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Israel: 2010 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV consultation with Israel, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 29, 2010, 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 December 21, 2010. 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).

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

ISRAEL[1]

Staff Report for the 2010 Article IV Consultation

Prepared by the European Department

Approved by Adam Bennett and Aasim Husain

December 21, 2010

Israel passed through the global recession swiftly. The challenge now is to sustain growth and low inflation while boosting medium-term prospects—in the context of continued global uncertainty, shekel appreciation, and a housing market that is overheating.

Buoyant activity and employment alongside incipient inflation pressures calls for the overall stance of policies to be tightened more quickly than planned. But the onus for the accelerated effort should fall mainly on fiscal rather than monetary policy. This shift in the policy center of gravity will help to contain inflation, reduce upward pressure on the shekel, and support the new fiscal rule. Alongside, monetary policy should focus on inflation and move further towards a neutral stance. In so doing, it should continue to respond to shocks to global demand, and foreign exchange intervention should become more symmetric. Steps to rebalance housing supply and demand can support these efforts. To secure Israel's medium-term prospects, greater coordination between the authorities responsible for the stability of the financial system, and enhanced procedures governing medium-term public spending will be essential.

The 2010 Article IV discussions were held in Jerusalem and Tel Aviv during November 17–29. The team comprised Mr. Doyle (Head, EUR), Ms. Budina (FAD), Mr. Cipriani (INS), and Mr. Roger (MCM). Mr. Friedmann (Advisor, OED) attended most meetings. The mission met with Minister of Finance Steinitz, Governor of the Central Bank Fischer, representatives of the Prime Minister's office, and other senior officials, academics, and private sector representatives. A joint press conference was held with the authorities at the conclusion of the mission.

The mission's concluding statement was published on November 29, 2010 and can be found at: http://www.imf.org/external/np/ms/2010/112910.htm.

[1] For purposes of Fund relations, the West Bank, Gaza and the Golan Heights are considered to be under the authority of Israel within the terms of Article XXXI, Section 2(g) of the Articles of Agreement. Information regarding economic developments in West Bank and Gaza may be found in *Macroeconomic and Fiscal Framework for West Bank and Gaza—Sixth Review of Progress*, 9/21/2010. The discussions with the Israeli authorities and the analysis in this staff report took into account the economic developments in these territories to the extent they are relevant for purposes of completing the Article IV consultation with Israel.

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I. Background

Following a moderate slowdown in 2009, Israel's economy has rebounded decisively[1]

1. Output fell mildly and for only 2 quarters from Q4 2008, and for 2009 as a whole growth was 0.8 percent, and is projected to rise to some 4 percent in 2010 (See Selected Economic Issues (SEI) I). Despite public debt around 80 percent of GDP, initial market jitters over Israel in the wake of Lehman Bros soon subsided. There have been no signs of sovereign debt stress—with CDS spreads in the neighborhood of 80 bps in 2010, and the strength of long-term prospects has been underscored by recent entry into the OECD.

2. The recovery was led by consumption and exports (Text Table, Figure 1). After falling with the onset of the 2008 global economic shock, consumer spending led the recovery from Q2 2009. The strength of consumption was mainly in non-durables—spending on durables fell sharply (by 6 percent in 2009) and recovered relatively slowly, but this primarily affected imports. Exports recovered alongside from H2 2009, in part as world trade rebounded, and they are already back at pre-crisis levels. Demand for housing construction also picked up strongly from Q2 2009, a delayed supply response to the take-off in the housing market which began a year earlier. But in Q3 2010, outright falls in export volumes and sharp deceleration in private consumption may signal emerging limits on the durability of output strength.

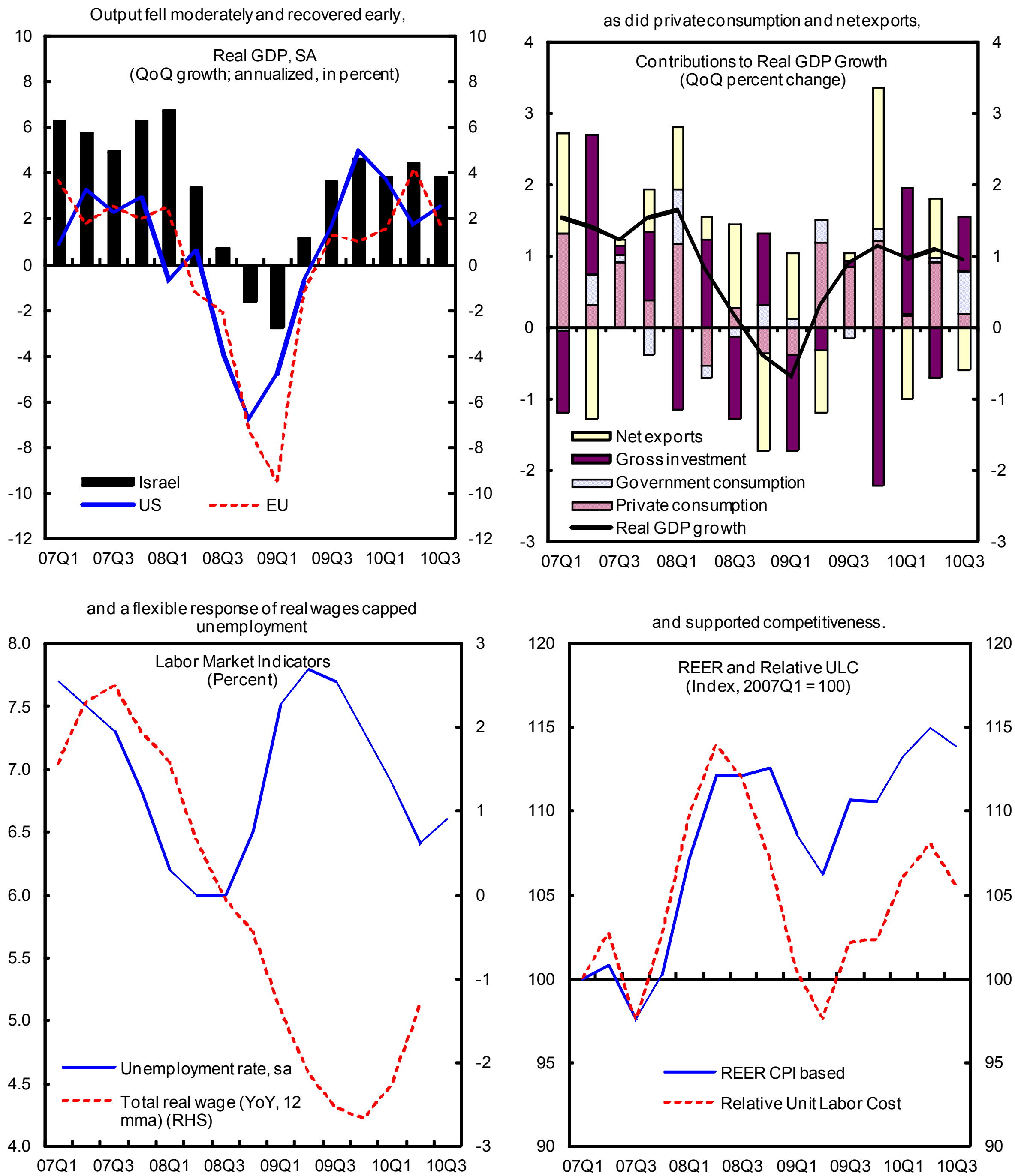
Israel- National Account (chained data at 2005 prices, seasonally adjusted)
(quarter-on-quarter percentage changes, unless otherwise stated)

	2009				2010		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
GDP	-0.7	0.3	0.9	1.1	1.0	1.1	0.9
Private Consumption	-0.7	2.2	1.5	2.2	0.3	1.6	0.3
Government Consumption	0.5	1.3	-0.6	0.7	0.1	0.3	2.5
Gross Fixed Capital Formation	-5.0	-4.9	-1.2	-10.3	16.0	-6.1	2.7
Of which: Housing	1.0	0.4	1.5	1.7	2.1	4.3	3.2
Non-Housing	-5.4	-0.2	0.8	-3.4	5.6	3.7	2.1
Exports of Goods and Services	-8.7	-1.0	4.3	9.0	1.9	3.3	-2.5
Imports of Goods and Services	-11.2	1.3	4.1	4.0	4.6	1.4	-1.2
Changes in Inventories 1/	-0.3	-0.9	-0.4	-1.4	1.7	-1.8	0.0

/1 Contribution to growth

[1] Macrofinancial data are adequate for surveillance (See Informational Annex).

Figure 1. The Great Recession—Short and Sweet in Israel



Sources: Haver Analytics; OECD Analytical Database; INS; and IMF staff calculations.

Credit to households, and employment buoyed consumption

3. Credit from domestic and foreign sources to households has been buoyant—at annual rates of some 8 percent in 2009 and 2010, but credit to non-financial firms has all but stagnated. In part, this reflects the resilience of the banking sector, while non-banks—and notably the corporate bond market—encountered difficulties (Box 1). Credit to firms remains weak.

4. Employment held up well alongside domestic demand. After a modest decline in the first half of 2009, jobs rose 4½ percent through Q2 2010 (2.8 percent for permanent jobs), partly cushioned from the global shock by economy-wide real wage declines of 2½ percent in 2009—the result of cautious settlements and upside inflation surprises. As recovery has taken hold, unemployment fell from its peak of 8 percent in early 2009 to 6 percent in Q2 2010, with participation rates leveling off at 56 percent in 2009–10 after rising prior to that.

And the shekel appreciated, capping inflation

5. External developments put the shekel under considerable appreciation pressure recently (Figure 2). Despite weakness in exports and net income receipts overall in 2009, the current account balance strengthened by 3 percentage points of GDP—reflecting sharp falls in durables and investment imports and falling international energy prices. With exports and imports both recovering through Q2 2010, the current account surplus is expected to be a little weaker in 2010 overall. On the financial account, short-term net inflows by residents surged from end-2007 while short-term net flows by non-residents remained broadly stable. The resulting upward pressure on the shekel paused in mid-2008, but resumed again after the Spring of 2010 as global financial markets thawed. Since then, the cautious tightening of domestic policies, increasing investor confidence in the relative strength of Israeli economic prospects, and the termination of programmed intervention by BoI has seen the real value of the shekel soar back to its mid-crisis peaks—some 15 percent above pre-crisis levels. As a result, competitiveness has been eroded.

6. But the strong shekel has helped to contain inflation (Figure 3). With import prices accordingly held in check, wholesale prices are still below their mid-2008 peaks, and, until recently, food prices have been flat since then too. Nevertheless, since end-2007, the headline CPI has been continuously slightly above the 1–3 percent target range, partly boosted by indirect tax hikes. It has only recently fallen back into target range, with import prices leading the decline.

And house prices soared

7. After many years of stagnation in nominal terms, prices of owner-occupied dwellings rose steadily since the onset of global financial market tensions in the fall of 2007. House prices are now 40 percent above pre-crisis levels, albeit with mixed evidence on whether or not they are still rising. These developments partly reflect the supportive stance of

macrofinancial policies in the face of downturn in 2009. And by at least in part offsetting the wealth effects on Israeli households of falling securities prices, they may have provided some support to household consumption.

Box 1. Financial Sector Structure and Vulnerabilities

The Israeli banking system is dominated by five banks. Although profits declined in 2008 (reflecting losses on modest holdings of domestic equity and bonds, and limited foreign ABS exposures abroad), only one bank recorded outright losses. Banks continued to raise capital ratios during the crisis, through retained profits, bond and equity issues. And average risk-weighted capital ratios have risen to 13.6 percent, while the Tier 1 capital ratio has risen to 8.5 percent. As NPLs have declined lower provisioning needs have led to increased returns on equity and assets for most banks, although returns remain below pre-recession levels.

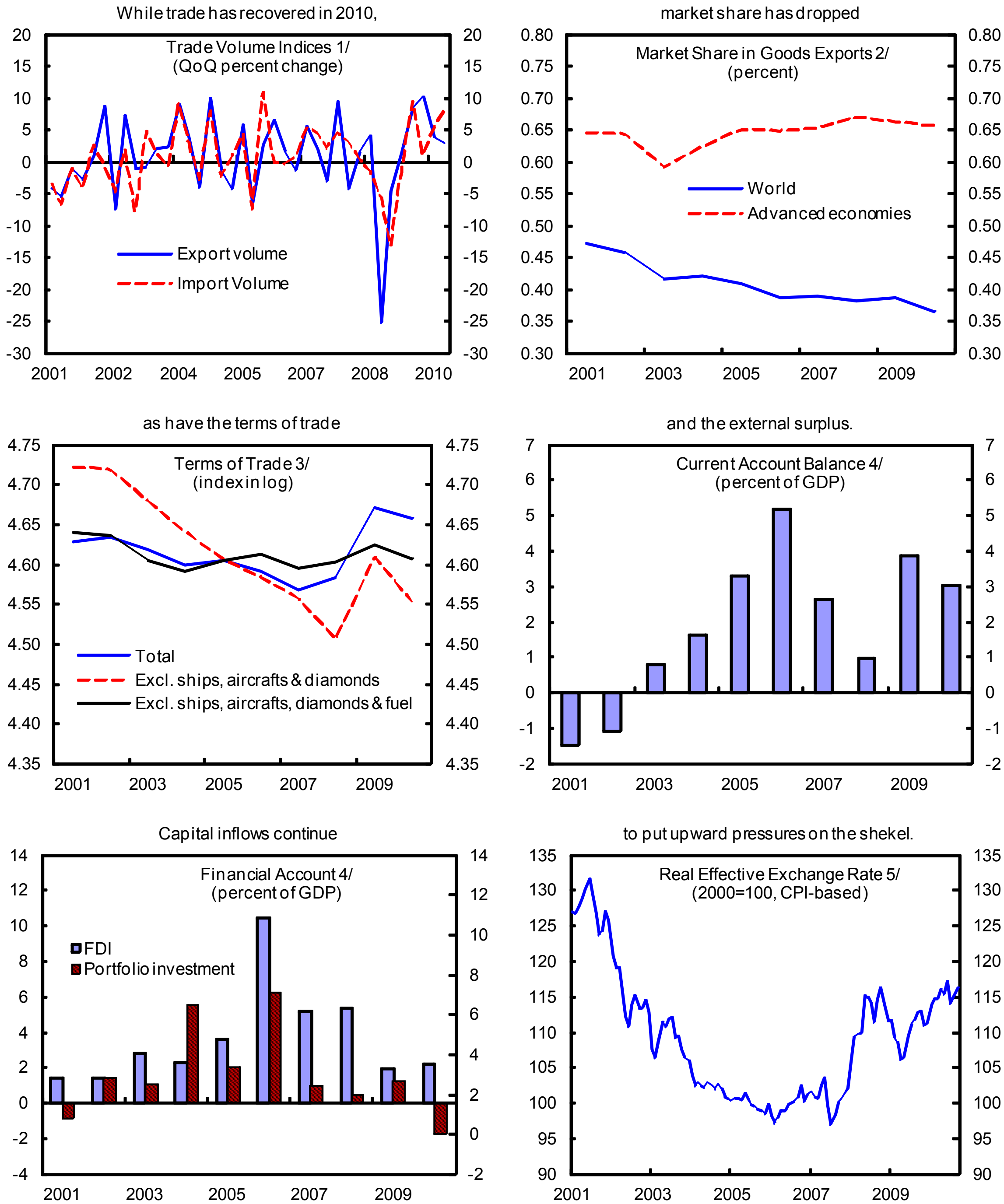
Balance Sheet Indicators for Israel's Five Biggest Banks

	Bank Leumi		Bank Hapoalim		Discount Bank		Mizrahi Bank		First Int'l Bank	
	Jun-10	Jun-09	Jun-10	Jun-09	Jun-10	Jun-09	Jun-10	Jun-09	Jun-10	Jun-09
	(Percent)									
Share of system assets	29.8	29.7	27.9	28.2	17.2	17.7	11.4	10.7	9.2	9.4
Credits/assets	64.7	64.9	70.9	71.3	61.7	61.7	80.6	79.5	59.8	58.5
Deposits/liabilities	82.7	84.7	78.9	80.7	78.7	79.4	86.0	86.2	85.1	84.9
Credits/deposits	84.4	81.8	96.7	94.7	83.1	81.8	99.4	97.9	75.4	73.7
Bonds & sub. notes/liabilities	8.8	7.7	7.9	7.8	6.8	5.5	6.8	7.1	5.0	5.3
Equity/assets	7.2	6.3	7.1	6.5	5.5	5.0	5.5	5.5	6.3	5.9
Equity/risk-weighted assets	14.8	12.9	13.6	12.8	12.5	11.5	13.9	12.2	12.9	14.0
Return on equity	11.5	10.2	9.5	4.5	6.0	11.0	12.3	8.7	7.0	8.8

Source: Bank of Israel.

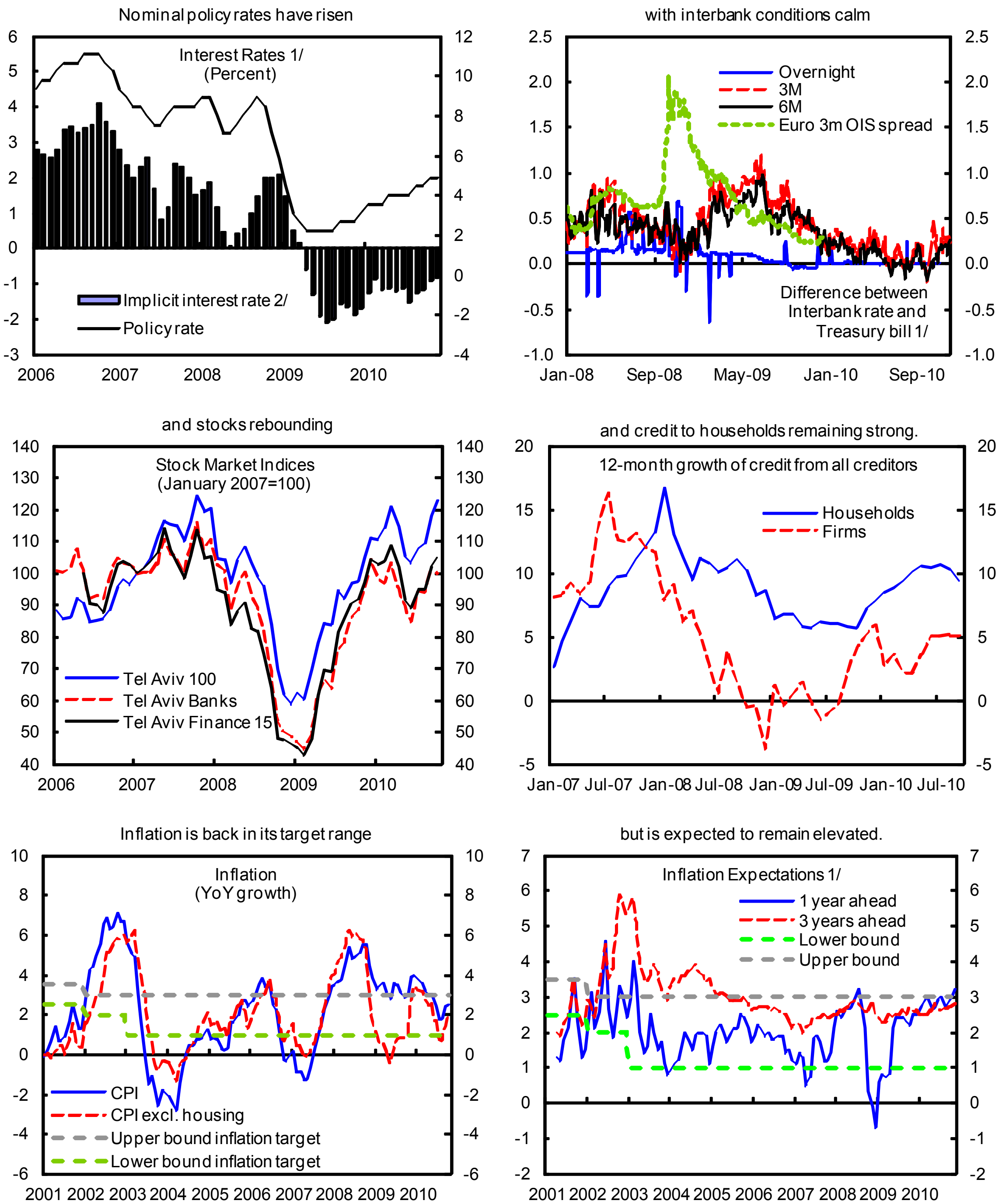
The non-bank financial sector, including insurance, pensions, and mutual funds, grew rapidly prior to the crisis, with its share of lending, through equity and bond markets, rising to nearly half of total financing of the corporate sector. As globally, the Israeli capital markets suffered major losses in 2008-09, and the corporate bond market temporarily seized up at the end of 2008 (Figure 4). Insurers and pensions experienced large losses. Since early 2009, bond and equity market prices have risen above pre-crisis levels, strongly boosting the performance of insurance and pension portfolios and solvency ratios. The volume of bond and equity market issuance, however, is well off pre-crisis levels, especially in the non-financial corporate sector.

Figure 2. Israel: External Indicators, 2001–10



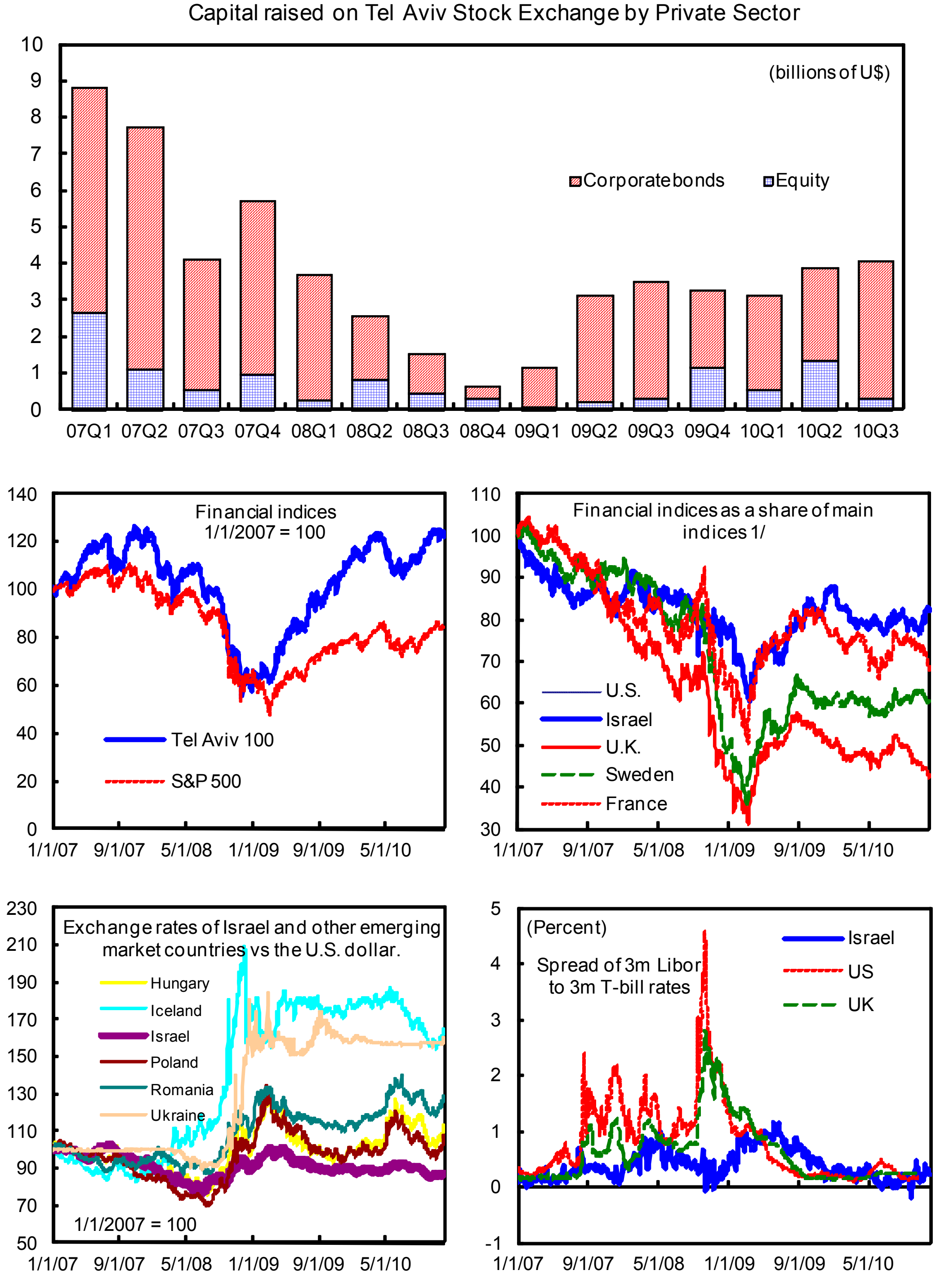
Sources: Haver Analytics; INS; and IMF's Direction of Trade Statistics.
1/ Includes goods and services; data as of 2010Q2.
2/ Average for January to July 2010.
3/ Average for 2010 Q1 and Q2.
4/ Staff projection for 2010.
5/ A decrease represents depreciation; data as of September 2010.

Figure 3. Israel: Selected Monetary and Financial Indicators



Sources: Bank of Israel; Bloomberg; DataInsight; and Haver Analytics.
1/ Data as of November 2010.
2/ Defined by the Bank of Israel as policy rate minus inflation expectations.

Figure 4. Financial Market Indicators



Sources: Bank of Israel; Bloomberg; and TASE.
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.

Policies were tightened promptly, once growth was again entrenched

8. On the fiscal side, policy tightening largely reflects automatic stabilizers—a mirror image of the earlier loosening in 2008–09. With the budget set for two years (2009–10) and growth higher than budgeted in both, central government nominal revenue overperformed, especially in 2010. This occurred despite the earlier-than-anticipated reduction in the VAT to 16 percent from January 2010. Meanwhile, nominal spending was held well below budget in 2009 as may recur to some degree in 2010. This yielded a 0.8 and 1½ percentage point of GDP budget overperformance in 2009 and 2010 respectively (Text Table).

Budget and Macroeconomic Outlook

	2008	2009		2010	
	Outturn	Budget	Outturn	Budget	Jan-Sep 2/
	(Billions of NIS)				
Central Government 1/					
Revenue	227	215	216	227	167
o/w Taxes	183	173	178	183	165
Expenditure	245	259	255	270	181
o/w Defense	52	49	52	54	45
Budget balance	-17	-44	-40	-43	-14
	(Percent of GDP)				
Central Government 1/					
Revenue	31.3	28.8	28.1	29.1	20.3
o/w Taxes	25.2	23.2	23.2	23.5	20.0
Expenditure	33.7	34.7	33.2	34.6	21.9
o/w Defense	7.2	6.6	6.7	6.9	5.5
Budget balance 2/	-2.4	-5.9	-5.1	-5.5	-1.6
General Government					
Overall balance	-2.6	…	-5.5	…	…
Cyclically adjusted primary balance	0.1	…	-0.8	…	…
Gross public debt	76.7	…	77.6	…	72.5
Memorandum items:					
Real GDP growth (percent)	4.3	-1.0	0.8	1.5	…
Nominal GDP, NIS billion	726	746	768	780	826

Sources: Israeli authorities; and IMF staff estimates.
1/ Data as per the national defintion, covers the budgetary sector and NII, excluding net credit.
2/ The deficit ceiling rule is applied to Central government balances.

9. The 2009–10 budget and its outturn also represented the first steps to establish the credibility of the framework of fiscal rules recently adopted targeting phased near-term deficit reduction and capping spending growth to support progress to medium-term public debt reduction. (See SEI II.)

10. On the monetary policy side, Israel was the first central bank globally to commence its tightening cycle from September 2009, raising policy rates in 25 basis point steps from their floor of ½ percent to 2 percent by October 2010 (Figure 3). This stance was reinforced by adoption of a new Bank of Israel Law in 2010 formalizing its established inflation targeting practices (See SEI II). Nevertheless, the real interest rate continues to be negative, and the overall monetary stance remains expansionary, notwithstanding the appreciation of the shekel since mid-2008.

11. With an eye on house price developments, the BoI has tightened restrictions on housing sector financing. Penalties have been increased on lending in excess of the 20 percent indicative limit on the share of banks' lending. Banks have also been required to review risks in their mortgage lending portfolios, and to raise loan-loss provisioning (by at least 75 basis points) for loans granted since April with loan-to-value (LTV) ratios above 60 percent. This measure was reinforced from late October when the reserve requirement on such loans was raised further. While this only raises borrowing costs by some 50 basis points, 1/3 of new mortgages extended during 2010 exceed this LTV threshold. These measures are seen as "warning shots"—the Bank of Israel has stated publicly that if the housing market does not cool in response, further actions will be taken.

12. But as growth resumed, so did calls for wage rises. While negotiations in the public sector were consensual and recently completed—envisaging rises of 6½ percent over three years, in line with targeted inflation—private sector wage growth has picked up.

And global prospects weaken in 2011

13. The WEO projects a temporary slowdown of growth in advanced economies in 2011 towards 2 percent. But unlike output, growth in global trade is not projected to recover in 2012, falling to 6½ percent in 2011 and 2012. And with the real price of oil projected broadly unchanged from current levels, further steady declines in Israel's terms of trade are projected after the significant gains in 2009.

The WEO Outlook (annual growth rates)

	2010	2011	2012
World GDP	4.6	4.3	4.6
Advanced Economies GDP	2.6	2.2	2.6
Import Growth: Volume			
World	10.2	6.5	6.7
Advanced Economies	8.4	5.0	5.2
Good only excl. oil: Israel's Partners	12.2	6.8	6.6
Oil price	23.3	3.3	4.4
Israel Export Prices	13.2	-2.1	-1.5
Israel Import Prices	12.2	0.0	0.0

14. Alongside, global uncertainties remain heightened. The WEO 90 percent confidence interval for global growth for 2011 ranges from 2–6 percent (with the 70 percent confidence interval ranging from 3–5 percent). As a small open economy, Israel is highly exposed. Using estimated elasticities of Israeli exports and output with respect to world growth, this implies a 90 percent confidence interval for Israeli output ranging from 2–5 percent.

II. Core Diagnostic Issues

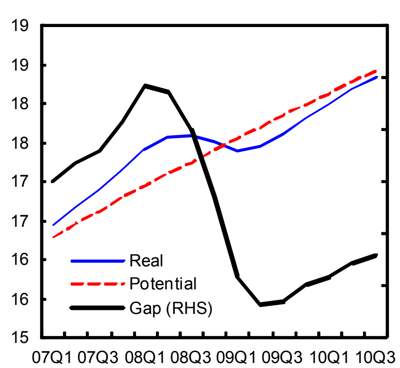
15. With this background, five issues are core to policy design. These are considered in turn.

A. How Large is the Output Gap, and Will it Restrain Inflation?

16. The output gap is likely close to zero, given that Israel was close to capacity in 2008, experienced a relatively mild and short passage through the great recession, but nevertheless also saw sharp falls in fixed investment. Numerical estimates based on the standard technical measures support this view (Box 2), with—until most recently—fast falling unemployment rates corroborating. And although headline inflation has fallen back into range, private nominal wage growth has picked up, "break-even" inflation forecasts have risen to the upper limit of the inflation target over the medium term. While the strong shekel has contained inflationary pressures so far, further tightening of policies is warranted.

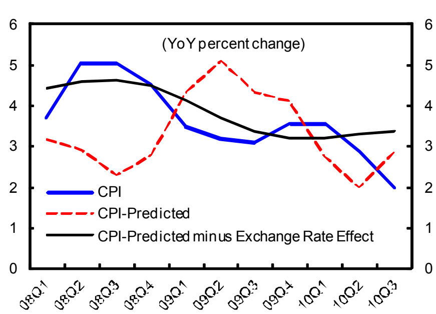
Box 2. The Output Gap

A Hodrick-Prescott filter with λ equal to 1600, on data for 1993Q1 to 2010 Q3 suggests output above capacity in 2007, and falling below capacity in 2008-09. However, the gap appears to be falling rapidly, to below ½ of a percentage point of GDP at present. (Note, output was projected forward for 10 quarters prior to estimation to address end-point problems.)



Box 3. Inflation

Inflation in 2010 has fallen back into target range, despite the swiftly falling output gap and rising wage pressures. Shekel appreciation has been key to this. Standard modeling of quarterly CPI by staff—with the output gap, the NEER, and import prices as dependent variables—suggests that, absent the strong shekel since mid-year, the CPI would be 1 percentage point higher in Fall 2010 than the outturn—and therefore still above the target range.

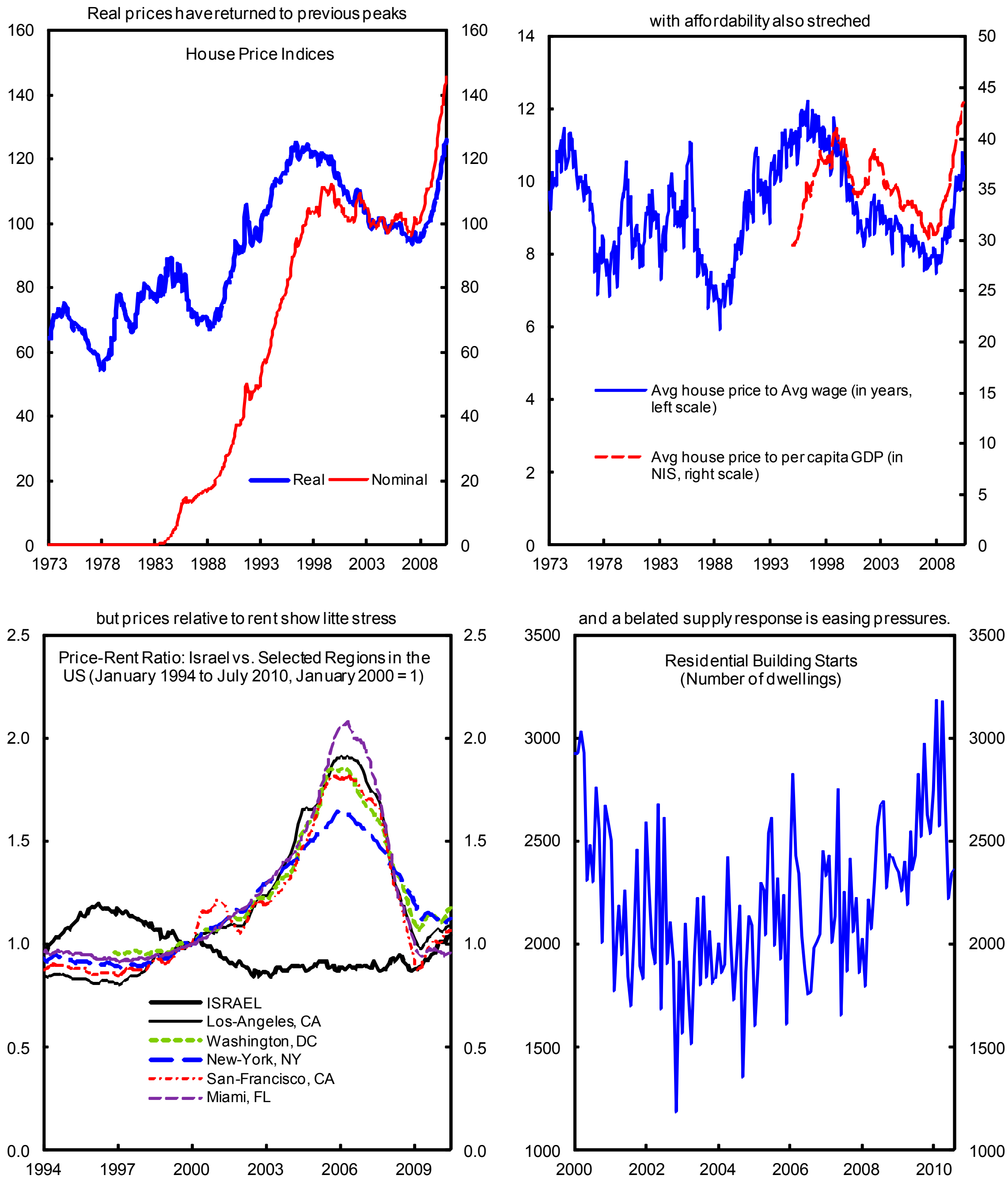


B. Do House Prices Presage General Inflationary of Financial Stability Strains?

17. House prices are up over 40 percent since the great recession began (Figure 5). The absence of a prior housing bubble, alongside long-standing supply constraints, restrictive planning regulations, global recession safe-haven inflows, low policy interest rates, and uninterrupted bank lending to households have conjoined to produce an uncomfortable echo of advanced countries in the early-to-mid 2000s. But, with the possible exception of Q2 2010, private consumption behavior seems largely unaffected by the boom—perhaps as it offsets other losses in asset portfolios. Moreover, in contrast to recent experience elsewhere, there is no evidence that the boom is related to a weakening of credit standards: mortgages are "full recourse;" almost all stay on the original creditors' books (with none packaged into structured products), and headline delinquency rates remain low and have declined over the past year. Additionally, loan to values remain low, although this may be a reflection of the increase in house prices.

18. Nonetheless, with affordability now stretched relative to historical norms, caution is appropriate; indeed, these developments in the housing market corroborate other signs that policies are accommodative.

Figure 5. Israel: House Prices



Sources: Bureau of Labor Statistics; Haver Analytics; and IMF staff estimates.

C. Is the Shekel Competitive?

19. While shekel appreciation has stemmed inflation thus far, the CPI-based real effective exchange rate is well above its trading range in the four years to end-2007 and the ratio of export prices to the GDP deflator is now well below ratios typical in those years (Figure 6).

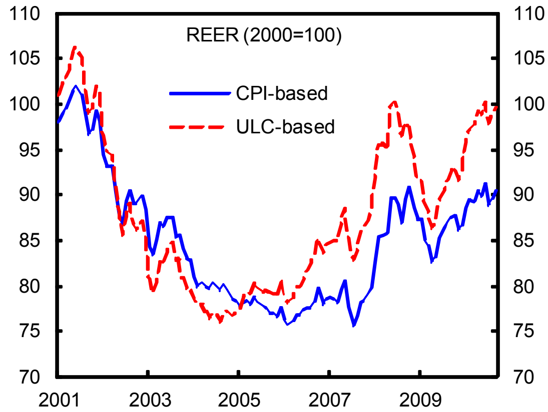
20. There is some—albeit not unqualified—evidence that the 2003–07 trading range is in the neighborhood of the equilibrium rate, or a little below it. Not only was this range established for a prolonged period, but at that time, there was no foreign exchange intervention by the BoI and the economy broadly in balance—securing steady growth and unemployment falling towards 5 percent, along with sustained low inflation. The current account was in surplus, but this reflects structural factors: a relatively low fixed investment ratio (20 percent of GDP in 2007, a boom year) in part due to enduring geopolitical risk; and high and rising private savings ratios, boosted by the commencement of a 30-year long phased switch from defined benefit to defined contribution pension schemes for new cohorts of labor market entrants, which began at the end of the millennium.

21. Since then, the strong economic performance of Israel relative to core advanced counties may have raised the equilibrium rate somewhat—at least until the core recovers—with a further boost possible by recent discovery of significant offshore natural gas reserves. But quantifying the size and duration of the former remains uncertain, and the latter is attenuated the relatively modest size—perhaps 30 percent of GDP in NPV terms—of the discoveries relative to other natural resource exporters, and because the authorities intend to apply the proceeds to public debt reduction.

22. Furthermore, formal CGER estimates of competitiveness remain dispersed, as they were a year ago. The Equilibrium Real Exchange Rate (ERER) measure, like the CPI-REER, suggests that the shekel is significantly on the strong side. But the macro balance and external stability estimates suggest that it is undervalued. Both latter measures may exaggerate competitiveness in Israel, notably as both reflect an assumption that the impact on savings rates of the continued phased pension reforms has ended, even though the phasing itself has many years to run.

Figure 6. Israel: Indicators of Competitiveness

The shekel is well above mid 2000's levels



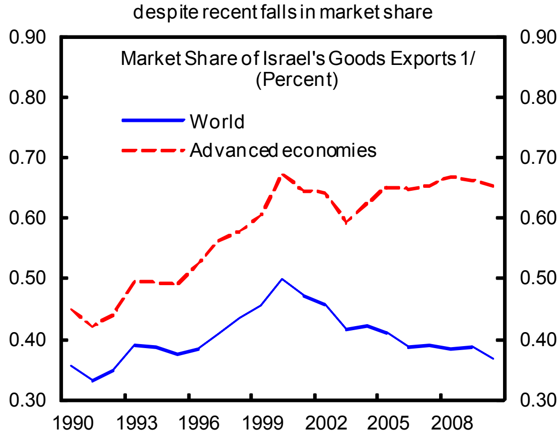
but CGER qualifies concerns

Real Exchange Rate
Fall 2010 CGER Assessment

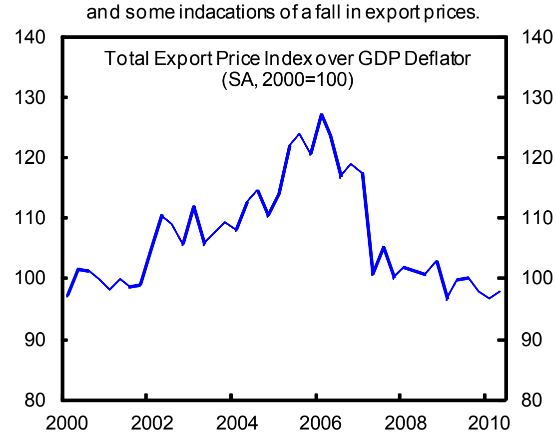
Approach	RER Valuation Conclusion
MB	-10%
ES	-15%
ERER	10%

MB: Macro Balance
ES: External Sustainability
ERER: Reduced from Equilibrium RER

despite recent falls in market share



and some indacations of a fall in export prices.



Sources: Global Data Source; Haver Analytics; IMF's Direction of Trade Statistics; and IMF staff estimates.
1/ 2010 is the average from January to July 2010.

23. In resolving the assessment of competitiveness in the face of these conflicting indicators, it is notable that broader macroeconomic signs of overvaluation in Israel are becoming evident. Israel's export market share globally and in advanced countries fell in H1 2010, with outright export declines in Q3, falling FDI inflows, continued weakness in non-housing fixed investment all constituting cautionary signs, and even a small pickup in the unemployment rate in Q3 2010. Nevertheless, "noise" in the global economy may cloud interpretation of these indicators.

24. Accordingly, in assessing overall competitiveness of the shekel, the ERER and direct price measures are emphasized relative to the MB and ES measures. On this basis, the shekel could be somewhat on the strong side (i.e., overvalued). While there are significant margins of uncertainty around that assessment, further significant and sustained appreciation beyond current rates would tilt the balance of this judgment decisively.

D. Are Capital Inflows Set to Continue or Even Intensify?

25. There is risk of significant and sustained exchange rate appreciation beyond current rates appears high, however. As discussed above, relatively strong Israeli economic performance has been reflected in the policy interest rate differential and strong portfolio inflows in 2010 (Figure 7). On WEO projections showing advanced country deceleration in 2011, the divergences in policy interest rates appear set to persist. So early relief from—let alone reversal of—these appreciation pressures is unlikely.

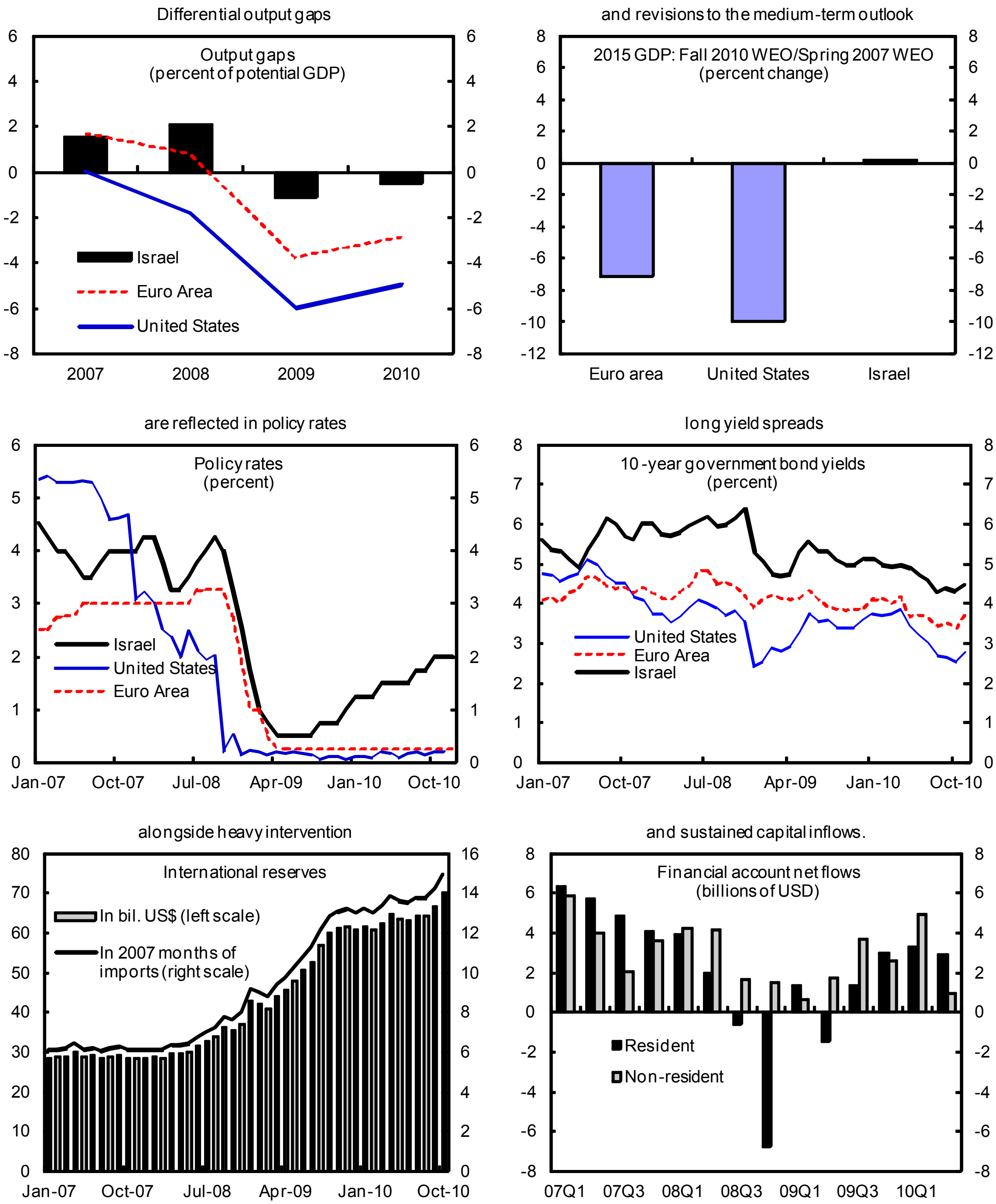
26. Policy would thus best be predicated—in the central case—on addressing these inflows pressures as "enduring" rather than as "short-lived" phenomena. And they require a purposeful policy response to the extent that they have already eroded competitiveness and to the extent that they may yet do so.

E. Are Sovereign Risks Significant?

27. Israeli sovereign financing and CDS spreads remained firm during the global recession. Increases in headline debt ratios and contingent liabilities from the financial sector were limited, the maturity structure of debt is long, and economic growth and its outlook are strong. Fiscal risks are not imminent. But spreads spiked in the wake of Lehman and global post-crisis strains compound perennial Israeli geopolitical risks—so strengthened macroeconomic buffers would be helpful. These include further reductions in public debt (See SEI IV).

28. In summary, inflation and housing pressures signal a need for policy tightening, while the nexus of competitiveness and capital flows issues underscore the premium on doing so without compounding upward pressures on the shekel. This, and the need to continue long-run public debt reduction, places fiscal adjustment at the heart of policy recommendations.

Figure 7. Israel: Outlook for Capital Flows



Sources: CEIC database; Data Insight; DataStream; WEO; and IMF staff estimates.

III. MACROFINANCIAL POLICY SETTINGS—2011–12

A. Central Case Macroeconomic Projections

29. Staff central case projections, predicated on the WEO and the Israeli authorities' announced policy frameworks, reflect the assessments outlined above.

30. In particular, in accord with the ceilings on the headline deficit under the new fiscal rule, the 2011–12 two-year budget anticipates a decline in the deficit from 4 percent of GDP in 2010 to 3 and 2 percent of GDP in 2011 and 2012 respectively. It assumes growth of 4 percent in 2011 and 2012, with inflation on target. Alongside, further moderate monetary policy tightening is anticipated.

31. In this light, with Israel's growth momentum checked by international deceleration and domestic fiscal consolidation, staff projections show GDP growth of some 4 percent in 2010, falling back to 3½ percent in 2011 before recovering again in 2012 (see Text Table and Table 5). Inflationary pressures are expected to show up in 2011–12, although partially checked by continued shekel strength. Inflation is projected to decline back to the mid-point of the target range and capital inflows pressures are expected to ease thereafter. But until then, competitiveness and external performance are projected to suffer.

Annual Projections

	2010	2011	2012
Real GDP	3.9	3.5	3.8
Domestic demand	3.7	3.7	3.6
Private consumption	4.9	4.0	4.3
Public consumption	2.2	2.1	0.9
Gross capital formation	2.2	5.0	4.7
Fixed capital formation	8.2	6.5	6.0
Exports of goods and services	11.8	2.4	7.5
Imports of goods and services	10.6	2.8	7.1
Current account (percent of GDP)	2.2	1.2	1.5
CPI	2.6	3.0	2.5
Unemployment rate (percent)	6.6	5.5	5.0

B. Fiscal Policy

Fiscal consolidation is needed

32. Given need for consolidation and to establish the credibility of the framework of fiscal rules, the authorities' plans therefore mark an essential step in the right direction.

33. The 2011–12 budget anticipates a 0.8 percentage point of GDP strengthening in the structural primary balance in 2011 and a further 0.6 percentage point strengthening in 2012. Furthermore, nominal revenues net of tax policy changes grow some 4 percentage points higher than nominal GDP. This allows expenditure to rise in accord with the new rule consistent with the corresponding path for deficit ceilings.

34. On the tax side, income tax rates fall as anticipated.[2] However, additional revenue efforts, such as postponing the earlier anticipated ½ a percentage point reduction in the VAT rate to 15½ percent from 2011 to 2013, and increasing energy and other excise taxes in 2011, will increase revenue. In 2012, additional energy tax increases will offset the impact of planned tax cuts. On the spending side, outlays grow at 2.66 percent for 2011–12, adjusted with the forecast average inflation rate, in line with the ceilings under the new expenditure rule (SEI IV). Within this, the budget secures a switch in outlays from defense to higher education.

[2]This reform included tax policy changes in PIT and CIT as follows: In 2011, some PIT tax brackets will be widened but the tax rates are unchanged, while over 2012-2016 the reform includes a schedule of cuts in all PIT rates besides the two lowest - by 1 percent a year through 2012-2015 and by 2 percent to 39 percent in 2016. The reform also envisages a schedule of corporate income tax cuts – by 1 percent a year through 2011 – 2015 and by 2 percent to 18 percent in 2016.

Budget and Macroeconomic Outlook

	2010	2011		2012		2015
	Est.	Budget	Est.	Budget	Est.	Est.
			(Billions of NIS)			
Central Government 1/						
Revenue	238	262	258	283	277	333
o/w Taxes	197	215	213	234	229	277
Expenditure	270	287	284	301	295	344
o/w Defense	54	54	54	56	56	66
Budget balance	-32	-25	-26	-18	-19	-11
			(Percent of GDP)			
Central Government 1/						
Revenue	28.9	30.3	29.3	30.8	29.5	30.1
o/w Taxes	23.8	24.9	24.2	25.5	24.5	25.0
Expenditure	32.8	33.3	32.3	32.8	31.5	31.1
o/w Defense	6.5	6.3	6.1	6.1	5.9	5.9
Budget balance 2/	-3.9	-2.9	-3.0	-2.0	-2.0	-1.0
General Government						
Overall balance	-4.1	…	-3.2	…	-2.2	-1.1
Cyclically adjusted primary balance	-0.6	…	0.1	…	0.7	…
Gross public debt	75.5	…	72.8	…	69.8	62.3
Memorandum items:						
Nominal tax revenue growth,net of tax changes	8.1	8.7	8.0	9.0	7.8	6.8
Nominal GDP growth (percent)	7.4	6.7	6.7	6.3	6.4	5.2
Inflation (annual average)	2.6	…	3.0	2.0	2.5	1.7
Real GDP growth (percent)	3.9	4	3.5	4	3.8	3.4
New real expenditure growth rule (percent)		2.7	2.7	2.7	2.7	2.8
Nominal GDP, NIS billion	826	864	880	919	936	1109

Sources: Israeli authorities; and IMF staff estimates.

1/ Data as per the national defintion, covers the budgetary sector and NII, excluding net credit.
2/ The deficit ceiling rule is applied to Central government balances.

But planned consolidation may be insufficient

35. Even with the structural budget deficit set on a downward track, capital inflows and associated competitiveness concerns persist. The tools available to address those issues directly—including intervention, macroprudential instruments, and capital controls—have proven to have limited effectiveness and notable costs (see section B below). There is therefore a case for accelerating the planned consolidation to address these concerns. Counter concerns—that growth might falter and require continued fiscal support—are attenuated by scope for monetary relaxation in such a context—given Bank of Israel policy rates at 2 percent (See SEI III). Accordingly, the planned structural consolidation would best be regarded as the minimum—with significant broader macroeconomic benefits to be accrued from going further and faster.

Additional consolidation can be accomplished without amending the budget

36. As budget operation mechanisms and expenditure reserves allow considerable scope to hold spending below the allocations (as evident from the 2009–10 budget outturns), one option would be to operate the 2011–12 budget in this way. As this additional consolidation can be done via freezing reserves, it does not require amendment of the budget.

Uncertainties in the revenue outlook may also require action

37. The difficulties in fully accounting for outturns in 2009–10, notably in respect of corporation tax, give rise to associated uncertainties in the revenue projections for 2011–12. Accordingly, if during 2011 receipts appear to be falling below target, even with macro projections broadly on track or better than expected, corrective steps will be required at an early stage. With discretionary spending restraint already devoted to securing structural over-performance as discussed above, such revenue shortfalls would likely have to be addressed on the revenue side, with action on indirect taxes—in line with OECD recommendations--one of the options.

And a full review of the taxation of non-renewable resources is warranted

38. Given significant natural gas discoveries, a review of the current tax structure is appropriate at an early stage. The establishment by the Ministry of Finance of a commission to review the current tax arrangement is thus welcome. The commission's general intention to raise the "tax take" from these activities to advanced country norms is fully appropriate. Reforms to adopt international best practice in this area, including appropriate pricing arrangements in the tax and securing appropriate intergenerational distribution of the proceeds are also encouraged. Accordingly, the first use of such tax receipts should be to reduce public debt, given that overall revenues will be modest on current estimates of the volume of gas. But if large additional finds are made, revenues should be placed in a sovereign wealth fund for intergenerational equity and to avert Dutch disease.

C. Monetary and Exchange Rate Policies

Monetary policy faces a dilemma

39. With output recovering and the crisis passing more swiftly than anticipated, the BoI correctly acted early, beginning the withdrawal of stimulus.

40. And the cessation of preprogrammed forex intervention began the process back towards the BoI's eventual aim to return to a freely floating exchange rate regime—in which intervention occurs only in the most exceptional circumstances to address market disorder, as in the decade up to 2008. In the meantime, intervention continues and Israel's exchange rate regime remains classified as "floating." These steps were reinforced by the adoption of a new Bank of Israel Law. (See SEI II.)

41. But unemployment is close to historical lows, core inflation is at the upper end of the target range, and inflation expectations—even out as long as 5 years—have risen from the center of the target range to the top. Markets are currently factoring an increase in the policy rate by 75–100 basis points over the coming year, which would bring real interest rates just into a positive range. But even in that context, inflation expectations remain well above the middle of the target range through the medium-term.

42. Further tightening is needed. Delays would risk a further acceleration of inflation to the top, or even above the target range, and associated need for subsequent disinflation.

Various policy instruments could help resolve the dilemma

43. The first best option would be through additional fiscal consolidation—as noted above. But recognizing that additional fiscal effort—even within the existing two-year budget parameters—is challenging, consideration could also be given, in principle, to use of other instruments to address these dilemmas—intervention; macroprudential instruments, and various forms of capital controls. In Israel's context, however, each has some drawbacks:

Intervention—but it would be one-sided, and might need to be large.

44. Given the small size of the market, there is some evidence of effectiveness and market commentary routinely points to the scale of action the authorities' have undertaken.[3] But scope for further intervention is qualified by the high level of reserves (US$ 65 billion, 15 months of 2007 imports) and by the associated BoI losses.

45. And sustained one-sided intervention carries risks. In particular, it may come to be seen by markets as qualifying the authorities' commitment to allow the exchange rate to broadly track its fundamentals. This risk arises even if intervention is aimed to respond to sustained capital inflows arising from the "temporary" growth differential between Israel and core advanced countries.

46. This conundrum is further grounds for addressing the issue with fiscal policy. But absent that additional support, intervention should more clearly remain focused on addressing disorderly conditions, rather than becoming central to resolving dilemmas in responding to capital inflows, competitiveness and inflation concerns, even if this means allowing the exchange rate to appreciate.

Macro prudential instruments—but not as the centerpiece of policy restraint

47. Banks are already subject to reserve requirements and to the high LTV additional requirements for mortgage lending, both of which could be raised further if needed.

[3] BoI research finds a consistent "unexplained residual" in exchange rate equations during the period of preprogrammed intervention

Furthermore, the BoI is also responsible for consumer protection arrangements in the banking system. But given the advanced stage of the cycle, there may be a role for accelerated and anti-cyclical progress to raise bank capital standards towards goals under Basle III (See below). However, such instruments cannot bear the full burden of policy restraint, but they could support conventional fiscal and monetary instruments to that end.

Capital controls—but effectiveness is uncertain

48. Controls on particular kinds of inflows could in principle play a role if the affected flows are large and have low substitutability with other kinds of flows. But efforts to satisfy this requirement internationally have typically run aground when the inflows were large and enduring and Israel has little recent experience with controls, which on earlier occasions focused on curbing outflows rather than inflows. The signaling effects of such a step could also be problematic.

49. Given downsides to each of these alternative means of reconciling inflationary and competitiveness concerns, additional fiscal effort remains the option of choice.

D. Financial Stability

Banks proved resilient to global downturn, and have strengthened further

50. Financial stability indicators suggest that the resilience of the banking system has increased over the past year. Capital adequacy ratios, notably including Tier 1 capital relative to risk-weighted assets, have risen for most banks, while impaired and non-performing loan ratios have declined. Indicators of credit risk also appear strong; although household leveraging has increased somewhat in recent years, the overall level is low, and mortgage loan-to-value ratios are also low by international standards. Banks maintain highly liquidity, and interbank and direct exchange rate risk exposures are small.

Non-banks have also strengthened, but concerns remain

51. In the non-bank financial sector, solvency ratios are now comfortably above pre-crisis levels, and the evidence points to conservative portfolio allocations.

52. The performance of non-bank financial institutions is closely tied to that of the domestic capital markets which are, in turn, highly sensitive to external capital market developments. This represents an important source of vulnerability. In addition, there are lingering concerns with the quality of some corporate credit. The corporate sector is heavily dependent on bond financing, reflected in the high ratio of domestic bond issues to GDP (currently over 25 percent of GDP), so that if a problem did emerge with one of the country's large conglomerates, the impact on institutional investor portfolios could be substantial.

Banks are well-positioned ahead of regulatory reform--Basle III

53. The Israeli banking system should be well-positioned to cope with the introduction of higher capital requirements under Basel III. Regulatory and Tier 1 capital levels are already high (Box 1) and in June 2010 the BoI issued draft guidelines to banks to achieve targets for core capital of at least 7.5 percent by the end of the year.

54. The adoption of higher capital requirements will tend to have a countercyclical macroeconomic impact. In the current macroeconomic context, this could usefully complement initiatives to restrain demand, especially as it would tend to dampen upward pressure on the shekel exchange rate. However, it is not clear how large an effect the adoption of higher capital requirements will have, partly because it is difficult to judge how large banks' desired capital buffers are, or how they will be affected by adoption of higher capital requirements.

But financial sector supervision needs to be strengthened and better coordinated

55. Effective use of macroprudential tools will require the BoI to strengthen its monitoring and analysis of financial vulnerabilities and transmission mechanisms. On the monetary policy side, this will involve deeper analysis of financial aggregates, and closer monitoring of financial market developments. On the financial stability side, stress testing methods are being developed, but there is far to go.

56. In particular, stress tests need to draw on more detailed, bank by bank data, as well as making full use of information on corporate and household balance sheet data. Testing should also be undertaken in collaboration with CMISD in order to capture cross-sectoral linkages and vulnerabilities, and in collaboration with the main banks. They also need to be closely linked to the macroeconomic forecasting framework in order to assess the dynamic impact on financial stability of prospective macroeconomic developments or risks. Such analysis needs to be fed into decision making on the use of macroprudential tools as well as micro-prudential supervision, and BoI should begin publication of a Financial Stability Report on a regular basis to complement the Monetary Policy Report.

57. The BoI needs to be able to maintain adequate numbers of well-qualified staff in order to develop the above capabilities. There is also a need to set up or modify decision-making arrangements in the BoI to ensure that decisions on macro-prudential policy are as well-informed, systematic and accountable as in the monetary policy arena.

58. The adequacy of resources, capabilities, autonomy and accountability of the non-bank financial supervisors—the Israeli Securities Authority (ISA) and the Capital Markets, Insurance and Savings Division (CMISD) of the Ministry of Finance—should also be comprehensively reviewed. A series of recent Article IV consultations have recommended that the CMISD be shifted out of the MoF in order to better address the resource and accountability issues, as well as to minimize potential conflicts of interest arising from having the regulator within the MoF. In particular, there appears to be need to separate the

roles of "supervisor" from that of "promoter of the sector." This does not mean that the CMISD should necessarily gravitate toward the BoI; that is only one option, and in most OECD countries, the pension and insurance regulators are housed outside the central bank, either in a fully independent position, or as part of a unified, but independent financial services authority.

59. Finally, institutional arrangements need to be put in place to coordinate a comprehensive approach by the three supervisory agencies on financial stability issues and the use of macro-prudential instruments. The financial stability councils being put in place in Europe and the United States offer possible templates for Israel, but it will be essential to tailor any model to the specifics of Israel's institutional arrangements, as well as the characteristics of its financial system.

IV. Views of the Authorities

60. The authorities agreed with the overall assessment of economic developments and the nature of the policy dilemmas, including concern with the housing market. They also agreed that further withdrawal of stimulus is needed, noting that this is planned by fiscal consolidation according to the deficit reduction law on the fiscal side and anticipated on the monetary side. And they agreed that this process should pose as little risk to competitiveness as possible. They welcomed staff endorsement of the intention to move the taxation of natural gas towards international norms, and of the role of macroprudential instruments in policy on the housing market. Within that overall agreement, however, some significant differences of emphasis were noted.

Macroeconomic developments 2010–11

61. The authorities' central view is that the shekel is a little overvalued. But the policy dilemmas arising are similar to those of staff because the authorities emphasize overvaluation risk "at the margin." In particular, with policy interest rate differentials with the United States already at some 2 percentage points, further tightening of monetary policy is thought likely to induce further short-term capital inflows which will, in turn, contribute to overvaluation unless offsetting actions are taken.

62. Similarly, in regard to housing, the monetary authorities were a little more confident than staff that house prices are not excessively detached from fundamentals, with their concerns focused on the strength of the upward momentum. In some contrast, the fiscal authorities considered that house prices had already peaked, and may even have begun to fall a little. But both agreed with staff that further measures to ensure that a bubble did not emerge in this market were needed, with both supply and demand side measures appropriate.

Fiscal Policy

63. The fiscal authorities acknowledge the dilemmas posed by continued capital inflows and the role that fiscal policy can play in response. But they remain committed to the path of

budget consolidation that they have set out. They emphasize the priority they attach to adherence to their framework of rules, with even adjustments which would secure a strong performance relative to those rules possibly raising doubts about the framework. And they noted that a further tightening might be inappropriate given risk of global weakness.

64. These considerations are compounded by constraints on the expenditure and taxation sides. They emphasize the relatively low level of public expenditure of GDP—especially excluding security-related outlays—compared with the OECD, even allowing for the shift from security to higher education outlays that was achieved in the 2011–12 budget. Even committing to withhold the expenditure reserves could be difficult if the contingencies that they are intended to anticipate are realized. And as tax revenue reductions are a cornerstone policy objective of the administration—already compromised in the delay to VAT reduction and in excise rate rises—room for maneuver on this side is also limited.

65. They acknowledge, however, that revenue projections are in some doubt due to the imperfectly understood path of receipts during the recession and will keep this under close review and stand ready to act if shortfalls emerge.

Monetary Policy and Intervention Policy

66. The authorities acknowledge the concerns about inflation prospects that are reflected in medium-term inflation expectations rising to the top of the target band. But they note that this indicator does not correct for the risk premium, and they are leery of tightening on the basis of an unduly uncertain estimate of the NAIRU. While unemployment is low, structural changes in the labor market may mean that the NAIRU is lower still, and longstanding low participation and employment rates point to a reservoir of unused resources in the economy.

67. Discretionary foreign exchange rate intervention also retains a significant role. With capital flows exhibiting irrational behavior even in "normal" times, the inflows since 2008 include a significant element that is unrelated to "fundamentals." As the foreign exchange market is relatively small, intervention—both preprogrammed and discretionary—has proven effective not only at curtailing daily noise, but also at attenuating trends. In this context, intervention should be symmetric but only over a fairly long time horizon. This is reflected in the decision to operate a managed float under which the shekel has moved considerably in both nominal and real effective terms—which underscores the commitment to the float.

68. Furthermore, even with monetary policy ready and able to adjust rapidly to realization of global risks, there is concern not to tighten more aggressively now given competitiveness concerns "at the margin" and given the risk of adverse global outcomes—even though these risks have receded in recent months.

69. Capital controls are a "never-say-never" option. But reservations about their effectiveness and signaling mean they are not regarded as an immediate alternative at this stage.

Supervision of non-banks

70. The optimal location and structure of non-bank supervisors—and of all supervisors—remains under review by the authorities. The fiscal authorities emphasize the benefits to the dynamism and reform of the non-bank sector of the housing of the regulators in the Ministry, the strong information flows to the fiscal authority that is possible thereby, and the strengthening of resources that has been achieved in the past year. The monetary authorities see a general case to unify all risk supervision within the central bank, with all supervisors maintaining close coordination with the fiscal authorities from there. But neither see a case for early action, noting that debate on this matter should not distract attention from the broad range of supervisory initiatives that are under way. These issues might usefully constitute one element for discussion in the requested FSAP.

V. Summary and Staff Appraisal

71. **Israel was well prepared for the global recession, and responded decisively to it.** Low leverage and strong policy frameworks underpinned good preparations; while sharp cuts in policy interest rates to ½ a percent led the policy response, supported by pre-programmed foreign exchange intervention, accommodation of large automatic stabilizers, and steps to contain financial sector stress. Alongside, policy frameworks were strengthened—a new Bank of Israel Law, increased bank capital requirements, entry into the OECD, and underpinning all these, a new fiscal rule targeting debt reduction. In addition, an innovative "two-year" budget framework was initiated, which helped stabilize expectations further.

72. **As a result, growth remained positive throughout.** It was just under 1 percent in 2009, and is set to grow around 4 percent in 2010. And unemployment is already back down to around 6 percent, close to its historic low.

73. **With growth, withdrawal of policy stimulus has begun.** The BoI policy rate has been raised, forex intervention has been reduced and is now discretionary, and stabilizers have put the headline fiscal deficit back on a downward track. Nevertheless, with real interest rates negative and the budget in structural deficit, the overall policy stance remains expansionary.

74. **But strains have emerged.** Buoyed by global capital movements, the shekel appreciated by some 15 percent in real terms relative to pre-crisis levels, and is still rising. While this has helped to contain inflation, inflation expectations across the medium term have risen to the top of the target band, in the context of an output gap that has all but closed. And nominal house prices have risen over 40 percent in two years.

75. **Monetary policy faces a difficult choice between addressing these strains and sustaining competitiveness.** Rising inflation would suggest a need to raise rates. Capital inflows and strengthening shekel, eroding competitiveness, would argue otherwise. This dilemma can only be resolved by harnessing another policy instrument.

76. **Accordingly, the authorities rightly plan fiscal consolidation.** Headline deficit reductions to 3 and 2 percent of GDP in 2011 and 2012 respectively imply structural consolidation of some 1½ percentage points of GDP over those two years. Alongside, further increases in the BoI policy rate of 75–100 basis points are anticipated during 2011. In this context, growth is projected to slow to 3½ percent in 2011 before rising again in 2012.

77. **But given sustained capital inflows, the announced fiscal trajectory still leaves monetary policy with too stark a choice between addressing inflation concerns and sustaining competitiveness.**

78. **Accordingly, fiscal deficit reduction may need to be more rapid than planned.** A strengthening of the planned fiscal stance for 2011 and beyond—by some 1 percentage point of GDP in structural terms—is recommended. This action would dampen demand growth, lowering inflation pressures, thereby allowing a slower rise in BoI rates than would otherwise be needed. In turn, this would ease upward pressure on the shekel.

79. **A mix of expenditure and tax actions could be used to achieve this objective.** The latitude under the budget operation mechanisms to hold spending below budgeted authorizations—including by retention of all the various reserves in the budget—should be applied. This action avoids need to change the approved budget. But if this greater-than-planned structural consolidation is to be secured, risks on the revenue side—arising from generous official estimates—may also need to be addressed. With discretionary spending restraint already assigned to strengthen the deficit, indirect taxes may need to be raised in line with OECD recommendations.

80. **On the monetary side, with output and employment buoyant and inflation expectations high, further progress towards a neutral stance is needed.** If fiscal policy is tightened as recommended, policy rates could rise broadly as is now anticipated. But if not, a faster than anticipated rise in policy rates will be needed—albeit at the expense of competitiveness—to head off risk of higher inflation and the need to correct that later. But given nominal policy rates already well above the lower bound, monetary policy can also play a key role in responding to global uncertainty. Policymakers should remain ready to act decisively—swiftly raising policy rates if upside global risks materialize, and vice versa.

81. **With the balance of core policies adjusted in this way to address immediate strains, other policy instruments could also play a supportive role**. Further foreign exchange intervention on both sides could help to sustain orderly market conditions. But given that reserves and central bank sterilization losses are already considerable, and that persistent one-sided use of this instrument undermines the credibility of the floating exchange rate regime, it is ill-suited as the main means of reconciling inflation and competitiveness objectives. Likewise, capital controls could be considered after other policy options have been fully deployed. But any use of them would have to be focused in ensuring effectiveness in the face of sustained pressures. And accelerated progress towards the

eventual Basle III capital requirements for banks, especially if coupled with countercyclical buffers, could support restraint.

82. **With supervision and regulation being strengthened in various ways, the available indicators of financial stability are reassuring—but limited in scope.** Capital adequacy and impaired loans have improved and non-bank financial institutions have advanced similarly. But with stress testing still focused at sub-sector level and in its early stages, and a number of indicators of risk not available, caution is warranted. Though perhaps masked by the cycle, credit quality in the corporate bond market remains a lingering concern following its rapid expansion since 2004, as does the latent threat to banking stability if rapid house price inflation continues.

83. **Accordingly, further progress is needed to strengthen diagnosis and management of risks.** Stress testing procedures should give added focus to systemic risk assessed over longer horizons. Diagnosis and formulation of the appropriate policy responses requires full collaboration between and within supervisory institutions, as well as routine guidance from and feedback to all the authorities responsible for stability, including the BoI and the MoF. Such steps should proceed promptly, to be reviewed in the requested FSAP. And in line with typical OECD practice, non-bank supervision would best be moved out of the MoF. This would establish its independence and address resource constraints. There are a number of good options for where it should go—including the option chosen by about half of OECD countries of full independence.

84. **Continued structural reform remains essential.** This includes progress in education, research, the business environment, and infrastructure.

85. Staff recommends that Israel should remain on the standard 12–month consultation cycle.

Table 1. Israel: Selected Economic and Social Indicators, 2007–11

(Percent change, unless otherwise indicated)

	2007	2008	2009	2010 1/	2011 1/
Real economy					
Domestic demand	6.4	2.8	-0.2	3.7	3.7
Real GDP	5.3	4.2	0.8	3.9	3.5
Private consumption	6.3	3.0	1.7	4.9	4.0
Public consumption	3.1	2.6	2.5	2.2	2.1
Gross capital formation	11.3	2.4	-8.9	2.2	5.0
Unemployment rate (percent)	7.3	6.1	7.7	6.6	5.5
Overall CPI (end-of-period)	3.4	3.8	4.0	2.2	2.7
Money and credit (period average)					
Narrow money (M1)	15.3	14.1	50.9	…	…
Broad money (M3)	12.9	8.0	14.1	…	…
Interest rates (average, percent)					
Bank of Israel policy rate 2/	3.9	3.7	0.8	2.0	…
Public finance (percent of GDP)					
Central government revenue	33.8	31.3	28.1	28.9	29.3
Central government expenditure	34.1	33.7	33.2	32.8	32.3
Central government balance	-0.3	-2.4	-5.1	-3.9	-3.0
General government balance	-0.4	-2.6	-5.5	-4.1	-3.2
General government debt	77.7	76.7	77.6	75.5	72.8
Of which: foreign currency external debt	19.0	13.9	14.4	14.7	14.1
Balance of payments (percent of GDP, unless otherwise noted)					
Exports of goods and services	42.5	40.3	34.7	35.0	33.6
Real growth rate (percent)	9.3	5.9	-12.5	11.8	2.4
Imports of goods and services	43.8	41.7	32.3	33.9	34.3
Real growth rate (percent)	11.9	2.4	-14.1	10.6	2.8
Trade balance	-1.3	-1.4	2.4	1.1	-0.6
Oil Imports (billions of U.S. dollars)	8.9	12.8	8.1	10.7	12.6
Current account	2.9	0.8	3.9	2.2	1.2
Foreign reserves (end period, billions of U.S. dollars)	28.6	42.5	60.6	67.3	74.0
Exchange rate					
Exchange rate regime				Floating	
Present rate per U.S. dollar (December 7, 2010)				3.62	
NEER annual percent change (period average) 3/	3.4	11.1	-4.6	3.6	…
REER annual percent change (period average) 3/	1.0	11.4	-1.8	3.6	…

Social Indicators

GDP per capita (current U.S. dollars, 2008): 27,904; Life expectancy at birth (2008): 79.1 (male) and 83.0 (female); Infant mortality rate (2008): 3.6 per 1,000 births; Physicians (2008): 3.6 per 1,000 people; Automobile ownership (2003): 284 per thousand; CO2 emissions (tons per capita, 2006): 10.0; Population density (2008): 337.7 inhabitants per square kilometer; Poverty rate (2008): 19.9 percent 4/.

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/ As of November 2010.
3/ Year-on-year percentage change, as of October 2010.
4/ Poverty rate from National Insurance Institute of Israel.

Table 2. Israel: Balance of Payments, 2006–15

(Billions of U.S. dollars)

	2006	2007	2008	2009	2010 1/	2011 1/	2012 1/	2013 1/	2014 1/	2015 1/
Current account balance	7.4	4.9	1.6	7.6	4.9	2.8	3.8	4.6	5.4	6.5
Merchandise	-3.8	-5.7	-7.2	-0.1	-3.9	-7.9	-8.7	-9.4	-10.5	-11.6
Exports, f.o.b.	43.3	50.3	57.2	45.9	51.4	52.4	55.5	59.4	63.4	67.4
Imports, f.o.b.	47.2	56.0	64.4	46.0	55.3	60.3	64.2	68.8	73.9	79.0
Civilian imports	44.7	53.6	61.9	44.1	53.4	58.4	62.3	66.9	72.0	77.1
Military imports	2.5	2.4	2.5	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Services	4.6	3.6	4.4	4.8	6.3	6.5	7.5	8.6	9.8	11.1
Exports	19.2	21.1	24.3	22.0	24.9	25.7	28.0	30.5	33.2	36.2
Imports	14.7	17.6	19.9	17.1	18.6	19.2	20.5	21.9	23.4	25.1
Factor Income	-0.7	-0.2	-4.1	-4.6	-6.0	-3.8	-3.0	-2.5	-1.9	-0.9
Receipts	8.4	10.9	7.3	5.7	6.0	7.0	8.0	9.0	10.0	11.0
Payments	9.2	11.1	11.3	10.3	12.0	10.8	11.0	11.5	11.9	11.9
Net transfers	7.4	7.3	8.5	7.4	8.5	8.0	8.0	8.0	8.0	8.0
Public	4.4	3.9	4.4	3.7	4.0	4.0	4.0	4.0	4.0	4.0
Private	3.0	3.4	4.1	3.7	4.5	4.0	4.0	4.0	4.0	4.0
Capital and financial account balance 2/	-6.0	-6.1	12.9	6.6	1.8	3.9	2.9	-4.6	-5.4	-6.5
Capital account	0.8	0.8	1.1	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Financial account 2/	-6.8	-6.9	11.8	5.7	0.9	3.0	2.0	-5.5	-6.3	-7.4
Direct investment, net	-0.2	0.2	3.7	2.7	-3.2	-3.1	-1.5	-1.5	-1.5	-1.5
Foreign direct investment (in Israel)	15.3	8.8	10.9	3.9	0.8	0.9	1.5	1.5	1.5	1.5
Portfolio investment, net	1.1	-2.2	-1.0	-5.2	0.1	2.1	-0.5	-4.8	-4.9	-6.0
Other investment	-7.7	-4.9	9.1	8.2	4.0	4.0	4.0	0.8	0.1	0.1
Change in reserves 3/	-0.2	1.7	-14.2	-16.6	-6.7	-6.7	-6.7	0.0	0.0	0.0
Errors and omissions	-1.2	-0.5	-0.3	2.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items (percent of GDP, unless otherwise indicated):										
Current account balance	5.1	2.9	0.8	3.9	2.2	1.2	1.5	1.8	2.0	2.3
Gross external debt	59.7	53.9	43.2	47.1	45.1	45.8	45.3	42.9	40.6	38.5
GDP (billions of U.S. dollars)	146.2	168.0	202.3	195.4	218.0	232.0	245.5	258.8	273.1	287.9

Sources: 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 3. Israel: Financial Soundness Indicators, 2003–mid-10 1/

(Percent)

	2003	2004	2005	2006	2007	2008	2009	2010 Jun.
Core Set								
Deposit Takers								
Regulatory capital to risk-weighted assets	10.3	10.8	10.7	10.8	11.0	11.1	13.7	13.6
Regulatory Tier 1 capital to risk-weighted assets	6.9	7.3	7.1	7.4	7.6	7.5	8.5	8.5
Nonperforming loans net of provisions to capital	33.3	31.0	27.2	21.2	15.8	17.7	14.7	13.2
Nonperforming loans to total gross loans	2.6	2.5	2.3	1.9	1.4	1.4	1.4	1.3
Sectoral distribution of loans to total loans								
Other financial corporations (OFCs)	7.2	7.9	8.7	8.8	10.2	9.7	9.4	9.5
General government	3.3	2.7	2.5	2.2	2.0	2.1	2.2	2.0
Nonfinancial corporations (NFCs)	48.1	44.7	43.4	41.9	41.5	41.8	41.6	41.3
Other domestic sectors	26.0	28.4	28.5	29.3	28.3	32.1	33.4	33.8
Nonresidents	15.4	16.2	16.9	17.8	17.9	14.3	13.4	13.5
Return on assets	0.4	0.6	0.8	1.0	1.0	0.0	0.5	0.6
Return on equity	7.9	12.0	14.0	17.5	16.0	0.4	8.7	9.3
Interest margin to gross income	64.1	63.1	62.6	61.9	60.9	58.8	58.8	61.5
Noninterest expenses to gross income	60.2	59.7	61.7	66.2	64.5	82.8	65.0	69.3
Net open position in foreign exchange to capital	2.1	4.1	-0.5	1.8	-8.9	-15.5	-9.6	-9.5
Encouraged Set								
Deposit Takers								
Capital to assets	5.3	5.5	5.6	5.9	6.1	5.7	6.3	6.6
Gross asset position in financial derivatives to capital	32.9	30.2	27.2	24.7	28.9	57.0	26.7	34.8
Gross liability position in financial derivatives to capital	31.1	31.4	28.9	22.9	29.1	64.3	34.4	41.9
Trading income to total income	12.3	17.9	23.7	8.8	6.9	-16.5	19.3	…
Personnel expenses to noninterest expenses	61.0	60.3	59.7	62.4	59.9	58.4	56.5	58.3
Spread between reference lending and deposit rates (basis points)	2.0	2.7	3.0	3.5	4.1	4.3	3.4	…
Customer deposits to total (non interbank) loans	115.6	117.7	119.5	118.2	113.0	106.7	110.7	107.6
Foreign-currency-denominated loans to total loans	35.4	34.5	31.4	28.1	27.0	25.3	22.0	21.5
Foreign-currency-denominated liabilities to total liabilities	40.1	41.5	42.5	40.7	39.8	36.2	33.5	33.3
Net open position in equities to capital	11.4	12.8	11.5	16.2	17.6	13.0	7.8	
Other Financial Corporations (OFCs)								
OFCs' assets to total financial system assets	38.3	40.2	42.4	42.7	43.3	…	…	…
OFCs' assets to Gross Domestic Product (GDP)	91.7	93.7	101.7	104.2	111.7	…	…	…
Nonfinancial Corporations								
Total debt to equity	207.7	196.2	183.7	184.7	…	…	…	…
Return on equity	5.1	11.6	17.0	13.7	…	…	…	…
Earnings to interest and principal expenses	96.7	129.9	142.3	145.1	…	…	…	…
Households								
Household debt to GDP	41.3	39.8	40.1	38.1	38.8	39.9	40.6	41.6
Market Liquidity								
Average bid-ask spread in the securities markets (percentage of mid-point price)	…	…	0.014	0.012	0.013	0.014	0.012	0.012
Average daily turnover ratio in the securities markets	2.2	2.2	2.0	2.1	2.3	2.4	1.9	2.2
Real Estate Markets								
Residential real estate prices (annual percentage increase)	-6.1	-1.3	4.4	-4.3	3.2	10.6	19.9	19.9
Residential real estate loans to total loans	11.9	12.4	13.1	13.9	12.5	13.2	15.6	16.3
Commercial real estate loans to total loans	17.9	16.6	16.1	15.8	16.4	16.6	17.7	17.9

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 4. Israel: Summary of Central Government Operations, 2007–12 1/

	2007	2008	2009		2010		2011		2012	
	Act.	Act.	Budget	Act.	Budget	Staff proj.	Draft Budget	Staff proj.	Draft Budget	Staff proj.
					(In percent of GDP)					
Revenues and grants	33.8	31.3	28.8	28.1	29.1	28.9	30.3	29.3	30.8	29.5
Tax revenues	27.6	25.2	23.2	23.2	23.5	23.8	24.9	24.2	25.5	24.5
Income Tax revenues	13.5	11.4		9.6		9.6		9.5		9.2
Taxes on Goods and services	11.8	11.7		11.7		12.2		12.7		13.2
Value Added Tax	7.8	7.8		7.7		7.7		7.7		7.8
Grants	1.9	1.8		1.5		1.7		1.7		1.7
Other revenue	2.2	2.2		1.7		1.8		1.8		1.8
Loans from NII	2.1	2.1		1.6		1.6		1.6		1.6
Total Expenditure	34.1	33.7	34.7	33.2	34.6	32.8	33.3	32.3	32.8	31.5
Expense	34.2	33.9		33.3		32.8		32.8		32.7
Compensation of employees	5.8	5.6		5.5		5.5		5.5		5.5
Use of goods & services	6.3	6.2		5.9		5.9		5.9		5.9
Consumption of fixed capital (CFC)	0.3	0.3		0.3		0.3		0.3		0.3
Interest	5.2	4.7	4.8	4.6	4.9	4.5	4.3	4.4	4.2	4.2
Subsidies	0.8	0.8		0.8		0.8		0.8		0.8
Grants	9.4	9.4		9.2		8.8		8.8		8.8
Social benefits	3.0	3.0		3.1		3.1		3.1		3.1
of which: Social security benefits	0.0	0.0		0.0		0.0		0.0		0.0
Other	3.4	3.8		3.9		3.9		3.9		3.9
Net acquisition of nonfinancial assets	-0.1	-0.1		0.0		0.0		0.0		0.0
Required cumulative adjustment								0.4		1.1
Overall balance	-0.3	-2.4	-5.9	-5.1	-5.5	-3.9	-2.9	-3.0	-2.0	-2.0
Financing	0.3	2.4	5.9	5.1	5.5	3.9	2.9	3.0	2.0	2.0
Net acquisition of financial assets	1.8	1.3	0.3	-0.4	0.6	1.6	1.1	1.0	0.7	0.7
Net incurrence of liabilities	-1.6	1.1	5.6	5.5	4.9	2.3	1.9	2.0	1.3	1.3
Domestic	-0.7	2.4	5.0	4.9	4.4	1.9	1.6	1.7	1.2	1.3
External	-0.8	-1.3	4.4	0.6	0.5	0.4	0.3	0.3	0.0	0.0
Memorandum items:										
General government balance	-0.4	-2.6	…	-5.5	…	-4.1	…	-3.2	…	-2.2
Cyclically adjusted primary balance	3.0	0.1		-0.8		-0.6		0.1		0.7
Deficit limit				6.0		5.5		3.0		2.0
Ceiling on the real expenditure growth								2.7		2.7
Public debt to GDP	77.7	76.7	…	77.6	…	75.5	…	72.8	…	69.8
GDP growth rate (in percent)	5.3	4.2	-1.0	0.8	1.5	3.9	3.8	3.5	4.0	3.8
Inflation (in percent)	0.5	4.6	3.8	3.3	3.0	2.6	2.2	3.0	2.2	2.5
Exchange rate (NIS per US$)	4.1	3.6	…	3.9	…	…	3.8	…	3.8	…
GDP (in billions of NIS)	690	726	746	768	780	826	864	880	919	936

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

1/ Data as per the national defintion, covers the budgetary sector and NII, excluding net credit.

Table 5. Israel: Indicators of External and Financial Sector Vulnerability, 2001–10

(Percent of GDP, unless otherwise indicated)

										Projected	
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Date
Financial indicators											
Broad money (percent change, 12-month basis)	15.5	6.1	2.2	4.6	7.9	7.4	12.9	8.0	14.1	4.6	Oct-10
Private sector credit (percent change, 12 month basis)	14.3	11.7	-3.1	3.9	7.1	4.3	6.7	9.2	4.5	0.5	Sep-10
External Indicators											
Terms of trade (average, percent change) 1/	-1.2	0.4	-1.4	-1.9	0.6	-1.4	-2.2	1.6	9.1	…	
Current account balance	-1.6	-1.1	0.6	1.8	3.2	5.1	2.9	0.8	3.9	2.2	Proj.
Gross official reserves (end period, billions of U.S. dollars)	23.4	24.2	26.4	27.4	28.4	29.3	28.6	42.5	60.6	67.3	Proj.
Official reserves in months of imports of goods and nonfactor services	6.5	6.8	7.1	6.3	5.9	5.7	4.7	6.1	11.5	10.9	Proj.
Total gross external debt/GDP (percent)	52.9	62.6	62.0	61.6	58.1	59.7	53.9	43.2	47.1	45.1	Proj.
Total net external debt/GDP (percent)	0.1	-0.6	-4.4	-8.7	-15.4	-22.5	-25.5	-21.3	-28.1	-20.3	Proj.
Country risk ratings (S. & P. / Moody's) 2/	A- / A2	A- / A2	A- / A2	A- / A2	A- / A2	A- / A2	A / A2	A / A1	A / A1	A / A1	Oct-10
Exchange rate (per U.S. dollar, period average)	4.21	4.74	4.55	4.48	4.49	4.46	4.11	3.59	3.93	3.62	Dec-10
Change in Stock Market Index (percent)	-20.9	-6.0	15.7	35.3	21.0	20.0	23.2	-18.3	-3.3	14.9	Nov-10

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 6. Israel: Medium-Term Scenarios, 2009–15

(Percent, unless indicated otherwise)

	2009	2010	2011	2012	2013	2014	2015
GDP growth rate	0.8	3.9	3.5	3.8	3.8	3.7	3.4
Inflation (average)	3.3	2.6	3.0	2.5	2.4	2.1	1.7
Fiscal balance/GDP 1/							
Central government balance	-5.1	-3.9	-3.0	-2.0	-1.5	-1.0	-1.0
General government structural primary balance	-0.8	-0.6	0.1	0.7	1.0	1.3	1.5
Central government expenditure/GDP	33.2	32.8	32.3	31.5	31.2	30.9	31.1
Public debt/GDP (end of period)	77.6	75.5	72.8	69.8	67.3	64.6	62.3
Current account/GDP	3.9	2.2	1.2	1.5	1.8	2.0	2.3
Foreign reserves (billions of U.S. dollars)	60.6	67.3	74.0	80.7	80.7	80.7	80.7
				(Percent changes)			
Memorandum Items:							
Aggregate domestic demand	-0.2	3.7	3.7	3.6	3.3	3.4	3.3
Private consumption	1.7	4.9	4.0	4.3	4.2	4.2	4.2
Public consumption	2.5	2.2	2.1	0.9	0.7	0.7	0.6
Gross capital formation	-8.9	2.2	5.0	4.7	4.0	4.0	4.0
Exports of goods and services	-12.5	11.8	2.4	7.5	6.8	6.6	6.5
Imports of goods and services	-14.1	10.6	2.8	7.1	5.9	6.0	6.6

Source: IMF staff estimates and projections.

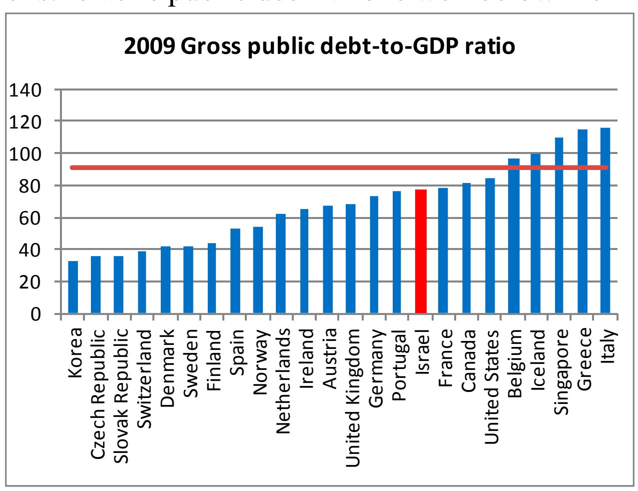
1/ For the purpose of its budget deficit targets, the central government excludes net credit.

ANNEX I: ISRAEL—PUBLIC DEBT SUSTAINABILITY AND RISKS

1. **Fiscal institutions in Israel – such as the fiscal rules, which limit deficit and real spending growth - have helped to reduce public debt form very high levels.** Strong growth, sizeable primary surpluses, and real exchange appreciation helped reduce public debt by some 20 percentage points of GDP since 2003, reaching 77 percent of GDP in 2008. Foreign-currency debt has fallen markedly as well, as the improved fiscal position facilitated government access to the domestic capital market. Despite the fiscal deterioration in response to the global shock in 2009, public debt ratio remained broadly stable, owing to Israel's resilience to global economic shock, but also to anchoring long-term fiscal expectations on sustainability through the introduction of a new medium-term fiscal rule (See SEI IV).

2. **Israel's projected path of fiscal policy – based on the new fiscal rules – does imply a gradual decline in public debt to about 60 percent of GDP**. Despite a larger fiscal deficit, public debt is likely to fall to about 75.5 percent of GDP in 2010, reflecting NIS appreciation, robust economic growth, and low interest rates. The medium-term fiscal strategy, anchored by the new fiscal rules, assumes a gradual decline in the central government deficit from 4 percent in 10 to 3 percent in 11, 2 percent in 12, 1.5 percent in 13, and 1 percent from 2014 onwards (See SEI IV). Gradual fiscal consolidation and continued strong economic growth is likely to bring public debt down to 62 percent of GDP by 2015.

3. **Israel's public debt outlook is stronger than in many advanced economies, but, this outlook is still exposed to shocks.** Israel's public debt ratio is well below the average for advanced countries (Text chart).[1] However, there is a potential for high volatility in macroeconomic variables, stemming from high sensitivity of Israeli economy to external shocks (See SEI III). The increase in global macro-financial risk, combined with high sensitivity of Israeli economy to external shocks could magnify macro-economic volatility and increase uncertainty around projected public debt paths.



[1] See Fiscal Monitor database, Nov 2010.

For example, a sudden reversal of capital flows could possibly dampen growth, lead to spikes in borrowing costs, and result in high exchange rate volatility.[2] Furthermore, recent econometric evidence suggest that high debt refinancing needs and high debt levels are likely to be accompanied by higher long-term real interest rates, therefore adversely affect global financing conditions and debt dynamics.[3]

4. **Risk assessments are therefore a critical input to a medium term fiscal strategy amining at maintaining sustainability and managing risks**. High macroeconomic volatility and increased uncertainty to public debt path makes it critical to incorporate uncertainty in the analysis of fiscal sustainability. Two different approaches have been used to incorporate uncertainty in the fiscal sustainability analysis. To deal with vulnerability to specific shocks and to assess robustness under extreme events, this annex reports results from a variety of stress tests. While under a full Monte Carlo simulation, extreme events are just one out of many realizations and will largely be averaged out, demonstrating robustness under extreme events demonstrating robustness under extreme events may contribute importantly to credibility, so stress tests focusing on extreme events are a useful tool.[4]

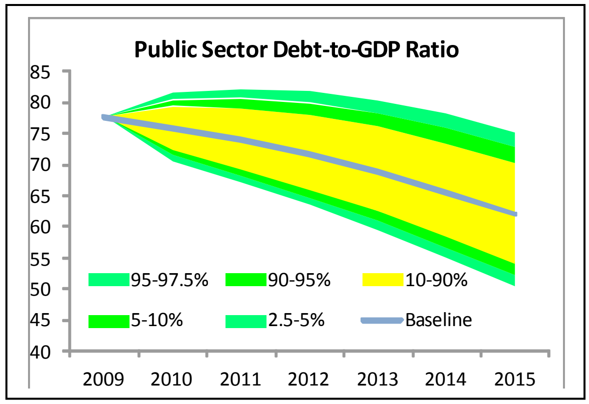
5. **Stress tests reveal risks to debt consolidation strategy.** The most severe impact on public debt is produced by an adverse growth scenario – a negative permanent shock to growth of half a standard deviation is likely to completely stall the debt consolidation process, with public debt ratio at 76 percent in 2015. Furthermore, an extreme tail risk of a negative permanent shock to growth of one standard deviation, similar to the impact of the 2009 global economic shock on Israel, is likely to reverse debt decline and to bring back public debt ratio to nearly 90 percent of GDP in 2015. Debt consolidation process is also likely to slow down significantly under shocks from contingent liabilities, sharp exchange rate movements, and higher interest rates (Figure II.1). For example, fiscal contingent liabilities amounting to 10 percent of GDP could raise public sector debt to 72 percent of GDP by 2015, while currency depreciation of 30 percent would raise the debt ratio to about 69 percent of GDP. An

[2] Rogoff (2008) used new data set to illustrate vulnerabilities of emerging markets, in particular, the fact that sovereign debt defaults are quite sensitive to global capital flow cycle.

[3] See IMF (2010), *Fiscal Monitor*. High debt ratios could increase long-term real interest rates by almost 2 percentage points, affecting negatively global financing conditions. In addition, high debt ratios are also likely to affect negatively potential growth in advanced economies, with possible consequences for emerging markets.

[4] It is important to note that this risk assessment assumes that fiscal rules will be adhered to only ex-ante as ex-post adherence to a deficit rule would imply a very large fiscal adjustment in the presence of large economic shocks.

increase in real interest rates would have a smaller, but still sizeable, effect with public debt ratio reaching 66 percent by 2015.

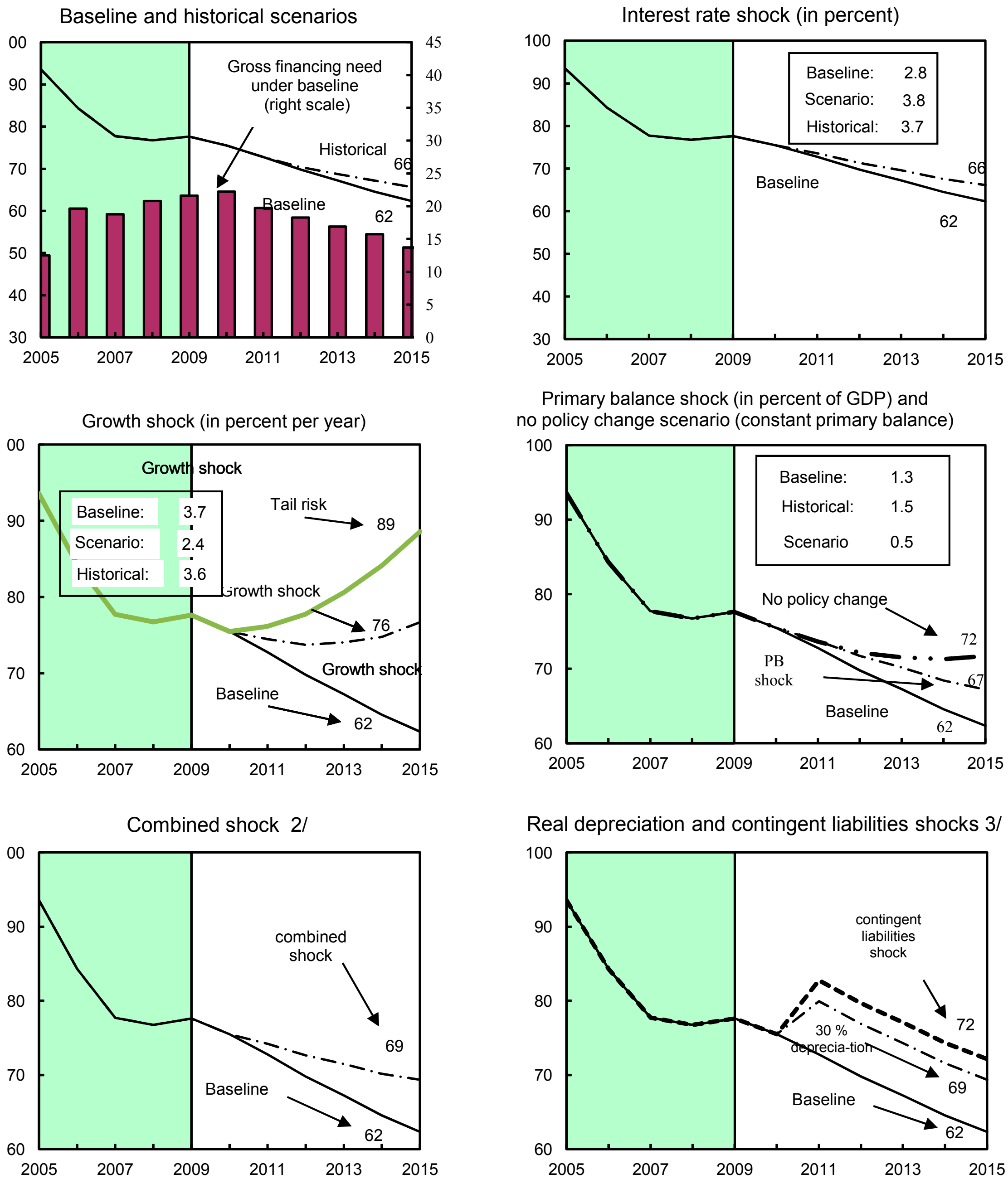


6. **Given the uncertainty surrounding key macro variables, how much confidence can we have in the outcome of the baseline scenario?** To get a broader view on the riskiness of the baseline projections, Monte Carlo simulations have been used to derive the probability distribution of future debt stocks ("fan charts"), based on stochastic properties of key risk variables in the debt dynamics process.[5] While under the central scenario the new fiscal rules result in further public debt reduction to slightly above 60 percent by 2015, risks surrounding public debt dynamics are still relatively high - there is 97.5 percent chance that the maximum likely debt ratio will remain close to its 2009 level (text chart). In general, variance reducing policies, such as fiscal reaction function could be used to lower the uncertainty around public debt past.

7. **In the medium-term, recent natural gas discoveries could have a positive impact on fiscal sustainability.** While the likely impact of the natural gas is highly uncertain, reforms to adopt international best practice in taxation of natural resources, including appropriate pricing arrangements in the tax and in securing appropriate intergenerational distribution of the proceeds can help in ensuring a positive impact on fiscal sustainability. Accordingly, the first use of such tax receipts should be to reduce public debt, given that overall revenues will be modest on current estimates of the volume of gas. However, if the gas wealth proves to be much larger than anticipated, additional revenues could be placed in a sovereign wealth fund to ensure intergenerational equity and to safeguard against possible Dutch disease effects.

[5] See Budina, Nina, and Sweder van Wijnbergen, 2008, "Quantitative Approaches to Fiscal Sustainability Analysis: A Case study of Turkey since the Crisis of 2001," *World Bank Economic Review*, Vol. 23, Issue 1, pp. 119−140 and Budina, SIP on Maintaining Fiscal Sustainability under Uncertainty in Indonesia, Indonesia Art. IV 2010.

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



Sources: International Monetary Fund, country desk data, and 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 2010 Article IV Consultation—Informational Annex

Prepared by the European Department

December 21, 2010

Contents Page

Annexes

Annex II. Israel: Fund Relations

(As of November 30, 2010)

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. Israel maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, with the exception of measures introduced for security reasons pursuant to Decision No. 144-(52/51). Israel subscribes to the SDDS and is in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars.[1]

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	928.20	100.00
Fund holdings of currency	743.91	80.15
Reserve position in Fund	184.30	19.86

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	883.39	100.00
Holdings	859.30	97.27

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

V. **Financial Arrangements**: None

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

	Forthcoming				
	2010	2011	2012	2013	2014
Principal					
Charges/Interest		0.10	0.10	0.10	0.10
Total		0.10	0.10	0.10	0.10

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**:

The de facto exchange rate arrangement is classified as “floating,” as the authorities have made discretionary interventions on more than three occasions since July 2009. The discretionary interventions serve as a transitional step facilitating the exit from the preprogrammed USD purchases that began in March 2008. The authorities clarify that they do not target any specific exchange rate.

X. **Article IV consultation**:

The last Article IV consultation was concluded on February 13, 2009. 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 April 2004.
- Monetary and Financial Policy Transparency was conducted in 2003, issued as IMF Country Report No. 03/76 in March 2003.
- AML/CFT ROSC was conducted in 2003, issued in June 2005.
- Data Module ROSC was conducted in 2005, and issued as IMF Country Report No. 06/125 in March 2006.

XII. **Technical Assistance**:

The Fund has been providing policy advice and technical assistance to the Palestinian Authority (PA) 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 intensified since 2007, with a focus on the macroeconomic, fiscal, and financial areas. Staff missions to the WBG have been assisting the PA in the design and implementation of its macroeconomic and fiscal framework in line with the objectives set out in the Palestinian Reform and Development Plan (PRDP) presented at the Paris international donors' conference in December 2007. The most recent progress report on that framework was presented at the Ad-Hoc Liaison Committee (AHLC) meeting of donors held in New York on September 22, 2009. Technical assistance has also been stepped up since 2007, in particular 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.

Israel—Statistical Issues Appendix As of 11/10/2010	
I. Assessment of Data Adequacy for Surveillance	
General: Macroeconomic statistics are of generally high quality and broadly adequate for surveillance, although there are few shortcomings particularly in monetary and government finance statistics. A Report on the Observance of Standards and Codes—Data Module, a Detailed Assessments Using the Data Quality Assessment Framework (DQAF), and a Response by the Authorities were published on the IMF website on March 24, 2006 (*IMF Country Report No. 06/125*).	
National Accounts: No issues to report. **Price statistics:** No issues to report.	
Government finance statistics: The methodology underlying the reported overall annual fiscal balance is not in conformity with internationally accepted best practice, as interest expenditure excludes the inflation component. The authorities are gradually moving toward implementation of the methodology that is standard in other countries, so that the discrepancy will decline over time. Data submitted by the Central Bureau for Statistics for the Fund's *Government Finance Statistics* broadly follows the *GFSM 2001* format. However, for financial assets and liabilities, only transaction data are submitted, but not stock data. Within-year monthly reports on central government operations—compiled by the MoF—cover only the main aggregates of budgetary accounts, not broken down by components.	
Monetary statistics: Banking statistics are not based on balance sheet reporting, but instead on a selection of data reported by banks to the regulatory authorities. Current information does not permit full sectorization of the economy in the monetary statistics, and more detailed information on instruments also would be useful.	
Balance of payments: Balance of payments and international investment position data are compiled on a quarterly basis and follow the fifth edition of the *Balance of Payments Manual.* External sector data were not examined in the Report on the Observance of Standards and Codes	
II. Data Standards and Quality	
Participant in the Special Data Dissemination System (SDDS) since April 1996, and in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars.	Data ROSC published on March 24, 2006.
III. Reporting to STA (Optional)	
Data are regularly reported for publication in the *Government Finance Statistics Yearbook* and in the *IFS*.	

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8]	
						Data Quality – Methodological soundness[9]	Data Quality – Accuracy and reliability[10]
Exchange Rates	Nov-10	6-Dec-10	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Oct-10	15-Nov-10	M	M	M		
Reserve/Base Money	May-10	19-Jul-10	M	M	M	LNO, LO, NO, LO	O, O, O, NA, NA
Broad Money	Sep-10	10-Nov-10	M	M	M		
Central Bank Balance Sheet	May-10	10-Nov-10	M	M	M		
Consolidated Balance Sheet of the Banking System	May-10	10-Nov-10	Q	Q	Q		
Interest Rates[2]	Sep-10	10-Nov-10	D and M	D and M	D and M		
Consumer Price Index	Oct-10	16-Nov-10	M	M	M	O, O, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2008	Aug 09	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Q2-2010	5-Oct-10	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q3-2009	30-Dec-09	Q	Q	Q		
External Current Account Balance	Q2-2010	15-Sep-10	Q	Q	Q	NA	NA
Exports and Imports of Goods and Services	Q2-2010	15-Sep-10	M	M	M		
GDP/GNP	Q3-2010	16-Nov-10	Q	Q	Q	O, O, O, LO	LO, O, LO, O, LO
Gross External Debt	Q3-2009	15-Dec-09	Q	Q	Q		
International Investment Position[6]	Q2-2010	Sep-10	Q	Q	Q		

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

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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

IMF Executive Board Concludes 2010 Article IV Consultation with Israel

On January 7, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the 2010 Article IV consultation with Israel, and considered and endorsed the staff appraisal without a meeting.[1]

Background

Israel was mildly affected by the global recession: following a slowdown in 2009, output is projected to grow by some 4 percent in 2010, led by consumption and exports. Credit from domestic and foreign sources to households has been buoyant—at annual rates of some 8 percent in 2009 and 2010, reflecting the resilience of the banking sector. Credit to non-financial firms however has been largely flat. As recovery has taken hold, unemployment has fallen from its peak of 8 percent in early 2009 to 6 percent in 2010. With public debt a little below 80 percent of Gross Domestic Product (GDP), there were no signs of budget funding stresses. The strength of long-term prospects has also been underscored by the recent entry into the Organization for Economic Co-operation and Development (OECD) and by the discovery of significant offshore natural gas reserves.

As the growth outlook improved in the second half of 2009, the stance of policies was tightened. On the fiscal side, this largely reflected automatic stabilizers. The budget deficit is estimated to

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

have declined to 3.9 percent of GDP in 2010 and is planned to strengthen to 3 percent in 2011. Moreover, new fiscal rules were adopted in 2010 comprising deficit and spending ceilings. On the monetary policy side, the Bank of Israel raised policy rates from their floor of half a percent to 2 percent by October 2010. In August 2009, the central bank also discontinued its daily purchase of US Dollars in the Foreign Exchange market, although it continues to intervene to stem the appreciation of the shekel, with reserves reaching US$70 billion in 2010. Alongside, a new Bank of Israel Law was adopted in 2010 formalizing established inflation targeting practices.

In this context, the shekel came under considerable appreciation pressures, rising in real terms to some 15 percent above pre-crisis levels. This was reflected in export market share falling in the first half of 2010 and, in conjunction with global developments, outright export declines in the third quarter of 2010. Nevertheless, the strong shekel has helped to contain inflation, which has recently fallen back into its 1-3 percent target range after an extended period above it. Israeli banks appear well-capitalized and liquid. In 2010, capital adequacy ratios rose for most banks, and impaired and non-performing loan ratios declined. However, nominal house prices have risen 40 percent over the past two years. Macroprudential measures were adopted by the Bank of Israel alongside supply side measures to stabilize the sector.

Executive Board Assessment

In concluding the 2010 Article IV consultation with Israel, Executive Directors endorsed the staff's appraisal, as follows:

Robust fundamentals—including sustained pre-crisis fiscal consolidation—and a swift monetary and fiscal policy response to the external downturn allowed Israel to pass through the global recession relatively unscathed. In part, this reflects the innovation of the “two-year” budget cycle, which helped to stabilize expectations in mid-crisis and established an important precedent for the future.

In that light, steps taken to withdraw policy stimulus have been appropriate. As economic growth rose through 2009-10, the budget deficit strengthened faster than planned. Alongside, the increase in the policy rate of the Bank of Israel in several steps helped to secure a decline of inflation back into its target range, with medium-term inflation expectations also remaining in range.

The resilience of the economy has been strengthened by the adoption of new fiscal rules capping spending and deficits, a new Bank of Israel Law, and by the entry into the OECD.

At the same time, strains have emerged. In particular, inflation expectations have risen towards the upper end of the target band, nominal house prices have boomed, and the shekel has appreciated significantly. Though all these developments reflect Israel's relatively strong economic performance, the authorities will need to keep them under control.

Accordingly, the additional policy tightening that is planned, including further fiscal deficit reduction in 2011-12, and the anticipated further increases in the policy rates of the Bank of Israel are welcome.

But in light of the emerging strains, additional action may be required. This would reinforce the credibility of the overall policy framework, but it should be designed to avoid compounding upward pressure on the shekel. Accordingly, fiscal policy should carry the burden of the additional effort, and so a stronger than planned structural fiscal consolidation is recommended for 2011 and 2012. In this context, monetary policy rates should rise broadly as is now anticipated. But if fiscal policy remains as planned, policy rates may need to rise further and more rapidly than planned—even if this puts further upward pressure on the shekel—in order to stem inflation.

With the balance of monetary and fiscal policy tightening adjusted as recommended, other policy instruments—notably foreign exchange intervention—can play a supportive role. Without this rebalancing, however, there is risk that intervention could become unduly one-sided, and the "managed" float regime could become misperceived as flexible in one direction only.

The strengthening in supervision and regulation of the financial sector and the robust indicators of financial stability are welcome. However, further progress is needed to strengthen the diagnosis and management of risk. To this end, the development of stress testing procedures focusing on systemic risk, and the enhancement of the collaboration between and within supervisory institutions is strongly encouraged. Furthermore, in line with typical OECD practice, supervision of non-banks might be further strengthened by locating it outside the Ministry of Finance.

Finally, in parallel with further strengthening of structural reforms, including in education, research, the business environment, and infrastructure, effective management of resources anticipated from discovery of significant natural gas reserves will also be necessary. In particular, the first use of tax proceeds from gas should be to reduce public debt, and additional funds from this source should be placed in a Sovereign Wealth Fund.

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 2010 Article IV Consultation with Israel is also available.

Israel: Selected Economic and Social Indicators, 2007–11

(Percent change, unless otherwise indicated)

	2007	2008	2009	2010 1/	2011 1/
Real economy					
Domestic demand	6.4	2.8	-0.2	3.7	3.7
Real GDP	5.3	4.2	0.8	3.9	3.5
Private consumption	6.3	3.0	1.7	4.9	4.0
Public consumption	3.1	2.6	2.5	2.2	2.1
Gross capital formation	11.3	2.4	-8.9	2.2	5.0
Unemployment rate (percent)	7.3	6.1	7.7	6.6	5.5
Overall CPI (end-of-period)	3.4	3.8	4.0	2.2	2.7
Money and credit (period average)					
Narrow money (M1)	15.3	14.1	50.9	…	…
Broad money (M3)	12.9	8.0	14.1	…	…
Interest rates (average, percent)					
Bank of Israel policy rate 2/	3.9	3.7	0.8	2.0	…
Public finance (percent of GDP)					
Central government revenue	33.8	31.3	28.1	28.9	29.3
Central government expenditure	34.1	33.7	33.2	32.8	32.3
Central government balance	-0.3	-2.4	-5.1	-3.9	-3.0
General government balance	-0.4	-2.6	-5.5	-4.1	-3.2
General government debt	77.7	76.7	77.6	75.5	72.8
Of which: foreign currency external debt	19.0	13.9	14.4	14.7	14.1
Balance of payments (percent of GDP, unless otherwise noted)					
Exports of goods and services	42.5	40.3	34.7	35.0	33.6
Real growth rate (percent)	9.3	5.9	-12.5	11.8	2.4
Imports of goods and services	43.8	41.7	32.3	33.9	34.3
Real growth rate (percent)	11.9	2.4	-14.1	10.6	2.8
Trade balance	-1.3	-1.4	2.4	1.1	-0.6
Oil Imports (billions of U.S. dollars)	8.9	12.8	8.1	10.7	12.6
Current account	2.9	0.8	3.9	2.2	1.2
Foreign reserves (end period, billions of U.S. dollars)	28.6	42.5	60.6	70.9	74.0
Exchange rate					
Exchange rate regime				Floating	
Present rate per U.S. dollar (December 7, 2010)				3.62	
NEER annual percent change (period average) 3/	3.4	11.1	-4.6	3.6	...
REER annual percent change (period average) 3/	1.0	11.4	-1.8	3.6	...

Social Indicators

GDP per capita (current U.S. dollars, 2008): 27,904; Life expectancy at birth (2008): 79.1 (male) and 83.0 (female); Infant mortality rate (2008): 3.6 per 1,000 births; Physicians (2008): 3.6 per 1,000 people; Automobile ownership (2003): 284 per thousand; CO2 emissions (tons per capita, 2006): 10.0; Population density (2008): 337.7 inhabitants per square kilometer; Poverty rate (2008): 19.9 percent 4/.

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/ As of November 2010.
3/ Year-on-year percentage changes, as of October 2010.
4/ Poverty rate from National Insurance Institute of Israel.