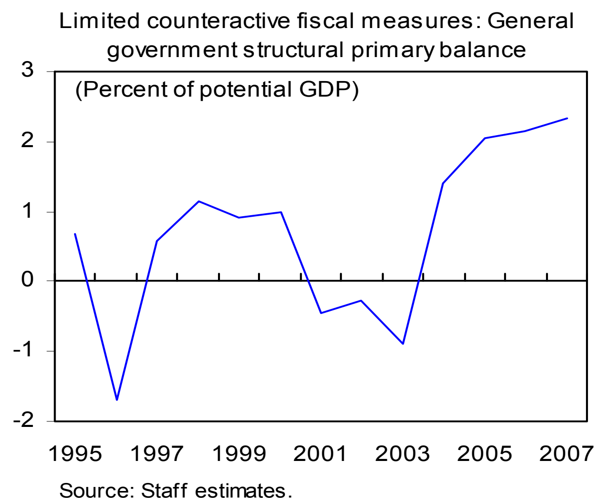


Policy Spillovers

6. **Since the shekel became freely floated in 2005,[1] Israel's monetary policy has not always moved in tandem with the largest countries'**. This may reflect imperfect synchronization business cycles and differences in inflation developments. In general, however, with Israel deeply integrated with the global economy, there might be "policy spillovers" where concerns about shekel's relative strength play an important role in monetary policy decisions.



7. **On the other hand, fiscal policy offered limited mitigation of external shocks.** Appropriate fiscal measures were adopted to counteract the external shocks in recent years, but—especially during the downturn—the effects were limited. Burdened with high public debt, the fiscal authorities were not able to ease sufficiently (while



[1] Note, however, that the Bank of Israel had not intervened in the foreign exchange market since 1998 (until recently).

maintaining fiscal sustainability and credibility) to significantly forestall the negative external spillovers.

Empirical Analysis

8. **Empirical analysis with vector autoregressive (VAR) models are carried out to more systematically evaluate and quantify the external spillovers to Israel.** Quarterly data from 1995Q1 to 2008Q2 are used. This period is roughly characterized by the following 5 phases: 1) stable modest growth; 2) the dotcom boom; 3) burst of the dotcom bubble and the intifada; 4) strong growth rebound supported by benign external environment; and 5) the outbreak of the financial crisis and the beginning of global slowdown.

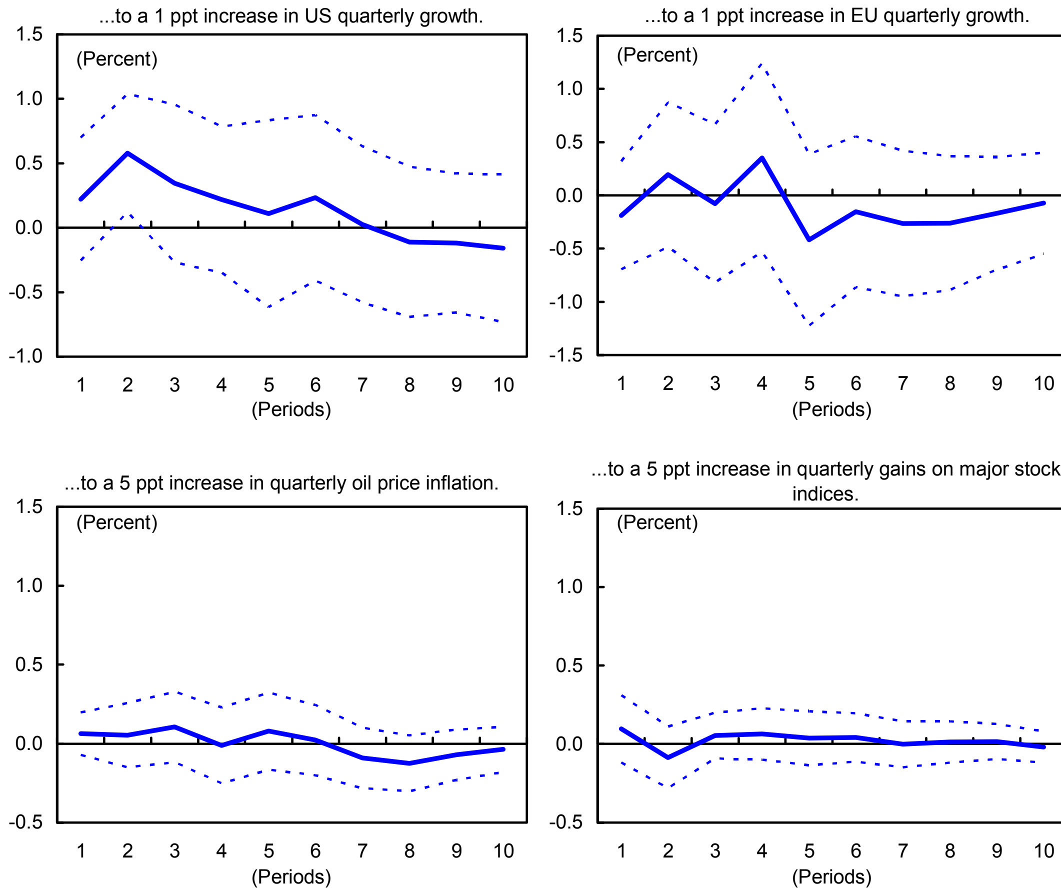
9. **The first step is to identify the key external determinants of Israel's economy over the near term.** The variables included in this first-step VAR are (in that order): i) oil price inflation—representing a global common shock (especially to the oil-importers); ii) economic growth of the U.S. and EU—the two regions with the greatest direct economic proximity with Israel; iii) returns on the major global stock market indices—proxying for the international equity market conditions and sentiment regarding the near-term global economic outlook; and iv) Israel's own economic growth.

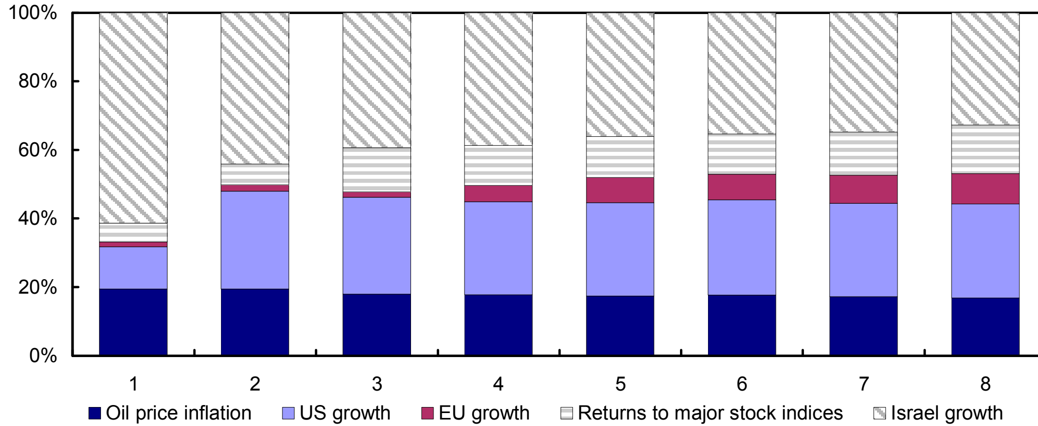
10. **The results suggest a very close tie between the Israeli and the U.S. economies**. Impulse responses show that a 1 percentage point increase in U.S. quarterly growth implies a ½ percentage point rise in Israel's quarterly growth over 2 quarters. Moreover, shocks to U.S. growth seem to have a rather persistent impact on Israel's growth, albeit with lower statistical significance beyond the second quarter.[2] On the other hand, oil price inflation, EU growth, and global stock market conditions appear to have weaker short-term associations with Israel's growth.[3] Similarly, variance decomposition indicates that U.S. growth is the single most important external factor explaining the variance of Israel's growth after the first quarter. (The error bands in the impulse responses below represent +/- 2 standard errors).

---

[2] Incidentally, the Israeli stock market tracks closely the U.S. NASDAQ market.

[3] The mild impact of oil price inflation might in part reflect the relatively low oil intensity of the Israeli economy.

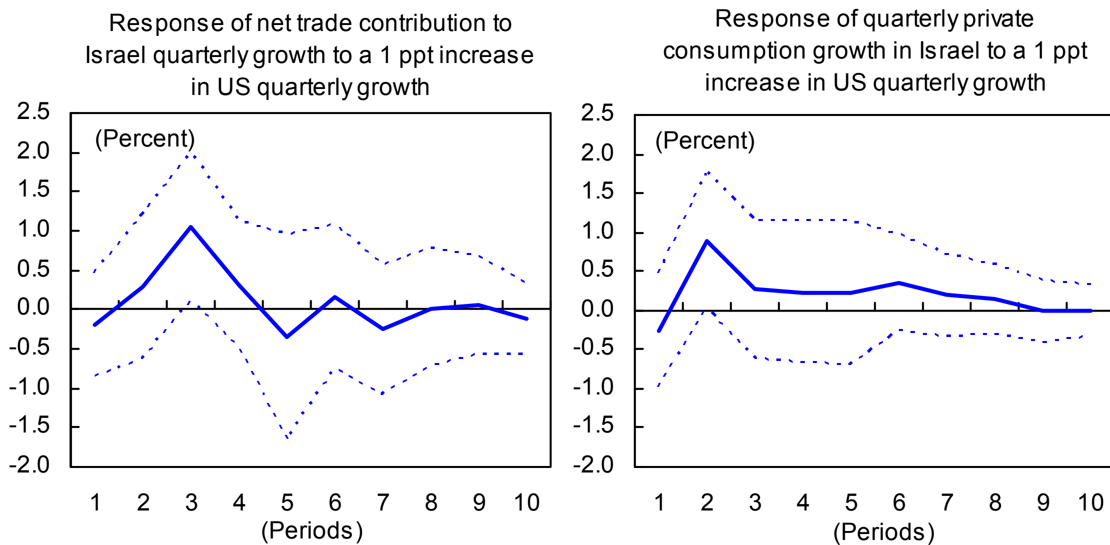




Source: IMF staff estimates.

11. **In light of the initial results, the second step is to trace the mechanics through which U.S. growth affects Israel.** In particular, another VAR model with the following variables is estimated: i) U.S. growth; ii) net trade's contribution to Israel's GDP growth; iii) Israel's private consumption growth; and iv) Israel's GDP growth.

12. **Shocks to U.S. growth are found to stimulate both Israel's private consumption and net trade.** A 1 percentage point increase in U.S. quarterly growth implies a ¾ percentage point additional expansion in Israel's private consumption in the second quarter, and a 1 percentage point rise in net trade's growth contribution in the third quarter. The impact on consumption might in part reflect (rational) anticipation of stronger net trade performance in the subsequent quarter, but it is also likely driven by financial linkages and/or other sentiment effects—especially since consumption shows little contemporaneous reaction to the shock.[4] On that score, trade connection appears to be just one of the multiple important channels underlying U.S. spillovers to Israel.



Source: IMF staff estimates.

[4] Suppose rational anticipation is a key factor. Then at the impact of the shock, the consumers would at once foresee the future net trade improvement, and immediately increase consumption accordingly.

ATTACHMENT III: EXTERNAL VULNERABILITY[1]

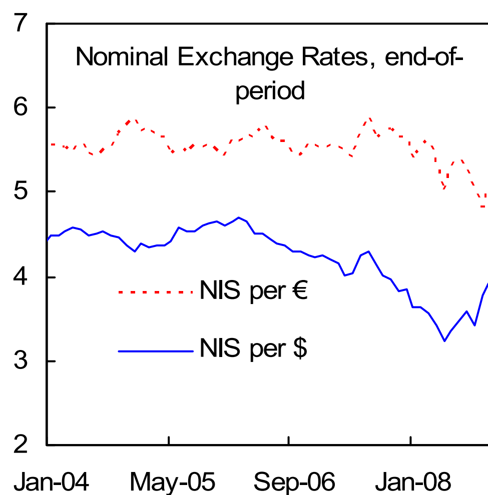
1. **Despite sustained balanced growth, significant external vulnerabilities remain and the global financial turmoil raises new challenges**. In particular, while most segments of the economy have been resilient over the past year, the non-bank financial sector has come under pressure and public debt ratios remain elevated.

2. **This note reviews indicators of vulnerability, including prices, stocks, and flows, and evidence pertaining to policy credibility.** Then after discussing lessons from earlier periods of economic stress, the note lays out the key issues arising for policy, which are discussed in the main body of the staff report.

Current Market Sentiment

External Indicators

- The Shekel has mostly been on an appreciating trend vis-à-vis the dollar and other major currencies since early 2006. Recently there has been some depreciation against the dollar, but this has coincided with significant reserves accumulation by the BoI.

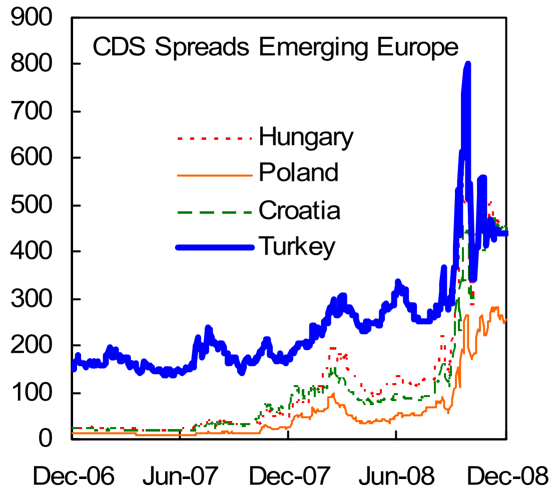


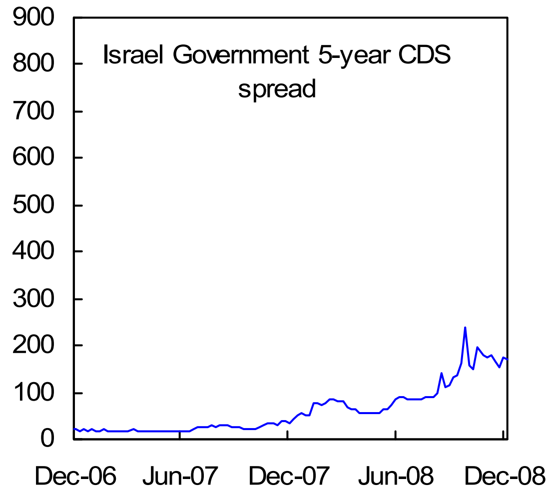
- The current account, seasonally adjusted, has remained in surplus through the third quarter of 2008, on account of continued positive net transfers and services exports, and despite a deterioration of the goods trade balance.

Indicators of Sovereign Risk

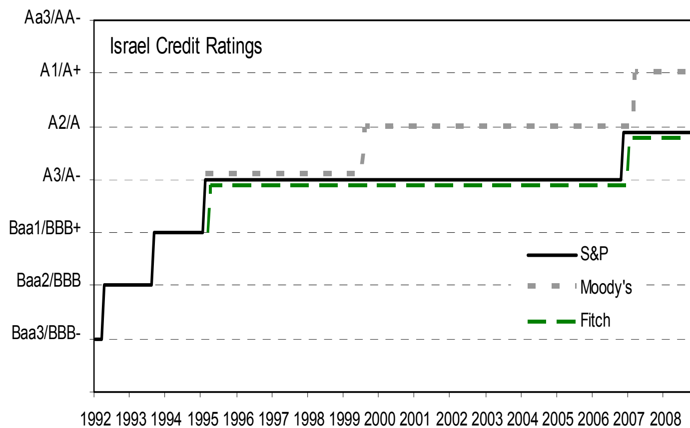
- While Israel government CDS spreads are up, the increase is much smaller than for many emerging European countries.

[1] Prepared by Erik Lundback





- Israel's sovereign credit ratings have not been significantly affected, with one of the agencies lowering the outlook from positive to stable.

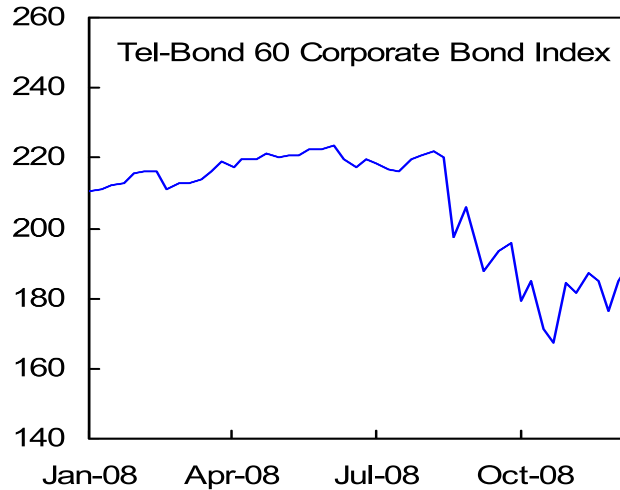


Securities' Indices

- The stock market is sharply down, in line with falls elsewhere.

- The corporate bond market has fallen significantly. This follows the international pattern, but also reflects problems specific, though not unique, to Israel. These include highly leveraged investments abroad in real estate financed through corporate bond issues. Previously large buyers, such as pension and provident funds, and insurance companies, have come under significant pressure, through asset value losses and saving withdrawals.

- Banks have appeared resilient in the current turbulent environment, but may not be willing to extend enough credit to compensate for the shortfalls in new flows from corporate bond market.

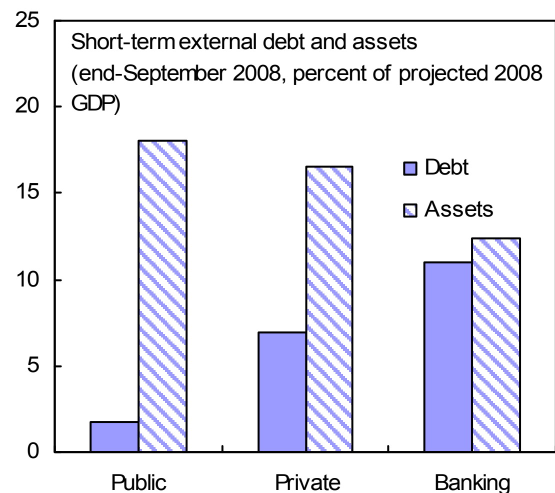


Key Exposures

The International Investment Position, External Debt, and Foreign Exchange Reserves

3. **Overall, the net International Investment Position is negative, but has been on an improving trend.** At end-June 2008, it was about -4 percent of GDP, an improvement by more than 35 percentage points from the beginning of the decade. Importantly, there has been a long-term shift from debt financing in the 80s and early 90s to non-debt financing.

4. **Nevertheless, total external gross debt, at over 40 percent of GDP, is not low and constitutes a key external vulnerability.** These risks are mitigated by several factors: total external debt is less than the total holding of debt assets; private sector short-term debt assets are more than twice the size of its short-term debt; and while most of the banks' external debt is short-term, it is more than matched by deposits abroad. However, recent global experience demonstrates that strong net-positions can turn around rapidly. It is also not known to what extent the debtors are the same as the holders of the assets.

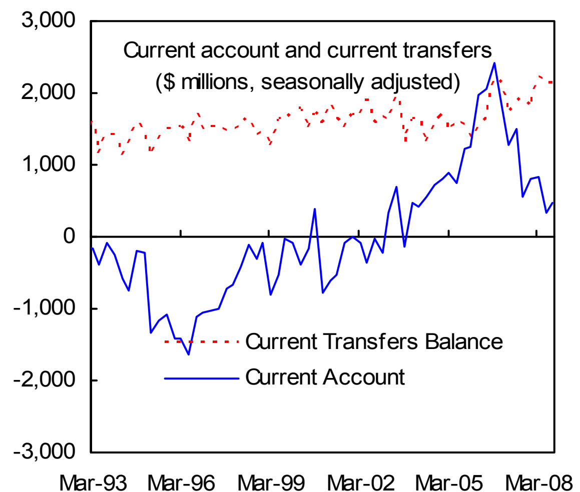


5. **Overall public external debt is fairly modest at about 15 percent of GDP.** Only a small portion matures in one year.[1]

6. **The foreign exchange reserves of the BoI are quite large, corresponding to over 100 percent of short-term debt.** Strong market conditions have allowed the BoI to accumulate international reserves in 2008. In late March, 2008 the BoI announced its intention to increase the level of foreign exchange reserves by $10 billion during a two year period to reach $35-40 billion. Initially, the daily purchases of foreign exchange was set to be $25 million, but continued strong market conditions and a rapidly appreciating Shekel motivated the BoI to change the daily purchases to $100 million. Subsequently, on November 30, the bank announced that the target level had been raised to $40-44 billion.

The Current Account

7. **There is no evidence of a fundamental imbalance in the current account.** Unlike some other fast growing countries, the current account have been in surplus in recent year with no apparent need for a sharp improvement and the real effective exchange rate is estimated to be close to its equilibrium. In addition, positive net transfers, which in the past have been a stable revenue stream, constitute a cushion, although a drop in contributions from Jewish communities abroad may be expected due to the global financial crises.



Public Debt

8. **Overall government debt, nevertheless, remains a vulnerability at around 80 percent of GDP.** In the past, concerns about government financing have been an important reason for capital outflows and pressure on the exchange rate. The large public debt also restricts countercyclical fiscal policies during downturns or crises, e.g. borrowing needs in a banking crises, and will be more expensive the higher the debt level. On the

[1] In April 2003, the United States approved a new loan guarantee program for up to $9 billion. The United States guarantees all payments of principal and interest. The program has been extended until 2011. The proceeds of the guaranteed loans may be used to refinance existing debt. Under the loan guarantee program, between September 2003 and November 2004 Israel issued notes totaling $4.1 billion.

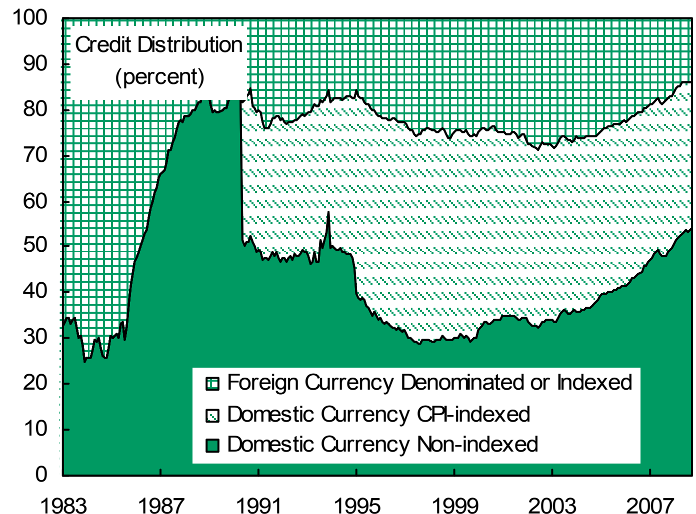
positive side, a significant part of near-term financing needs have already been secured, including via swap auctions.

9. **Israel has sources for public external financing which have been robust during earlier periods of stress.** Almost half of all public external debt is guaranteed by the U.S. government. Another third is State of Israel Bonds, which in the past proven to be a reliable and important source of financing for Israel, as many purchasers are individuals and institutions, including the worldwide Jewish community, that have an interest in Israel. On the other hand, the current global crises may have reduced the capacity of lenders and donors to finance Israel. Their willingness to support may also be less as the current economic crises is not mainly related to geopolitical events.

Banks and Other Financial Institutions

10. **The Israeli banking system appears to have relatively low direct exposure to the current global financial crises.** The direct exposures and losses due to asset classes particularly hit have reportedly been small. Banks are also not heavily dependent on wholesale funding, or on funding from any foreign parent banks.

11. **There are, nevertheless, external vulnerabilities of Israeli banks.** Foreign currency credits accounted for 14 percent of bank credit to the public as of end-June 2008 (including foreign exchange indexed loans).[1] Banks, and other financial institutions, are also exposed to external developments through lending to Israeli corporations active abroad. Export and investment abroad face significant challenges as the world economy seems to be heading into a sever and possibly long lasting downturn, which could lead to reduced repayment capacity.



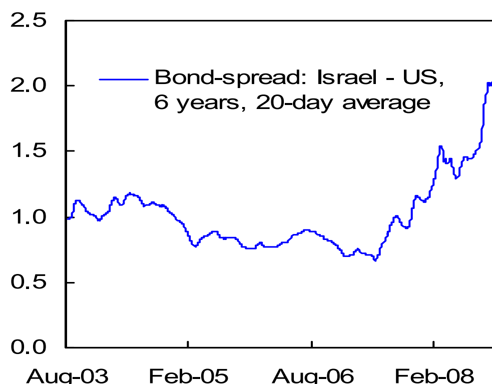
12. **Problems abroad for some bond issuers paired with general negative global sentiment seem to be the main reasons for the weakness in the corporate bond market.** As a result, availability of credit for the business sector has been hit and sharply reduced as corporate bond issuance has come to a halt. There is a clear risk, supported by anecdotal evidence, that bank credit will be similarly tight, and not able to replace corporate bond financing, in the near future.

[1] Excluding credit from earmarked deposits.

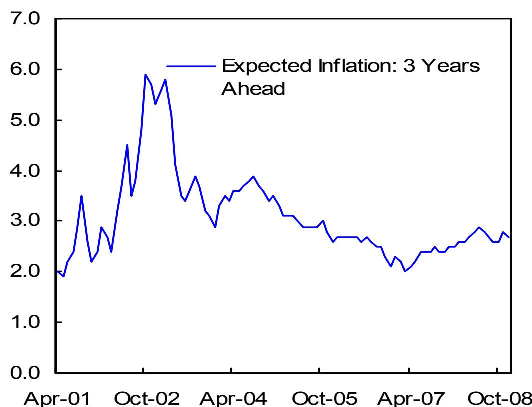
Securing Near Term External Financing Needs, and Rollover Risk

13. **The strong track record is reflected in macroeconomic policy credibility.** This dampens Israel's sensitivity to external shocks and enhances the efficiency and flexibility of policy responses.

14. **As a result, sovereign credit ratings are on a long-tem upward trend.** The ratings have, moreover, held up during economic downturns and exogenous shocks (e.g. at the time of the end of the dot.com boom and the Intifada in the early 2000s).



15. **The credit ratings are reflected in government bond yields.** Yields on government bonds, not guaranteed by the U.S., have been higher than comparable U.S. bonds, on account of Israel's lower credit rating. But, the yield spread has tended to be relatively stable around 1 percentage point and the increase during the last 1½ years has been less than in many emerging market economies.



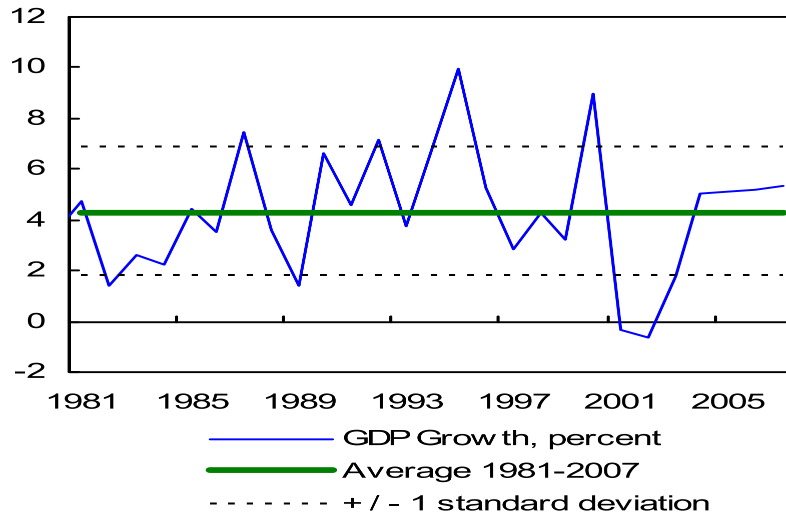
16. **This credibility is also apparent in indicators related to monetary policy.** In recent years the exchange rate has been strong and stable, and inflation and inflation expectations have been contained and steady.

Lessons from Past Experiences of Economic Stress

17. **Two periods of economic stress stand out in the last 30 years, when real GDP growth was significantly below its average growth rate.** Both periods demonstrate that appropriate policy responses are very important, both when the economy has some fundamental imbalances, as in the early to mid-1980s, but also when the economy goes into the difficulties from a much stronger starting point, as in the early 2000s.[2] The more recent

[2] Se IMF Israel Staff reports, 1985, 1986, and 2003 (Country Report 04/158).

period is arguably more relevant as a point of reference for current developments as the Israeli economy has changed significantly since the early 1980s.



18. **In particular good coordination of fiscal and monetary policies have proven to be crucial.** A good illustration is the policies in the first half of 2002. As a response to the economic troubles caused by the two shocks from the dot-com boom and the Intifada, fiscal policy was set to be restrained while monetary policy would be considerably loosened. Instead, as policies were implemented, both the fiscal and the monetary policy stance were expansive, which soon led to a significant loss of credibility and pressure on the exchange rate and financial stability.

19. **In both periods, concerns about high and increasing levels of public debt constrained policy options.** Policies that made fiscal sustainability come into question, led to pressures in the balance of payments and on the exchange rate. To restore confidence, policy adjustments were important, but U.S. support, in the form of aid or debt guarantees, was also key.

Policy Issues

20. **Israel's external vulnerabilities and the continuation of the global economic crises present major policy challenges.**

- *How can fiscal policy flexibility and credibility be balanced?*

In an economic downturn, a countercyclical policy stance is appropriate and there may be a need for extraordinary measures, e.g. to support the financial sector. At the same time, as past experiences demonstrate, fiscal policies must be credible in containing public debt over the medium-term.

- *How large should foreign exchange reserves be – and when should they be used?*

Sizeable foreign exchange reserves can instill confidence in the exchange rate market and provide liquidity for external financial transactions. There are, however, opportunity costs for holding and accumulating reserves, and they must be used appropriately.

- *Should financial sector stress be addressed preemptively, or should the government resist intervention and then manage the consequences?*

Government interventions in the financial sector are costly and will likely distort incentives, but in the absence of government intervention the consequences of a financial crises can be overwhelming.

- *What is the right monetary policy stance?*

Past experiences show that policy coordination is critical, and monetary policy must be calibrated to be consistent with fiscal and financial sector policies, which is challenging in the current uncertain economic and political environment.

Assessment of these issues is presented in the main text of the Staff report.

ATTACHMENT IV: FISCAL SUSTAINABILITY

Baseline scenario

With the primary balance projected to continue strengthening in the baseline scenario (with adherence to the 1.7 percent ceiling on real expenditure growth), Israel's fiscal vulnerability is expected to fall broadly. After the cyclical downturns expected for 2009-2010, gross financing need drops from 13¾ percent of GDP in 2010 to 8¾ percent in 2013, thus lowering rollover risks (and the associated risks of run on the shekel) over time. And public debt is firmly put on a downward path, reduced to 74 percent of GDP in 2013 (chart 1).

External risks

Risk aversion

External financial developments constitute key risks to the baseline projection. For instance, should the ongoing dislocation in the international financial system prove to be deeper and more protracted than expected, global risk appetite would be eroded further. In such a scenario, even if domestic factors (e.g., output growth and policies) evolve as projected, investors may demand higher yields or shed their holdings in shekel-denominated assets, thus impacting the real interest rates and/or the exchange rate.

- A permanent ½ standard-deviation shock to the interest rate—a 1.4 percentage point increase from the baseline—would dampen the pace of debt reduction and bring public debt to 80 percent of GDP in 2013 (chart 2).

- A one-time 30 percent depreciation in the REER (in 2009) would immediately increase public debt to 92¾ percent of GDP upon impact, reflecting a significant portion of the government's liabilities denominated in foreign currencies. Debt would subsequently fall at a pace envisaged in the baseline, but still stand at 86 percent of GDP in 2013 (chart 6).

Costly interventions

The spreading global financial turmoil may also directly undermine the functioning of the domestic financial sector, thus potentially necessitating costly government interventions.

- A one-time 10 percent of GDP shock to contingent liabilities (in 2009) would increase public debt to 91 percent of GDP. Assuming the baseline case of speed of debt reduction thereafter, public debt would be 85 percent of GDP 2013 (chart 6).

Domestic risks

Fiscal indiscipline

Given the back-loaded nature of deficit improvement in the baseline, the projected debt reduction is premised on sustained commitment to fiscal strengthening.

- A ½ standard deviation shock to primary balance—lowering average primary balance to 0.7 percent of GDP during the forecast period—would imply a more gradual debt reduction and increase debt by 4 percentage points of GDP (to 78 percent) in 2013 relative to the baseline (chart 4).

Growth slowdown

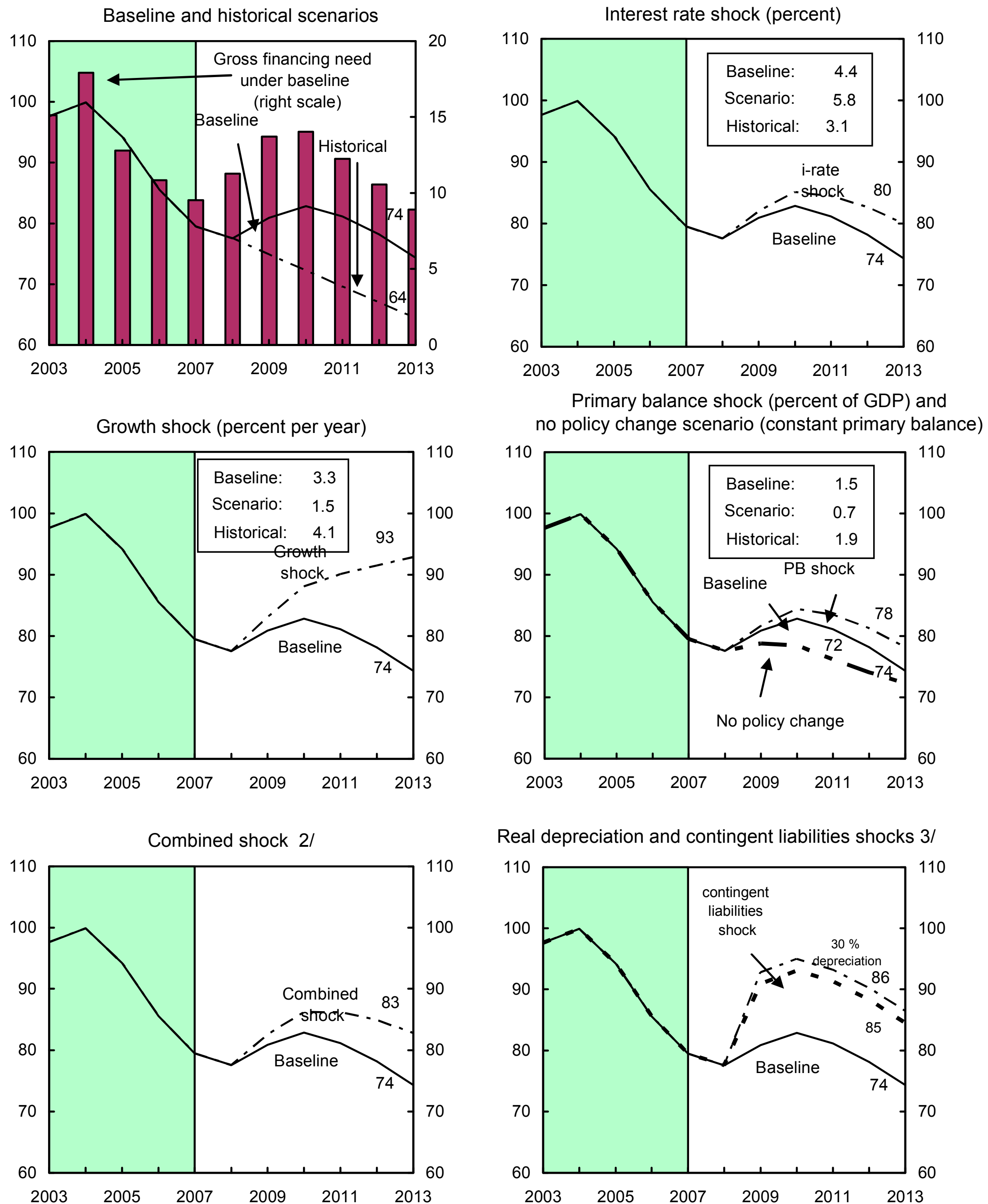
Lower-than-expected output growth could also significantly strain fiscal sustainability—as demonstrated during the 2001–03 economic downturn when public debt ballooned by 15 percentage points to 100 percent of GDP.

- A ½ standard deviation shock to growth would bring average projected annual growth down by more than half to 1.5 percent. Even with no fiscal loosening (i.e., no decrease in primary balance from the baseline), public debt would rise to 93 percent of GDP in 2013 due to adverse debt dynamics (chart 3).

But in more realistic scenarios featuring growth shocks, the government would likely engage in structural fiscal easing. Moreover, if there are also increased concerns about Israel's long-term economic prospects, sovereign spreads would likely rise. Such a confluence of shocks—lower growth, higher real interest rates and weaker primary balance—would pose threats to the debt reduction plan.

- One-quarter standard deviation shocks to growth, real interest rate, and primary balance (i.e., lowering average annual growth to 2½ percent, raising real interest rate to 5¼ percent, and reducing the primary balance to 1¼ percent of GDP) would bring public debt to 83 percent of GDP in 2013—an increase of 9 percentage points of GDP from the baseline (chart 5).

Figure 6. Israel: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the European Department

January 27, 2009

Contents | Page

Appendix

Fund Relations 2

APPENDIX . ISRAEL: FUND RELATIONS

(As of December 31, 2008)

I. **Membership Status**: Israel became a member of the Fund on July 12, 1954, and accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 21, 1993, and, other than solely for national and international security reasons, maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. Israel subscribes to the SDDS and is in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars.[1]

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	928.20	100.00
Fund holdings of currency	813.91	87.69
Reserve position in Fund	114.30	12.31

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	106.36	100.00
Holdings	8.56	8.05

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

V. **Financial Arrangements**: None

VI. **Projected Payments to Fund (SDR Million)**:

	Forthcoming				
	2009	2010	2011	2012	2013
Principal					
Charges/Interest	0.86	0.81	0.81	0.81	0.81
Total	0.86	0.81	0.81	0.81	0.81

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

VIII. **Safeguards Assessments**: Not applicable

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

IX. **Exchange Rate Arrangement**:

As of June 9, 2005 Israel's exchange rate regime is officially classified as floating. This step by the Government of Israel was taken to remove the last vestige of a policy in which the exchange rate of the NIS fluctuated within the limits of a crawling band. In practice, however, the NIS has been floating since 1997, when the Bank of Israel stopped intervening to protect the band.

X. **Article IV consultation**:

The last Article IV consultation was concluded on February 13, 2008. 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.
- AML/CFT ROSC was conducted in 2003, issued in June 2005.
- Data Module ROSC was conducted in 2005, and issued as IMF Country Report No. 06/125 in March 2006.

XII. **Technical Assistance**:

The Fund has been providing policy advice and technical assistance to the Palestinian Authority since the 1993 Oslo Accords, and presently has a senior resident representative based in Jerusalem. The Fund's work in the West Bank and Gaza (WBG) has recently intensified, with a focus on the macroeconomic, fiscal, and financial areas. Three staff missions to the WBG took place in 2008—in March, June and November—to assist the Palestinian authorities in developing and updating their medium-term macroeconomic and fiscal frameworks in line with the broad objectives laid out in the Palestinian Reform and Development Plan (PRDP) presented at the Paris international donors' conference in December 2007. Looking forward, the Fund will be regularly reporting to donors on the macroeconomic and fiscal situation, and on the implementation of public finance reforms. Technical assistance will be stepped up in the areas of public expenditure management, banking supervision and regulation, and macroeconomic statistics.

XIII. **Resident Representative**:

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

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/22
FOR IMMEDIATE RELEASE
February 18, 2009

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

IMF Executive Board Concludes 2008 Article IV Consultation with Israel

On February 13, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Israel.[1]

Background

The economy grew rapidly following the 2001–03 downturn. Real GDP growth averaged over 5 percent in 2004–07, as strong export of goods and services spurred private consumption and investment. In this context, the current account remained in strong surplus.

Fiscal and monetary policies reflected and supported strong and stable growth. The central government fiscal accounts steadily improved from a deficit of 5.4 percent of GDP in 2003 to balance in 2007, and public debt was lowered from 100 percent of GDP to under 80 percent of GDP during 2003–07. Inflation climbed steadily after mid-2007, surpassing the upper bound (3 percent) of the inflation target in December 2007. In response, the Bank of Israel (BoI) raised policy rates by 75 basis points between August 2007 and February 2008, to 4¼ percent.

External economic vulnerabilities are contained, with gross debt assets exceeding gross debt liabilities in the short term and overall. In the context of strong capital inflows—reflected in a 15 percent real appreciation of the shekel since mid-2007 back to its long run level—the authorities implemented a pre-announced program of reserve accumulation to attenuate external vulnerabilities further.

[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.

Trends changed in the Fall of 2008 as the deterioration of global financial conditions and the weakening of export markets took their toll. Exports and growth slowed, lowering the annual external current account surplus to 1¼ percent of GDP, and reducing growth to some 4¼ percent for the year. Alongside, fiscal revenue fell short in the fourth quarter, raising the central government deficit to 2.1 percent of GDP in 2008, with public debt at about 77½ percent of GDP. In this context, with the prospective global growth slowdown reversing earlier food and energy price inflation and associated inflation expectations, the BoI rapidly reduced policy rates—to 1 percent in February 2009. Inflation fell to 3.3 percent in January 2009 from the high of 5.5 percent in September 2008.

Israel's banking sector appears robust with interbank liquidity undisturbed. But, as globally, equity and domestic corporate bond markets weakened in 2008. Several measures to relieve credit strains have been announced, including the establishment of public-private corporate bond funds and expanding guarantees for credits to small and medium enterprises.

As the global crisis continues to unfold, activity is set to decelerate further, with inflationary pressures easing significantly alongside. And with fiscal revenues weakening in this context, fiscal deficits and public debt are set to rise.

Executive Board Assessment

Executive Directors welcomed the robust and balanced economic growth since 2003, underpinned by sound macroeconomic policies, and supported by a stable banking sector and favorable global conditions. Directors noted, however, that global strains and weakness in the corporate bond market weigh on credit and growth prospects, and accordingly, activity is set to slow markedly in 2009–10. Thus, significant economic challenges lie ahead, with the high level of public debt remaining a vulnerability.

Directors underscored that the immediate policy priority is to support credit flows, combined with contingency planning for tail events. In this context, they welcomed the recently announced plans to establish public-private funds to purchase corporate bonds, and recommended that these funds focus their activities on bond refinancing and new bond issues from solvent firms, in order to maximize the impact on credit flows to firms. Clearly defined terms of reference would ensure transparency and accountability.

While acknowledging the resilience of the banking sector to date, Directors called for a careful review of the legal procedures governing public interventions in, and assistance for, banks, with a view to ensuring adequate capacity to deal with any systemic stress in banks. Reform of the supervisory organizational structures and the introduction of an explicit deposit insurance scheme should remain under consideration, with the aim of implementing them once the current crisis has eased. Directors welcomed steps to enhance information-sharing and cooperation among the regulatory agencies, and encouraged further efforts to strengthen the supervision of the rapidly growing nonbank financial sector.

Directors commended the authorities for their disciplined budget execution in recent years, which had delivered strong budget outturns, secured significant debt reduction, and accordingly prepared fiscal policy for a supportive role in the current circumstances. In the near term, they agreed that automatic stabilizers should be allowed to operate fully, and welcomed efforts to bring forward planned infrastructure projects. While leaving the underlying structural fiscal balance close to its 2008 outturn, this would require a relaxation of the budget deficit ceiling. However, in light of the potential fiscal risks from the financial sector, the still-high debt ratio, and the need to maintain room for further fiscal maneuver if the economic outlook deteriorates further, Directors cautioned against further relaxation at this stage.

Directors emphasized the need to strengthen further the medium-term fiscal framework, anchored by a medium-term public debt goal and associated expenditure ceilings. The specifics of such a framework should balance the need for flexibility, given the uncertain global environment, with the need for sufficiently firm mechanisms to guide the political process. A debt objective defined over the medium term, supported by rolling multi-year ceilings on nominal annual spending, could strike this balance appropriately, although some Directors also saw merit in an automatic error correction mechanism and caps on real expenditures.

Noting that inflation is expected to fall sharply, Directors supported the recent decisive reductions in policy rates to forestall the risk of a protracted undershooting of the inflation target. There remains some room for further monetary easing, given the prospect of low inflation expectations and the constrained fiscal space. In this regard, Directors stressed the need for close monitoring of key indicators to ensure a timely response and maintain market confidence.

Directors agreed that inflation targeting and the flexible exchange rate regime have served the Israeli economy well, and they welcomed steps to reinforce these frameworks, supported by effective communication. Directors commended the authorities for the pre-announced accumulation of reserves, which bolsters credibility while abjuring discretionary intervention. Directors also welcomed the proposed new draft Bank of Israel Law, which aims to strengthen the governance of the monetary policy decision-making process.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with Israel is also available.

Israel: Selected Economic and Financial Indicators, 2004−09

(Percent change, unless otherwise indicated)

	2004	2005	2006	2007 1/	2008 1/	2009 1/
National accounts indicators (constant prices)						
Domestic demand	3.1	4.8	4.1	6.7	3.2	0.6
Private consumption	5.4	3.9	4.0	6.7	4.6	1.2
Public consumption	-1.8	1.7	2.7	2.9	0.1	-0.7
Gross capital formation	3.1	12.7	6.5	12.0	2.8	0.6
Fixed capital formation	0.9	2.9	9.9	15.5	3.8	0.7
Imports of goods and services	11.8	3.5	3.6	11.7	2.8	-0.7
Exports of goods and services	17.5	4.3	6.1	8.5	5.3	-0.9
Real GDP	5.0	5.1	5.2	5.4	4.3	0.5
Output Gap	-0.1	0.5	1.2	2.0	1.8	-1.4
Savings and investment (current prices, percent of GDP)						
Gross capital formation	17.4	18.8	19.0	20.1	20.1	20.1
Of which: public 2/	2.2	2.0	1.8	2.0	1.8	3.7
Savings	18.6	20.1	21.9	24.8	25.1	28.6
Private	21.1	20.9	21.7	23.6	24.1	27.6
Public	-2.6	-0.8	0.2	1.2	1.0	1.0
Labor market indicators						
Israeli civilian labor force	3.6	5.4	3.8	5.5	5.2	0.1
Employment	3.1	3.8	3.1	4.3	3.8	1.2
Unemployment rate (percent)	10.4	9.0	8.4	7.3	6.0	7.0
Real wages 3/	2.5	1.0	1.3	1.7	-0.4	...
Business sector 3/	1.5	1.5	1.7	1.4	-0.8	...
Public sector 3/	4.6	0.0	0.3	2.2	0.6	...
Prices						
CPI (end period)	1.2	2.4	-0.1	3.4	3.8	-0.1
CPI (period average)	-0.4	1.3	2.1	0.5	4.7	1.5
CPI (excluding housing and energy, end period)	-1.0	0.7	1.7	1.3	4.5	...
Interest rates (average, percent): BOI policy rate 4/	4.2	3.7	5.1	3.9	3.7	...
Money and credit (period average)						
Private sector credit 3/	3.9	7.1	4.3	6.7	12.0	...
Narrow money (M1) 5/	18.0	17.5	13.7	15.3	15.2	...
Broad money (M3) 3/	4.6	7.9	7.4	12.9	5.3	...
Public finance (percent of GDP)						
Central government revenue	35.1	35.3	35.2	35.4	30.0	30.0
Central government expenditure	38.7	37.1	36.2	35.4	32.1	34.2
Central government balance 6/	-3.6	-1.9	-1.0	0.0	-2.1	-4.2
General government revenue	44.3	43.9	44.7	44.1	40.9	40.9
General government expenditure	49.8	48.7	46.5	44.9	43.7	45.8
General government balance 7/	-5.5	-4.8	-1.8	-0.8	-2.8	-4.9
General government primary balance	1.5	2.7	3.3	3.9	1.9	-0.2
General government structural primary balance	1.4	2.0	2.2	2.3	0.3	-0.4
General government debt	98.2	94.2	85.6	79.5	77.6	80.9
Balance of payments						
Trade balance (percent of GDP)	-2.5	-3.1	-2.7	-3.7	-4.0	-2.3
Current account (percent of GDP)	2.1	3.0	5.6	2.8	1.2	2.5
Foreign direct investment (percent of GDP)	1.9	3.2	9.9	5.9	2.5	2.4
Foreign reserves (end period, billions of U.S. dollars) 5/	27.2	28.5	29.6	29.0	41.4	...
Exchange rate and terms of trade indices						
NEER (period average) 8/	-3.3	-0.8	0.4	3.9	9.4	
REER (period average) 8/	-6.0	-2.2	0.0	1.8	13.1	
Terms of trade (index, 2000=100)	96.0	96.5	95.2	93.2	...	

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

1/ IMF staff projections.

2/ Capital expenditure of the central government.

3/ Data for 2008 as of October.

4/ Data for 2008 as of December.

5/ Data for 2008 as of November.

6/ National definition, cash basis.

7/ International definition, accrual basis. On the difference between central and general government deficits during 2003–06: much of it is accounted for by the difference between accrual and cash bases accounting. On the latter, the key factor is the CPI indexation component that is paid on all NIS debt when it matures and is recorded below the line in the central government balance, but above the line in the general government balance when it accrues.

8/ Data for 2008 as of November.

**Statement by Age Bakker, Executive Director for Israel and
Mr. Yoav Friedmann, Senior Advisor to Executive Director
February 13, 2009**

Israel's Macroeconomic Developments and Outlook

The Israeli authorities would like to thank staff for fruitful discussions in Jerusalem. The authorities share the staff's views on the economy and broadly agree with its appraisal.

The Israeli economy performed strongly over the last five years, owing to favorable global economic conditions and prudent macroeconomic policies, placing Israel in a relatively good position, even as it is being hit by the global crisis. Overall economic activity expanded rapidly, the labor participation rate continued to rise, and the current account has been in surplus indicating healthy growth and sustainable macroeconomic policies.

In 2008, fiscal discipline was maintained, allowing for a further reduction in the relative size of the public sector and in the public debt-to-GDP ratio. Monetary policy adjusted swiftly to the changing environment as the authorities increased the interest rate in the middle of the year when imported inflation pushed prices upward. Then, soon after the start of the fourth quarter, the interest rate was rapidly reduced to unprecedented low levels, in response to the deepening of the global crisis and expected recession.

Israel's net International Investment Position (IIP) is almost balanced, reflecting net negative capital assets (27 percent of GDP) and net positive debt assets (23 percent of GDP). This structure of IIP is a result of large FDI and foreign portfolio investments in the last decade, current account surpluses in the last six years, and investment in debt assets abroad by residents. Israel's IIP structure and current account surplus reduce the vulnerability of the economy to a rollover risk and 'sudden stop.'

As a small open economy with exports exceeding 40 percent of GDP, Israel is not immune to the global crisis and the authorities are well aware of the challenges ahead. In the short term, this means mitigating the tight credit conditions and supporting domestic demand, and in the longer term, maintaining a sustainable fiscal policy, directed at lowering the public debt-to-GDP ratio and supporting growth.

The fall in the composite state-of-the-economy index[1] in the last few months of 2008, as well as the decline in goods' exports, indicates the severity of the slowdown in economic activity in the last quarter of 2008 and the strong effect of global demand on the Israeli economy.

---

[1] The composite state-of-the-economy index is a synthetic cyclical indicator for examining the direction in which real economic activity is moving, in real time. It is calculated from the monthly changes of six components: manufacturing production index; imports, excluding capital goods; trade and services revenue; the number of employee posts in the business sector; manufactured goods exports; and export of services.

Data from the Bank of Israel Companies Survey is also indicating a severe slowdown that encompasses all industries, with manufacturing exports recording the most notable decline in activity.

Recently, the Bank of Israel published its macroeconomic forecast for 2009 and, like the staff, significantly revised down its estimates. However, the central bank is somewhat more pessimistic than staff, projecting that GDP will contract by 0.2 percent, private consumption growth will decelerate to 1.1 percent, and exports will fall sharply, by almost 7 percent. The central government deficit is projected to reach 4.1 percent and unemployment to increase to an average level of 7.6 percent. With regards to 2010, the central bank forecasts a growth rate of 2.7 percent, which coincides with staff's projection.

In 2008, the real effective exchange rate appreciated by almost 12 percent. A possible explanation for this substantial appreciation is the difference in timing and intensity with which the global crisis struck the economy, affecting the nominal and real exchange rate. The Bank of Israel assesses that the real effective exchange rate in the third quarter of 2008 was overvalued by 4 to 10 percent. However, as it became clear since the fourth quarter, that the Israeli economy will be substantially affected by the global recession, the shekel (NIS) depreciated somewhat.

Fiscal Policy

In 2008, the authorities continued with their long-term strategy of fiscal consolidation and contraction of the public debt-to-GDP ratio, by restraining expenditure and maintaining the multi-year program of lowering direct taxes. The public debt-to-GDP ratio reached 78.2 percent, 1.5 percentage points lower than in 2007, and around twenty-five percentage points lower than in 1998.

The political environment in Israel is complex, against the background of the global financial crisis. Prime Minister Ehud Olmert resigned in September; his successor as the head of the Kadima Party, Tzipi Livni did not succeed in forming a new government, prompting general elections held on Tuesday, February 10. The 2009 budget will only be approved by the Knesset after a new government is formed.

Meanwhile, the Israeli authorities put together a fiscal stimulus plan, aimed at mitigating tighter credit conditions (domestic and external) and the effects of lower external demand—the two main channels through which the global financial turmoil hit the economy. The main building blocks of the fiscal stimulus plan are: establishing public-private funds to recycle corporate bonds, providing government guarantees for capital raised by banks, guaranteeing credit to SMEs, providing a safety-net for long-term investors close to retirement and increasing investments in infrastructure and R&D.

The authorities are aware that it is essential for the fiscal stimulus plan to be appropriate to the medium- and long-term targets and constraints. It is of utmost importance that such steps

do not result in an excessive increase of the government deficit or government debt. Therefore, the authorities allocated only a small amount of the stimulus plan to increase domestic demand directly.

The sharp economic downturn has already caused a drop in tax revenues, resulting in a shortfall of NIS 6.5 billion in budget revenues in 2008 compared with the forecast. However, the credibility acquired by fiscal policy allows a moderate short-term increase in the fiscal deficit, which is not likely to undermine economic stability or impair confidence in fiscal policy. It is expected that the 2009 budget, which will be approved soon after a new government is formed, will include a one-off increase in security spending because of the recent conflict with Hamas, as well as an adjustment for credit allocated through the above-mentioned programs.

The discussion of Israel's fiscal policy, and staff's suggestions for a revised fiscal rule, are broadly appropriate given the current crisis and Israel's structural fiscal position. In light of the expected cyclical increase in the deficit, the need to retain fiscal credibility via a medium-term fiscal rule, like a reduction in debt-to-GDP ratio below 60 percent early in the second half of the next decade, is clear. Although the specific depiction of the rule may take various forms, its essence - replacement of the current expenditure ceiling with a more flexible one - is appropriate. A detailed plan specifying the required measures to meet the medium-term targets, as proposed by staff, will increase its credibility.

Monetary policy

In 2008, monetary policy was adjusted swiftly to the changing economic environment. At the beginning of the year, the expected decline in economic growth and inflation spurred a change in monetary policy. As a result, the Bank of Israel had reduced its key policy interest rate as early as March. In the second and third quarters, inflation rose well above its target range[2], due primarily to the continued increases in world raw material prices, while the economy was still buoyant; and therefore the Bank of Israel increased its policy rate. The rapid and serious deterioration of the global economy from mid-September necessitated deep interest rate cuts, similar to steps taken by other central banks. Inflation was expected to fall sharply, and the Bank of Israel reduced its interest rate from 4.25 percent at the beginning of the fourth quarter to 1 percent in February 2009, its lowest level ever.

The objective of these interest rate cuts is to support real economic activity and limit any deviation of inflation below target, in light of the severe drop in demand and the fall in commodity prices. Inflation expectations for the next twelve months derived from the capital market (break-even inflation) were 0.5 percent in January. Israeli private forecasters predict

[2] The inflation target in Israel is defined as a rise of 1–3 percent in the CPI measured over the previous twelve months.

on average twelve-month inflation at about the same level. The Bank of Israel's econometric models also show that there is a high probability that inflation in 2009 will be below the target range.

In March 2008 the Bank of Israel announced a plan to increase foreign exchange reserves by purchasing a fixed daily amount ($25 million) of foreign currency in the open market. The idea of increasing the foreign exchange reserves had been around for several years, with the intention of enhancing Israel's resilience to domestic and external shocks. Comfortable market conditions persuaded the central bank to start executing its plan in 2008. In July, as the nominal effective exchange rate appreciated further, the Bank of Israel increased the daily amount of foreign currency bought in the market to US$100 million. In retrospect, the decision to implement the plan to increase the international reserves was timely, strengthening confidence and reducing financial vulnerability in the face of possible additional shocks.

As a result of the appreciation of the shekel against the US dollar in 2007 and 2008, a trend emerged away from indexation of housing prices to the US dollar. At the beginning of 2009 only a small percentage of housing contracts was still indexed to the US dollar, reducing significantly the pass-through from the exchange rate to inflation. Although this structural break makes the monetary transmission mechanism more complicated, it may reduce inflation volatility and thus increase the central bank's credibility in subsequent years. It may also enable the central bank to react more actively to real shocks to the economy within the IT regime.

Financial Sector

The Israeli banking system has been only mildly affected by the world financial turmoil because of its conservative approach to risk and due to comprehensive regulation and close supervision. The banking system and each bank individually were depending neither on wholesale markets nor on credit lines from abroad, as their short-term external debt is more than matched by deposits abroad and the mortgage banks were not depending on capital markets for their funding needs. However, with other sectors of the economy becoming affected by the global recession, the banks will likely have to increase provisioning for bad loans. Furthermore, the banks also incurred losses on their holdings of minority interests in non-financial companies, since these companies were hurt by the crisis.

The banks are aware that in spite of the difficulties they have to adhere to their early business plans of raising capital adequacy to 12 percent by the end of 2009. The government plan to provide guarantees of NIS 6 billion for capital raised by banks might make this task easier and reinforce their robustness.

Israel's financial system has undergone rapid reform-driven change. The non-banking financial sector increased significantly, reaching a share of almost 50 percent of the business sector's outstanding credit. The reform has generated significant challenges for supervisors

as risks have shifted from the banking sector to the non-banking financial institutions, and regulation has not yet been harmonized. These challenges intensified once the global financial crisis erupted.

The three regulators – Banking Supervision, Capital Markets Insurance and Savings Division, and Israel Securities Authority – are jointly preparing and implementing various action plans to combat the slowdown and to enhance preparedness for contingencies in the context of stresses in financial markets. The three regulators participate in various joint high-level committees; their staff participates in joint sub-committees and working teams. The Supervisor of Banks has intensified monitoring of banks exposures, enhanced regulatory requirements regarding, *inter alia*, banks' review of their business strategy and risk management policies, including control over their subsidiaries and branches abroad, and banks' public disclosure.

In October 2007, the EU Commission (Moneyval) examined whether Israel complies with the 49 recommendations of the FATF. In August 2008, it published a report which found that Israel is compliant or largely compliant with the majority of these recommendations. Israel is amending legislation and regulations, and strengthening enforcement in order to implement all recommendations of the report by the time it will be discussed by the EU Commission in July 2009.