

Israel: 2012 Article IV Consultation—Staff Report; Informational Annex; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Israel

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Israel, the following documents have been released and are included in this package:

- The staff report for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on February 13, 2012, with the officials of Israel on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 9, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 27, 2012 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for Israel.

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ISRAEL

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

March 9, 2012

KEY ISSUES

Context. After a strong recovery from the great recession, growth is now slowing. In this context, a loosening cycle for monetary policy has begun, fiscal automatic stabilizers are operating—which will imply that the 2012 fiscal balance target is overshoot—and earlier upward pressures on the shekel have abated.

Prospects. The global slowdown is expected to slow Israeli growth to slightly below trend in 2012, with inflation remaining squarely inside the target range, and the external current account balance turning slightly negative. Global uncertainty and regional strains are key risks.

Near-term policy challenges. Fiscal policy should remain focused on medium-term debt reduction—by adhering to the total spending limits in the 2012 budget and the ceilings under the expenditure rule for the 2013–14 budget—to underpin sustainability. Given anchored inflation expectations, monetary policy has scope to offset the effects of this fiscal action and steps to raise bank capital ratios on output and credit growth.

Policy Framework Recommendations. On the fiscal side: allow for stabilizers in the fiscal deficit targets and establish a Fiscal Council. On the monetary side: lengthen the horizon of forecasts, emphasize the mid-point of the inflation target range, and secure Bank of Israel (BoI) autonomy over its remuneration. On financial stability: establish a Financial Stability Committee (FSC), strengthen the frameworks for crisis management, emergency liquidity and early intervention and resolution, and raise required bank capital ratios.

Macro-social priorities. Participation rates among the Arab-Israeli and Haredi groups need to rise to tackle poverty and maintain the medium-term growth potential of the economy. This requires further reform of incentives and labor market institutions.

Approved By

**Rodrigo Valdés and
Vivek Arora**

The 2012 Article IV discussions were held in Jerusalem and Tel Aviv during January 31– February 13. The team comprised Mr. Doyle (Head, EUR), Ms. Batini, Mr. Ishi (all EUR), and Mr. Harris (FAD). Mr. Snel (OED) attended opening meetings, while Mr. Friedman (OED) attended the rest of the meetings. The mission met with Finance Minister Steinitz, Bank of Israel Governor Fischer, representatives of the Prime Minister’s Office, senior officials, academics, representatives of the Haredi community, including the chairman of the Knesset Finance Committee and the vice mayor of Jerusalem, representatives of Arab-Israeli community including the Bedouin mayor of Hura and leaders of Arab-Israeli women, and other private sector representatives. A joint press conference was held with the authorities at the conclusion of the mission.

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THE CHALLENGES AHEAD

External and domestic strains cloud the outlook

1. Israel emerged from the 2008–09 global crisis with strong economic growth, a resilient banking system, and unemployment at historic lows. In this context, policies were gradually tightened through mid 2011 (Table 1 and Figures 1 and 2).

2. But the external outlook has again deteriorated. Although the world economy is expected to avoid recession—assuming the euro area crisis is resolved—growth projections for 2012 and 2013 have been marked down substantially. And regional tensions have also risen (Annex I).

3. In addition, extensive peaceful social protests—in part reflecting a decade of stagnant real wages and concentration of

economic power—took place in 2011 and could resurface.

4. And inequality and poverty—both already high—are set to rise further reflecting low participation and rapid growth of the Arab-Israeli and Haredi communities (see SIP Chapter I).

What are the channels through which these factors will affect Israel ?

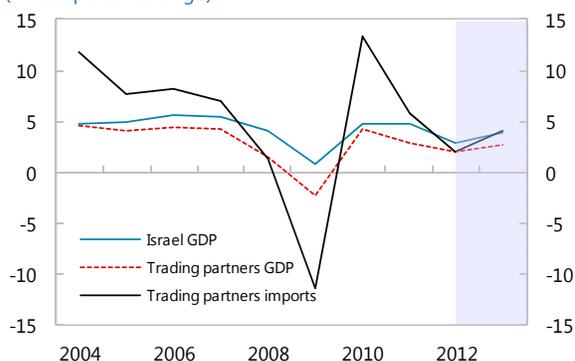
5. Exports, at 40 percent of GDP, depend on global demand for high-technology products, such as electronics and pharmaceuticals, and communications. One third of exports go directly to Europe, with more routed there indirectly. But if global weakness is reflected in international oil prices, this will help as Israel is a large net energy importer.

World Economic Outlook
(January 2012 update, annual percent change)

	2012		2013	
	Current	Change from Fall 2011	Current	Change from Fall 2011
Real GDP				
World	3.3	-0.7	3.9	-0.6
Advanced economies	1.2	-0.7	1.9	-0.5
Emerging and developing economies	5.4	-0.7	5.9	-0.6
Trade volume (imports)				
Advanced economies	2.0	-2.0	3.9	-0.8
Emerging and developing economies	7.1	-1.0	7.7	-1.0

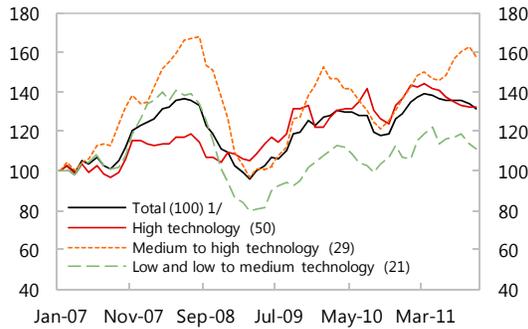
Source: IMF World Economic Outlook Update, January 2012.

Israel's GDP and Global Demand
(Annual percent change)



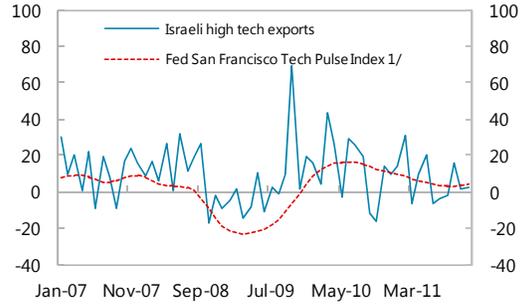
Source: IMF World Economic Outlook Update, January 2012.

Israel: Manufacturing Exports (excluding diamonds) by Technological Intensity (SA, January 2007 = 100)



Source: Haver Analytics.
1/ Parentheses indicate shares in total manufacturing exports.

Israeli high-tech exports and US IT Industry (Y/Y percent change)



Source: Haver Analytics.
1/ Coincident indicators of activity in the US IT sector, including IT investment, consumption, employment, production, and shipments.

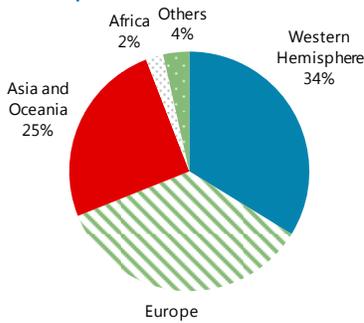
6. Links through the financial sector are limited. Banks' cross border activities are moderate: their total foreign assets and liabilities amount to 10 percent and 14 percent of GDP, respectively, with negligible direct exposures to peripheral advanced European countries. And, operations of foreign-owned financial institutions in Israel are negligible. Likewise, wholesale funding of banks is low, but stress will likely appear from the domestic corporate bond market (Figure 3).

7. Given the country's weak direct trade linkages to the region, regional tensions mainly affect Israel through security, investor and consumer confidence, and via the public finances.

8. Similarly, social pressures mainly affect fiscal choices, on taxation and spending. The "Trajtenberg Committee" (Box 1), set up to help the government plan a response to the social protests, has made a range of proposals for taxation and spending adjustments, most of which have been approved by the Knesset.

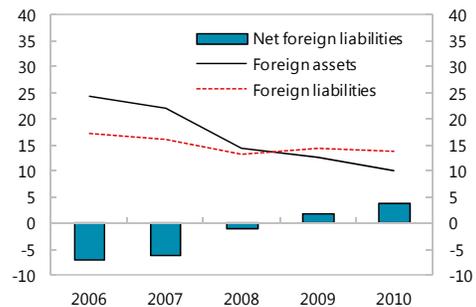
9. If continued, participation and demographic trends in minority communities will soon significantly lower the potential growth of the economy, with implications for overall income growth, inequality, and fiscal sustainability.

Israel: Exports Destination in 2011



Source: Haver Analytics.

Israel: Banks Foreign Assets and Liabilities (Percent of GDP)



Source: Haver Analytics.

IS ISRAEL PREPARED?

Israel has strong fundamentals

10. Externally, foreign exchange reserves have increased steadily since 2008 to reach \$77 billion, some 10 months of total imports, and above 130 percent of short-term external debt. For the first time over the last two decades, the net international investment position has turned to a surplus (6 percent of GDP, Tables 2 and 3).

11. Institutional frameworks are also strong.

12. In particular, Israel's new fiscal rule, embedded in the 2010 Deficit Reduction and Budgetary Expenditure Limitation Law, and reflected in the 2011-12 "two year" budget, comprises two disciplinary elements:

- The expenditure rule adjusts the cap on real expenditure growth as public debt approaches 60 percent of GDP.
- The headline budget deficit is targeted to fall to 2, 1½, and 1 percent of GDP in 2012, 2013, and 2014 respectively.

13. Furthermore, Central Bank legislation has been reinforced. The 2010 Bank of Israel (BoI) Law now stipulates price stability as the primary objective of monetary policy, and has strengthened the BoI's autonomy, transparency, and governance.

14. The FSAP Update, conducted as part of this consultation, concludes that the financial system is stable, with the BoI maintaining strongly proactive supervisory practices, which have preempted the systemic risks seen elsewhere (Figure 4 and Tables 4 and 5).

15. Israel also enjoys the option to issue sovereign bonds under Section 502(7) of the US Federal Credit Reform Act of 1990. While only some 7½ percent of Israeli public debt is currently covered by these guarantees—some 40 percent is untapped—, and further use of the scheme is subject to key formal limits, the guarantees provide contingent reassurance.

16. Moreover, following recent discoveries of new natural gas fields, the total estimated value of which is some 50 percent of 2011 GDP, Israel will become a net energy exporter in coming years. Looking ahead, the taxation of natural resources has been rationalized, and provisions are being made to place the proceeds in a sovereign wealth fund.

17. This overall assessment of fundamentals is reflected in Standard & Poor's rating upgrade from A to A+ on long-term foreign currency credit rating in September 2011. CDS spreads on the sovereigns have risen somewhat recently, but remain far below those of the stressed European countries.

And economic performance was strong in 2010 and into 2011

18. Output rebounded quickly from the global downturn as early as 2009 Q2, with growth of ¾ percent in 2009 and 4¾ percent in 2010. This was initially led by a pick-up in exports and private consumption, with a strong recovery in investment.

Israel: Recent Developments, 2009-11
(Percent change from the previous period, SAAR; unless otherwise indicated)

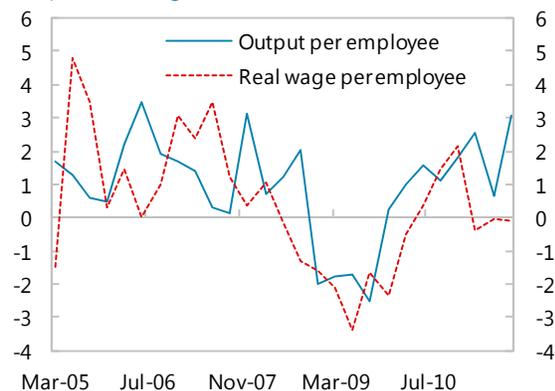
	2009				2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4 Prel.
GDP	-2.8	1.7	3.6	5.2	5.5	5.9	4.8	7.6	4.7	3.7	3.4	3.2
Private consumption	-3.4	9.8	7.2	6.5	0.6	7.8	0.9	10.9	5.5	-0.2	0.8	-0.8
Public consumption	3.1	5.9	-1.3	3.7	3.4	-1.3	10.3	2.4	0.9	3.9	2.6	8.5
Gross fixed capital formation	-17.3	-17.2	-1.3	-34.8	82.3	-13.2	4.5	29.2	72.7	0.5	23.7	3.2
Net exports 1/	0.8	-1.1	-0.2	2.3	-0.6	0.7	-0.1	-0.5	-1.5	-0.2	0.3	-0.8
Exports of goods and services	-32.4	-5.5	16.6	47.1	5.8	14.2	3.0	12.7	6.7	4.9	-7.7	-17.4
Imports of goods and services	-39.4	6.0	20.3	18.2	12.5	7.6	4.5	19.5	23.1	7.3	-10.6	-11.1
CPI (end period, NSA, year on year)	3.6	3.5	2.9	4.0	3.1	2.5	2.3	2.6	4.3	4.2	3.0	2.2
Output gap (percent of potential)	-1.4	-1.9	-2.0	-1.6	-1.2	-0.7	-0.5	0.4	0.6	0.6	0.5	0.4

Source: Haver Analytics; IMF staff estimates and projections.

1/ Contributions of GDP growth.

19. This was also quickly reflected in a return of employment to pre global crisis levels. The unemployment rate fell to a historical-low of 5½ percent, and wage pressures remained moderate, in part reflecting the increased entry of lower-wage earners. Unit labor cost growth was flat in 2011. But participation rates remain very low around 56–58 percent.

Israel: Labor Costs
(Y/Y percent change)



Source: Haver Analytics.

Macroeconomic policies were adjusted appropriately given the resumption of growth during 2009

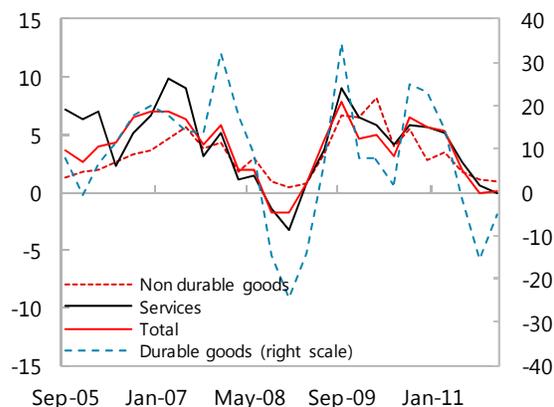
20. On the fiscal side, the 2010 overall balance strengthened by 1½ percentage points of GDP (Table 6).

21. As domestic demand recovered and inflationary pressures and regional tensions began rising, the BoI began a tightening cycle in September 2009, raising the policy interest rate from 0.5 percent to 3.25 percent by June 2011 (Figure 5). These steps were supported by the adoption of macroprudential actions targeted at the housing market (Box 2). Though the CPI inflation was above its target band for much of 2011, the tightening helped bring it back within the target range later in the year.

22. However, widening interest rate differentials vis-à-vis the United States and the euro zone alongside a resumption of “safe haven” flows led to large short-term capital inflows and significant shekel appreciation. In response, the BoI resumed intervention in

foreign exchange markets, accompanied by capital control and macroprudential policy measures, such as the introduction of reserve requirements on banks' derivative transactions with non-residents, new reporting requirements on foreign exchange swaps and derivatives, and the abolition of tax exemption for non-residents' investments in BoI securities and treasuries.

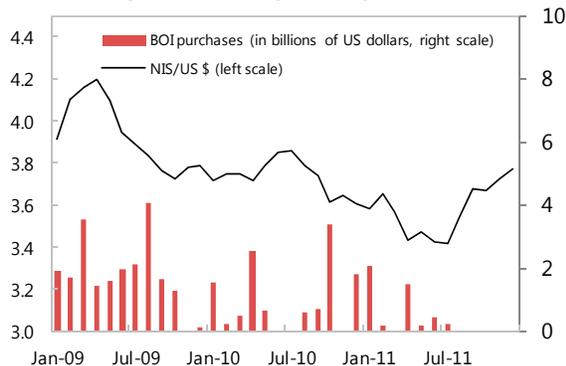
Israel: Real Private Consumption Growth
(3 month moving average, SAAR, q/q, percent)



Source: Haver Analytics.

24. With downside risks to the global economy mounting, the BoI began monetary easing cycle from September 2011, which alongside the macroprudential steps noted in paragraph 22, relieved appreciation pressures on the shekel. The BoI has intervened only twice since July 2011 (Figure 5 and Box 3).

Israel: Exchange Rate and Change in Foreign Reserves

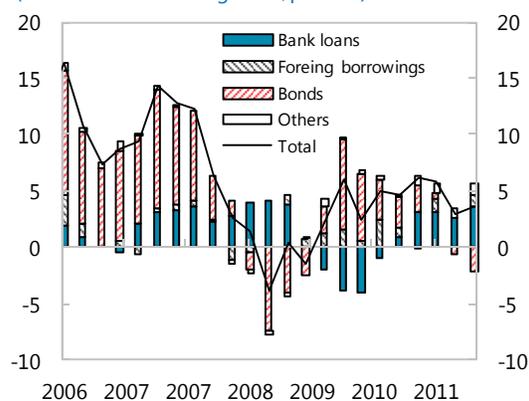


Sources: Bank of Israel; Haver Analytics; and IMF staff calculations.

But growth has slowed again

23. As external demand weakened again later in 2011, export volumes started dropping, with private consumption following suit, in part reflecting the negative wealth effect of falling asset prices and deteriorating consumer confidence.

Israel: Business Sector Borrowing
(Contribution to total growth, percent)



Sources: Bank of Israel; and IMF staff calculations.

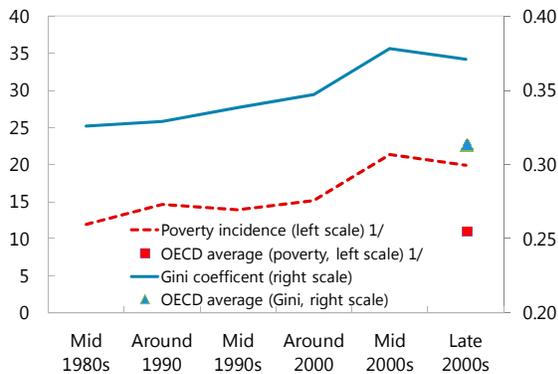
25. Throughout, the shekel was slightly on the strong side, before easing more recently to around equilibrium (Box 4).

26. While the two-year 2011–12 budget was prepared on the basis of further fiscal consolidation, the slowdown in the latter half of 2011 resulted in lower than anticipated revenue collections, as the automatic stabilizers came into effect, leading to a smaller than anticipated headline consolidation.

And poverty remains elevated

27. The poverty rate, among the highest in OECD countries, has remained near 20 percent. Income inequality has also risen as measured by the Gini coefficient (0.37 in recent years).

Israel - Poverty Incidence and Gini Coefficients
(Index, total population)



source: OECD,
1/ Poverty threshold is 50 percent of the current median income.

And key concerns with preparedness for an adverse global environment remain

28. On the fiscal front, public debt is high, at some 75 percent of GDP. And security-related expenditure—typically running at some 7 percent of GDP—constrains room for maneuver (Table 4).

29. Revenue shortfalls are anticipated to continue into 2012. The authorities now project the deficit to be 3.4 percent of GDP (in line with staff forecasts), exceeding the 2 percent deficit target.

30. Furthermore, the housing market remains vulnerable (Figure 6). Though prices have recently plateaued after over a 50 percent increase since 2007—it is unclear if this heralds

a soft landing. Risks in both directions remain high.

31. In this context, Israeli share prices have fallen faster than in advanced countries, and volatility in foreign exchange markets has again risen.

32. These strains are most apparent in the Israeli corporate bond market—that seized up in 2009. Spreads have risen, particularly in real estate and holding companies, and bond financing has dropped again in recent quarters.

On balance, however, Israel is unlikely to experience a severe downturn in the near term

33. As a baseline scenario, given the external slowdown projected, staff expect real GDP growth to fall to 2.9 percent in 2012 and rebound to 3.8 percent in 2013, its staff-estimated potential rate. Exports will be the main channel, weakening and then leading the subsequent recovery—albeit recovering more slowly than after the 2008 downturn. Absent a major global crisis, private consumption and investment are projected to be resilient throughout, reflecting capacity constraints, low unemployment, and supportive macrofinancial policies.

34. The baseline scenario implies that the output gap will turn slightly negative in 2012, and will gradually close as the economy rebounds. CPI inflation will remain within the target band, reflecting soft domestic demand alongside stable global energy and commodity prices.

Israel: Short-term Projections, 2012–13
(Percent change from the previous period, SAAR; unless otherwise indicated)

	2012				2013				2011 Prel.	2012 Projections	2013 Projections
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
	Projections				Projections						
GDP	1.7	3.2	3.9	4.0	4.3	3.5	3.5	3.5	4.7	2.8	3.8
Private consumption	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	3.6	1.5	2.5
Public consumption	2.0	2.0	2.2	2.2	2.0	2.0	2.0	2.0	3.7	3.4	2.1
Gross fixed capital formation	5.2	5.2	4.8	4.8	4.9	4.9	4.9	4.9	22.8	7.8	4.9
Net exports 1/	-0.1	0.1	0.2	0.3	0.3	0.2	0.2	0.2	-2.2	-0.3	0.9
Exports of goods and services	-3.5	-1.0	4.5	6.0	7.0	7.0	7.0	7.0	4.9	-4.4	6.0
Imports of goods and services	-3.0	-1.7	2.0	3.2	3.5	5.5	5.5	5.5	10.6	-3.7	3.7
CPI (end period, NSA, year on year)	1.4	1.3	1.9	2.0	2.0	2.0	2.0	2.0	2.2	2.0	2.0
Output gap (percent of potential)	-0.1	-0.2	-0.1	0.0	0.2	0.2	0.2	0.2	0.4	-0.5	-0.2

Source: Haver Analytics; IMF staff estimates and projections.

1/ Contributions of GDP growth.

But risks—notably to the downside—remain significant

35. Early resolution of the Euro area crisis and stronger-than expected global growth would buoy prospects. But persistent Euro strains and the associated drag on global output represent more likely downside risks to the Israeli outlook, with regional tensions, a

resumption of domestic social protests, and the possibility of early national elections all compounding these challenges to growth and to delivery of strong macroeconomic policies.

ADDRESSING THE CHALLENGES

With global strains rising, the key task is to maintain growth momentum while strengthening resilience to downside external shocks. With the output gap opening slightly and automatic stabilizers given free rein, fiscal policy should remain focused on debt reduction over the medium term and on strengthening social inclusion. In this context, monetary policy has room for maneuver, and is thus in a position to alleviate the impact on growth of steady fiscal withdrawal. The FSAP update proposed various steps to strengthen the financial sector.

A. Fiscal Policy and Framework

The 2012 budget deficit is expected to overshoot the original target significantly

36. Revenue for 2011 is below budget estimates. This reflects shortfalls relative to projections of:

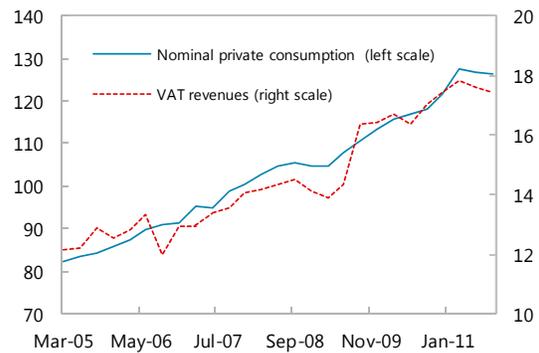
- VAT (due to the deceleration in private consumption);
- capital gains receipts (due to sharp falls in stock prices);
- real estate taxes (due to lower transactions); and
- fuel and energy excise hikes (due to cancellation of planned rises).

37. Thus, although expenditure was slightly lower than the budget in 2011, the budget deficit was 3.3 percent of GDP, somewhat above the 3 percent target.

38. These revenue shortfalls relative to official projections appear largely to reflect overoptimistic estimates. In particular, the outturns imply revenue ratios close to those in 2009 and 2010. Thus hoped for revenue increases did not materialize. But overall, with the possible exception of the yield from corporate taxation—where strong economic growth does not seem to be reflected in 2011 receipts—there is no evidence that the 2011 shortfalls are rooted in major structural problems with the revenue base.

39. Thus, the outlook for overall revenue ratios in 2012 is similar to that for 2011, implying an additional shortfall in 2012 of revenue relative to the two-year budget projections.

Israel: VAT Revenues and Private Consumption
(billions of NIS)



Sources: Haver Analytics; and Bank of Israel.

40. With expenditure ceilings for 2012 already set out in the approved two-year 2011–12 budget, and given staff growth and associated revenue projections, the deficit outturn for 2012 is projected at around 3.4 percent of GDP, exceeding the target by almost 1½ percentage points of GDP.

The top priority of fiscal policy is to keep public debt on a downward track over the medium-term

41. This will maintain confidence in Israel despite strained international markets, and so allow some flexibility in the deficit path in the short term (Box 5).

42. This critical task has become considerably more difficult. Near-term global and Israeli growth projections have been marked down, and so the 2012 budget is set to overshoot its deficit projection. Furthermore, a surge in retirements in coming years will reduce the growth of Israeli productive capacity to below the norms of the past decade. Social concern with prices will constrain options to raise indirect taxation. Calls for added public spending—including for

social needs and security—have mounted.¹ Unfunded fiscal commitments of some ¾ of a percentage point of GDP for 2012 have to be resolved within the 2012 budget framework.

43. Accordingly, the authorities' commitment to maintain the total spending limits in the 2012 budget is welcome, as is the Trajtenberg committee's determination to observe these and the medium-term spending limits. Alongside the decision to withdraw plans for phased reductions in direct tax rates, these actions have helped to underpin continued investor confidence in the Israeli sovereign in a difficult global environment. And they allow scope to let the automatic stabilizers operate on the revenue side in 2012.

44. But more is needed—in particular, a decisive effort to approach the 2013 budget deficit ceiling should be made. This will require contributions from all sides—from expenditure restraint including defense to keep total spending within the ceiling, new initiatives to raise revenues, and efforts to strengthen the productive potential of the economy.

45. Even so, unless the outlook for activity and revenues improves markedly in coming months, a full return to the headline target for 2013 would be unduly contractionary. Final determination of the appropriate 2013-14 targets for the fiscal balance should be made before mid-2012 reflecting domestic and global developments at that time.

¹ Defense spending may also rise further following the recent Supreme Court ruling that the exemption of Haredi men from military service is unconstitutional. This could lead to an unbudgeted surge in recruits, although the pace and scale of such developments will be determined in due course as part of a broader response by the authorities to the ruling.

46. This change in the 2013 deficit target will need to be accompanied by a further strengthening of the fiscal rules and frameworks. Given commitment to the expenditure rule, there will likely need to be a reset of the path of targets for the deficit ceiling. Options for that include clarification that the path will be adjusted for automatic stabilizers. Alongside, and in response to the mounting difficulty of securing medium-term debt reduction, the establishment of a permanent and independent Fiscal Council to assess whether overall fiscal policies are consistent with debt reduction may help to secure that goal.

47. Following the approval of the Knesset of the arrangements for taxation of natural resources, as recommended by the Sheshinski committee, the authorities are finalizing arrangements for the sovereign wealth fund. This should follow international best practice, including assigning all relevant proceeds to the fund, and in regard to the management arrangements it will follow and the size of transfers back to general revenues.

48. In this context, even with expenditure restraint fully playing its appropriate role, there is a good case for deficit-reducing discretionary fiscal policy actions to focus on taxation, over the near and medium terms. Key non-security spending items—such as health and education—are around levels of moderate-spending OECD peers (see SIP Chapter II). And in some areas, there is need for increases, notably in education and public investment, including in the Arab-Israeli communities. So scope for additional overall spending compression on a significant scale is not apparent. On the other hand, with the VAT rate at only 16 percent—albeit with few exemptions—and given the priority attached

to strengthening environmental and housing taxation, revenue increases in these areas alongside curbs to tax expenditures could reinforce the credibility of plans to lower public debt.

49. Although Israel has not exercised its option to issue debt under the longstanding US government guarantee scheme over recent years, it has provided additional reassurance in an environment of heightened sovereign risk. There is a good case to seek extension of this scheme when it expires in September 2012, and given heightened global risks, to seek to raise its limits.

Strengthening medium-term expenditure planning will add credibility

50. Continued expenditure restraint will be required—on both the civilian and defense sides, notably because government-approved undertakings exceed the ceilings implied by the fiscal rule. This perennial gap reflects longstanding shortfalls in medium-term expenditure planning mechanisms. As recommended in the 2010 Article IV consultation, and as is best practice in the OECD, a comprehensive institutional framework—including fiscal responsibility laws, a medium-term macro-fiscal framework, and a medium-term expenditure framework—is needed.

Israel: Medium-term Fiscal Outlook, 2010-15

	2010	2011		2012		2013	2014	2015
		Budget	Est.	Budget	Staff proj.				Staff projections
(Billions of NIS)								
Central Government 1/								
Revenue	234	262	257	283	270	295	313	331
o/w Taxes	196	215	212	234	225	236	250	265
Expenditure	265	287	286	301	301	317	334	352
o/w Defense	52	59	59	56	56	59	62	66
Budget balance	-30	-25	-29	-18	-31	-22	-21	-20
(Percent of GDP)								
Central Government 1/								
Revenue	28.8	30.3	29.6	30.8	29.8	30.8	30.9	31.0
o/w Taxes	24.0	24.9	24.3	25.5	24.8	24.6	24.7	24.8
Expenditure	32.6	33.3	32.9	32.8	33.2	33.1	32.9	32.9
o/w Defense	6.3	6.3	6.8	6.1	6.1	6.1	6.1	6.1
Budget balance 2/	-3.7	-2.9	-3.3	-2.0	-3.4	-2.3	-2.0	-1.9
General Government								
Overall balance	-4.6	...	-4.0	...	-3.5	-2.6	-2.3	-2.1
Cyclically adjusted primary balance	-0.2	...	-0.1	...	0.2	1.0	1.3	1.4
Gross public debt	76.1	...	74.3	...	73.4	72.1	70.5	69.0
<i>Memorandum items:</i>								
Nominal GDP growth (percent)	6.1	6.7	6.9	6.3	4.3	5.7	5.7	5.5
Inflation (annual average)	2.7	...	3.4	2.0	1.7	2.0	2.0	2.0
Real GDP growth (percent)	4.8	3.8	4.7	4.0	2.8	3.8	3.6	3.6
New real expenditure growth rule (percent)	...	2.7	2.7	2.7	2.7	3.4	3.1	3.4
Nominal GDP, NIS billion	813	864	869	919	907	958	1,013	1,068

Sources: Israeli authorities; and IMF staff estimates.

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

2/ The deficit ceiling rule is applied to central government balances.

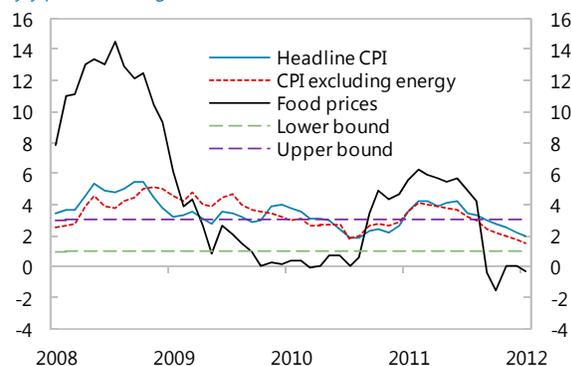
B. Monetary and Exchange Rate Policies and Frameworks

The monetary policy stance is broadly appropriate under baseline projections, but policy can be relaxed further if fiscal and financial sector policies are strengthened or output prospects weaken.

51. Headline CPI, which exceeded the 1–3 percent target range during the first half of 2011, has returned within the target range. While longer-term inflation expectations have remained stable and on target, near-term inflation expectations have dropped sharply towards the mid-point of the range since Fall 2011.

52. This reflects various opposing forces: upward pressure due to a narrowing output gap; and downward pressures reflecting a sharp decline in global food prices, reduced retail mark-ups following the summer social protests, and (until recently) a strong exchange rate.

Israel: Inflation
(y/y percent change)



Source: Haver Analytics.

53. On balance, the outlook is for further disinflation, with output projected to decelerate and global food and energy prices to stabilize or recede. Inflation is on track to

ease towards and even beyond the mid-point of the inflation target range.

54. But three factors warrant close attention.

- First, wage pressures. While unit labor costs have been stable—with wage growth matching a productivity surge after the 2009 downturn—pressures could mount. In particular, following increases of 2 ½ percent in the minimum wage in early 2011, rises of 8.9 percent are anticipated for October 2012. And if fiscal adjustment measures include increases in indirect tax rates, this could trigger wage pressures, with implications for inflation. Cooperation by wage setters to maintain stability will be essential to avoid this.
- Second, house prices. While it is unclear if house prices are misaligned, abrupt corrections would pose limited risks to financial stability but could destabilize domestic demand. Conversely, monetary relaxation could also reignite the market, although the transmission between the discount and mortgage rates has been attenuated by recent macro prudential measures aimed at reducing the proportion of new variable-rate secured loans to total loans. Measures to smooth the supply of land for housing over time, and steps to increase the taxation of second properties, backed up by additional macro prudential steps if necessary, would help de-link further changes in the policy rate from house price inflation.
- Third, phased anticipated increases in the required minima for banks' core Tier 1 capital, possibly compounded by strains in

the corporate bond market, and the recommended strong fiscal stance could slow both credit growth and activity. Thus, given lags, monetary policy should anticipate and offset these effects, once they are adopted. And if global tail risks materialize, there would be scope for more aggressive interest rate reductions.

The monetary and exchange rate frameworks have been strengthened

55. The adoption of a new BoI Law in 2012 has more formally entrenched inflation targeting as the monetary regime in Israel. However, there are a number of ways in which implementation might be strengthened. Options include emphasizing the mid-point of the inflation target range as the goal for policy; lengthening the horizon of published inflation and GDP forecasts; and providing more and more systematic public information on the Bank's forecasting technology. And, the arrangements for remuneration of Bank of Israel staff should be reviewed making this the Bank's remit alone to guarantee full budgetary autonomy—as in other inflation-targeting central banks—to secure the independence of the central bank (see SIP Chapter III).

56. The floating exchange rate regime remains appropriate. Though the switch from freely floating to floating which occurred in 2008 marked a break with a decade of practice, it proved an effective response to the disturbed global environment—notably because the new regime was mainly aimed at addressing disorder in the foreign exchange market rather than at affecting the trend. As inflation pressures have eased and markets have begun anticipating interest rate cuts, upward pressures on the shekel have eased and discretionary intervention has not

occurred in recent months. This leaves foreign exchange reserves at a comfortable level by most standard measures (Text Table).

	2009	2010	2011	Feb-12
In billions of US dollars	60.6	70.9	74.9	77.1
In months of imports of goods and services	9.6	9.1	10.0	...
In percent of short-term external debt	143.5	130.5	...	...
In percent of total external debt	65.0	66.9	...	...
In percent of broad money	53.7	57.0	58.9	...

Sources: Haver Analytics.

57. Looking ahead, the monetary regime should continue to emphasize the policy rate instrument, with intervention playing a secondary role. In the case that strong safe-haven inflows resume, a mix of expansionary monetary policy and tighter fiscal policy will be appropriate. Should these measures not suffice to maintain orderly markets, intervention and additional administrative controls on foreign currency transactions can be considered, but if so, exit strategies from use of all these instruments should be prepared.

58. The introduction of a reserve requirement on derivative contracts and information requirements on foreign investments in the short government bond market have signaled efforts to maintain orderly condition in foreign exchange markets. The measures remain appropriate.

C. Financial Stability

The FSAP Update assures on financial system soundness, but the global environment is highly uncertain

59. Israel's financial system appears robust in the context of a global and Israel slowdown, and even, to a significant extent, in the context of a global downside tail scenario (Tables 5–7 and Figures 6–8).

60. Various factors underpin that assessment:

- Households' balance sheets appear strong: despite the housing boom, household leverage has not increased even as their financial assets appreciated in recent years (Figure 7). Recourse-style mortgages, banks' close customer relationships, and proactive BOI regulations on LTV ratios and variable rate loans all kept loan losses low. Corporate borrowing from abroad is also modest (about 15 percent of GDP).
- Commercial banks' largest borrowers, typically conglomerates groups, have diversified business activities, and the BOI has strengthened supervision of concentration risk. Banks have negligible direct exposure to European sovereign, bank, and nonfinancial sector credit risks.
- Policy to secure bank stability has long emphasized highly proactive supervision as the core instrument, a practice now being adopted more widely internationally. And banks are overwhelmingly deposit funded, backed by strong implicit public deposit guarantees, minimizing liquidity risks. Overall risk weighted bank capital ratios are comfortable—which in parts reflect the

use of conservative standardized approach in measuring asset risk weights—although the quality of capital is not as high as in many comparable countries.

- Regulation of nonbanks and financial products has been strengthened (Figure 8 and Table 7). In insurance, the policy making and supervision capacity of the CMISD has been substantially upgraded since 2008. And in securities markets, following the Hodek Committee's recommendations of early 2011, the Companies Law was amended in August 2011 to improve the quality and timeliness of disclosure, and corporate governance requirements.

61. With this background, the stress tests conducted under the FSAP Update suggest that the effect on financial institutions of a major shock would be considerable but manageable.² A scenario more severe than that seen in 2008–09 would erode some banks' capital significantly, but could recover quickly if earnings are retained. Liquidity stress tests likewise are broadly comforting. Stress tests for insurance and long-term savings funds also confirm that institutions and policy holders have sufficient buffers to cope with strong shocks.

62. But some concerns should be highlighted:

- A major crisis associated with a contraction in trade and more difficult funding

² See the accompanying Financial System Stability Assessment.

conditions could squeeze corporates' market borrowing and have rapid and complex knock-on effects elsewhere in the economy.

- Concentration risk is significant. A failure of each bank's largest borrower group would lead to credit losses equivalent to 9-13 percent of Tier 1 capital. Furthermore, some companies face rising risk premia and large roll-over needs in the coming period.
- While households' indebtedness is relatively stable and low, tails of LTV ratios are high. Banks have also significantly increased their exposures to construction sector. Thus, if a housing correction were

to result in a drop in construction, banks would be exposed to credit risk through direct (increased nonperforming loans) and indirect channels (weaker economic growth).

63. The "Concentration Committee" has recommend that Israel's corporate pyramid structures should be reformed. Notably, controlling shareholders will be prohibited from holding or controlling both financial institutions and real business companies of a significant size. The implications of the transition for stability are not clear. Some groups are already beginning to adjust by selling assets, and careful attention is warranted.

Summary of Performance of Israel Five Major Banks
(In percent; unless otherwise indicated)

	Bank Leumi			Bank Hapoalim			Israel Discount Bank			Mizrahi Tefahot Bank			First International Bank		
	2009	2010	2011 Q3	2009	2010	2011 Q3	2009	2010	2011 Q3	2009	2010	2011 Q3	2009	2010	2011 Q3
Capital															
Total capital to RWAs 1/	14.1	15.0	13.8	13.7	13.9	13.6	12.1	13.2	13.3	14.3	14.0	13.6	13.8	12.4	12.7
Tier 1 capital to RWA	8.3	8.6	7.9	8.5	8.9	8.5	7.6	8.2	8.3	8.0	7.9	7.7	9.2	8.0	8.2
Equity to total assets	6.8	7.1	6.5	6.7	7.0	6.8	5.3	5.83	5.27	5.5	5.4	5.0	5.9	5.7	5.8
Asset quality															
NPLs to credit 2/	...	4.0	2.7	...	5.0	3.6	...	5.0	4.7	...	1.6	1.1	...	2.0	1.7
Loan loss provision to credit	0.7	0.3	0.1	0.9	0.5	0.3	0.9	0.7	0.4	0.3	0.4	0.2	0.4	0.2	0.1
Earning and profitability															
Return on equity	10.2	10.3	7.5	6.7	10.4	12.4	9.8	7.0	8.2	8.5	11.8	14.3	9.7	8.0	7.3
Liquidity															
Deposits to loans	122.4	111.4	112.6	107.5	103.9	99.3	123.9	116.3	125.9	80.8	99.0	99.0	137.4	126.3	123.1

Source: Bank of Israel.

1/ Risk weight assets (RWAs) under Basel II standardized approaches.

2/ Non performing loans (NPLs).

In light of the FSAP assessment and the downside tail scenario, several steps are recommended.

Bank capital requirements

64. As the banking sector develops, proactive supervision needs to be reinforced by higher quality capital. Tail risks associated

with large borrower groups and the concentrated structure of the banking sector reinforce this case. Focus should be on raising core Tier 1 capital, with some dilution of controlling shareholders if that is necessary to secure equity increases. The authorities are considering plans to do this.

Liquidity requirements

65. The BOI has already moved to tighten its regulation on liquidity management, but this is an area where international practice is fast evolving in the aftermath of the global crisis; the BOI will need to keep its regulations and practice up to date.

Non-bank financial sector supervision

66. Improving cross-border oversight, and the supervision of groups connected to insurance companies—in particular related holding companies—are among the priorities. For securities markets, enforcing high standards of due diligence in the underwriting of securities issues and closing the gap by bringing all unregulated broker dealers into regulatory periphery.

Supervisory coordination and macroprudential oversight

67. The institutional framework for cooperation among supervisory agencies has not been fully developed. While *ex post*, in mid 2008–09 crisis, cooperation between all the relevant agencies was frequent and substantive, *ex ante* it was considerably less so, greatly hampering preparedness. A Financial Stability Group consisting of representatives from the BoI, the CMISD, and the Israel Securities Authority, was set up in the mid-2011. But key operational issues remain, including those arising from the diverse mandates of the agencies involved, which complicate the sharing of information, the coordination of diagnostic analysis, and policy actions—including macro-prudential policies.

68. Thus, the FSAP suggested the establishment of a more formal standing Financial Stability Committee (FSC). If the FSC

does not resolve apparent impediments for *ex ante* cooperation among the supervisory agencies, current architectural arrangements may need to change to secure that goal.

Crisis management

69. A comprehensive review of crisis management framework should be conducted, before a major disturbance occurs. Several elements need to be integrated:

- The BOI's emergency liquidity assistance framework should be more fully articulated so as to facilitate quick action when needed, but also protecting the BOI from taking on undue risks.
- The legal framework for BOI's early intervention powers and instruments should be strengthened, and a special bank resolution framework should be established.
- A financial support mechanism for resolution is needed. Several possibilities are available (such as several versions of a resolution fund and deposit guarantee scheme), but in any case there needs to be some government rather than central bank back-stop for what is an essentially fiscal issue.
- A study of the implications of Israel "pyramid corporate" structures for the origination and transmission of stress in markets is needed. The results should guide supervision policies, and the implementation of proposals from the "Concentration Committee" on reform of corporate structures.

D. Macrosocial Challenges and Sustainability

Long-standing problems in the labor market should be tackled soon

70. Labor force participation rates are among the lowest in the OECD, largely reflecting Arab-Israeli women and Haredi (Ultra Orthodox) men. The wage levels of overall Arab and Haredi workers are lower than other Israeli groups, and both communities consequently experience high incidence of poverty. If the employment and wage in their communities were on a par with others, Israel output would be some 15 percent higher than it is, and annual fiscal revenues would also be higher than they are by some 5 percent of GDP. These participation issues are macroeconomic in scale.

71. Both communities want work, and both should be facilitated to realize that goal. Necessary steps include provision of basic child care and transportation in the Arab areas, arrangements for inclusion of Haredi males in the armed forces in ways that support their employment and productive potential, and action to remove impediments to business establishment in both communities. Both groups also need their particular education

requirements to be addressed, notably equalization of education provision at all levels in Arab-Israeli communities with that elsewhere, and focused provision of adult education to address Haredi needs. And social benefits to both groups, including child care, should be increasingly tied to employment.

72. A number of official initiatives to address the needs of these "currently" minority populations are underway—alongside the many ongoing private initiatives. These include targets for participation, extension of the earned income tax credit, establishment of a proactive unit for Arab affairs in the Prime Minister's office, and expansion of Haredi units in the defense forces. And the recent Supreme Court ruling against Haredi exemption from military service has made a decisive resolution of these issues even more urgent. Accordingly, as well as upgraded enforcement of anti discrimination legislation and basic labor regulations, much more is needed. This has implications, as noted, for additional spending, particularly education and public investment. Early and substantive progress will require strong leadership from all sides—and great political dexterity.

THE AUTHORITIES' VIEWS

73. The authorities agreed with the overall assessment of economic developments and the implications for policy including in the financial sector. They underscored need for maintenance of the 2012 expenditure ceiling and commitment to the expenditure rule for the 2013–14 budget. They recognized that while the deficit targets for 2012 and 2013 could be missed, this in large part reflected automatic stabilizers appropriately operating.

This, and the recent relaxation of monetary policy would support near term growth, with macroprudential measures in place to stabilize the housing market. Policymakers stand ready to adjust fiscal and monetary policy settings in the event of a major global shock. And the authorities agreed on the need to raise labor participation rates.

74. Within that overall agreement, however, some differences of emphasis were noted.

Fiscal Policy and Framework

75. The authorities have decided not to increase the rate of VAT further at this stage. This reflects in part the concerns over the increase in the cost of living, and that the VAT, unlike many elsewhere, has few exemptions, but all options remain on the table.

76. Furthermore, in February 2012 the government approved the general framework of principles for the sovereign wealth fund, under which withdrawals from the fund will be restricted to the regular annual transfer to the budget based on long term yields.

77. The authorities indicated that they would explore the option of extending the existing US guarantee scheme as one element of their broader efforts to reassure markets of their commitment to fiscal stability. However, they did not see need at this stage to seek to raise the limits under the scheme.

78. The authorities also do not see a compelling case to establish a Fiscal Council. They regard the scrutiny by international agencies, the BoI, local experts, rating agencies, and investment banks as providing a sufficient degree of oversight. However, the idea would remain under review.

Monetary Policy and Framework

79. The authorities emphasized that they regard the current stance of policy as appropriately weighing upside and downside risks, while maintaining "sufficient firepower in reserve" to respond to possible adverse shocks. However, they agreed that their

assessments would adjust in light of fiscal and supervisory initiatives, once these were adopted. They noted that the decrease in intervention over time essentially had constituted an exit strategy. It remains an option in line with the announced policy in cases of disorderly markets or significant departure from economic fundamentals.

80. They noted that while a number of developments to the inflation targeting framework could be considered, any change should be gradual and reflect local circumstances, given no "first best" model of inflation targeting.

81. The BoI noted concerns with the current arrangement, regarding the remuneration and contractual conditions for its staff. However, the fiscal authorities emphasized need for those arrangements to be consistent not only with private sector but also with public sector arrangements. Accordingly, the current arrangement for the BoI would remain in place.

Financial policy

82. The authorities are considering a number of options for the operation of the proposed FSC. Their inclination, rather than to move directly to formalizing the arrangement, is to "learn by doing" first, and to design a formal arrangement in light of lessons learned. At present, cooperation between the regulators has improved notably, in terms of both consultation and information flows: however, the need to prepare for effective crisis management (even given the relative safety and soundness of Israel's financial system) requires an improvement in the pace and intensity of this cooperation, especially regarding the development of micro-based information flows on institutional inter-

connectedness (network diagrams) and related stress tests that include contagion risks.³ The BoI noted the lack of emphasis on these important points in the FSAP and the Article IV papers.

Labor participation

83. While agreeing that this matter is essential, the authorities also emphasized that

cultural issues and low job market skills restrict participation in the labor market. They noted early signs that these matters are responding to an adjustment in incentives, and that dialogue with all communities would continue. And as part of the need for flexibility on all sides, the authorities emphasized need for the adoption of more of the core curriculum across all schools, and increased enforcement of anti-discrimination legislation.

STAFF APPRAISAL

84. Israel's economy remains strong. Growth has been robust with fixed investment rising more recently, unemployment is at a historic low, while inflation and inflation expectations are squarely inside the 1–3 percent target range. The shekel is now broadly consistent with fundamentals and international reserves are appropriate by most measures. These successes reflect strong policy frameworks.

85. But vulnerabilities remain and growth is slowing. Public debt and security expenditures are high, house prices have surged by over 50 percent in recent years, and poverty is elevated. And risk premia in the corporate bond market have risen significantly.

86. Given the prompt accommodative policy response to signs of slowdown, a severe downturn is unlikely. The Bank of Israel reversed its tightening cycle from September 2011, and automatic stabilizers are operating fully. Accordingly, GDP growth is projected to decline to a little below 3 percent before returning to trend at 3¾ percent in 2013, with both sides of this cycle led by exports.

³ See Moretti, M., *et al.*, "Stress Testing at the IMF," IMF WP 08/206.

87. Nevertheless, policies and policy frameworks should all be adjusted further to better anticipate the risks, as elaborated below.

88. On the fiscal side, medium-term debt reduction remains the top priority. This requires firm adherence to the total spending limits in the 2012 budget and a decisive effort to approach the 2013 budget deficit ceiling. Discretionary fiscal actions to this end should focus on taxation, given limited scope for overall compression of spending

89. But a full return to the headline target for 2013 would be unduly contractionary. The target should be adjusted, as part of a broader suite of reforms to the fiscal framework, including specification that the deficit path will be adjusted for automatic stabilizers, confirmation that natural resource revenues will be placed in a well-managed sovereign wealth fund, and establishment of an independent Fiscal Council.

90. The monetary stance is broadly appropriate under the baseline projections, but the recommended fiscal and financial stability policies would create scope for further relaxation. In particular, phased increases in the required minima for core tier 1 bank capital, and the strong fiscal stance

recommended could slow activity—which monetary policy should anticipate. Any remaining concerns with renewed housing inflation should be addressed with macroprudential tools.

91. Alongside, the monetary framework should continue to be enhanced. Options include lengthening the horizon of published inflation and GDP forecasts, and increased emphasis on the mid-point of the inflation target range as the goal for policy. In this connection, the arrangements for remuneration of Bank of Israel staff should be reviewed as they raise concerns with effective independence of monetary and supervisory policy.

92. Furthermore, with the shekel broadly at its equilibrium, a de facto free floating exchange rate regime should be maintained. But the option to intervene to sustain orderly conditions, if necessary, is appropriately warranted.

93. On the financial stability side, “normal” risks appear contained. Banks and other financial institutions would likely be able to withstand even a severe downturn including a domestic housing crash, and heightened credit risk in the corporate sector.

94. Nevertheless further steps are warranted, including plans to raise bank capital ratios and to strengthen liquidity requirements in accord with Basle III. A stronger financial crisis management framework and preparations for shocks outside of historical experience should be implemented. The use of

the BoI’s emergency liquidity facilities and the legal framework for early intervention and resolution powers should both be reviewed urgently. The risks arising from the bankruptcy of one or more of the large corporate groups should be studied. And finally, the establishment of an FSC—comprising all the main supervisors—could help substantially in facilitating a more systemic approach to financial sector policy. But if this FSC does not succeed in addressing coordination challenges amongst supervisors, the architectural layout of financial sector supervisors may need to be recast.

95. But even with all this, stability in Israel in the long run will not be assured unless labor participation rates—notably the Arab-Israeli and Haredi communities—are raised. These exact a heavy toll on output, fiscal revenues, and inequality, and this toll is set to rise as the share of these populations rises towards half in coming decades. Actions needed include provision of basic child care and transportation, accommodation for both groups in the defense/civic services, business establishment in both communities, and imaginative reform of education. And social benefits to both groups, including child care, should be increasingly tied to employment. Steps are underway in this direction, but much more is needed to secure the long-term sustainability of the Israeli economy, and with it, the welfare of all of its citizens.

96. Staff recommends that Israel should remain on the standard 12-month consultation cycle.

Box 1. 2011 Social Protest and the Trajtenberg Committee Recommendations

In July 2011, a nationwide protest movement happened, initially focused on rising house prices, but subsequently encompassing broader social issues and the cost of living. Protestors, pitching tents in main streets in large cities such as Tel Aviv, demanded lower indirect and higher direct taxes, free education and childcare, suspension of privatization, and investment in social housing and public transport. Though initially small, their

numbers swelled to some 400,000 (five percent of the population) and they stayed through September.

The Trajtenberg committee, which the government established to address issues raised recommended several measures that have budgetary implications. On December 6, 2011, the Knesset passed legislative amendments to change taxation.

Key measures	Annual Budgetary Impact (billions of NIS)	Approved by the Knesset
Revenue		
Cancellation of scheduled income tax rate reductions		
The corporate tax was due to fall from 24 to 18 percent, and the top rate of personal income tax from 45 to 39 percent, both by 2016.	1.8	yes
Increases in corporate income and capital gains taxes		
Increase in the corporate income tax from 24 to 25 percent, and possibly later to 26 percent.	0.7	yes
Increase in investment income taxes on dividends, interest, loan discount, capital gains and land appreciation.	1.4	yes
Increase in tax on dividend payments to major shareholders from 25 to 30 percent.	n.a.	yes
Changes in personal income tax rates		
Reduction in the top rate from 45 to 48 percent on annual income over NIS489,480.	0.8	yes
Reduction of the medium rate from 23 to 21 percent on annual income NIS103,929 - NIS168,840	-0.8	yes
Imposition of an additional 2 percent tax on those with income over NIS1 million per year	0.4	no
Changes to social security contributions		
Reduction of the ceiling on employee social-security contributions to five times the average wage (following a temporary increase in the ceiling to eight times the average wage in 2008).	-0.8	yes
Increase in employers' national insurance contribution rate for those earning above 60 percent of the average wage from 5.68 to 7.5 percent.	2.5	No
Changes to indirect tax		
Cancellation of the scheduled increase in excise on gasoline and diesel	-2.5	yes
Commitment to a scheduled cut in import duties, except on cars and agricultural products.	-0.75	yes
Cancellation of the scheduled cut in the VAT rate from 16 to 15.5 percent	2	yes
Additional tax breaks for families		
Extension of child tax credits to fathers	-1	yes
50 percent increase in the earned income tax credit for mothers	-0.8	yes
Total revenue impact (excluding those approved by the Knesset)	0.1	
Expenditure		
Expansion of child care and early childhood education		
Increase in public spending on day care services for ages up to three years old; introduction of free compulsory education from age 3 to 5; reduction in school fees.	4	Yes
Targeted schemes for minorities		
A number of schemes are proposed, all of which aim to encourage the integration of minorities into the workforce, particularly Arab-Israeli females and ultra-orthodox men.	n.a.	yes
Additional measure to lower housing costs		
Several schemes are proposed, for instance affordable long-term rental housing units, increased rent subsidies, increase in property tax on empty apartments	0.2	partly
Overall the Trajtenberg committee recommended additional spending of NIS30 billion over 5 years. Not approved by the Knesset	6	No
Defense		
Reduction of defense spending by NIS2.5 billion per year over 5 years.	-2.5	No
Total expenditure impact (excluding those not approved by the Knesset)	4.2	
Overall budgetary impact	-4.2	

Box 2. Measures to Stabilize the Real Estate Sector

- August 2009: A regulatory alert for caution in extending adjustable rate housing loans. Intended to reduce potential losses in case of borrower's payback difficulties as a result of an increase in interest rate.
- March 2010: New treatment for credit to a "purchasing group"—individuals who organize themselves for the joint purchase of land rights in part to get tax benefits. Credit allocated to purchasing groups must be classified as "construction and real estate" credits that embed higher risk. Intended to reflect the true risk inherent in the business.
- July 2010: Supplemental reserve for high leveraged housing loans. Additional reserve of at least 0.75 percent for new loans with loan-to-value (LTV) ratio exceeding 60 percent—intended to increase bank reserves to absorb losses when adverse developments in the housing market and real economy occurs.
- October 2010: higher capital requirements for high leveraged housing loans. Applying a risk-weighted factor of 100 percent for housing loans where the amount indexed to a floating interest rate is over 25 percent & LTV of at least 60 percent. This regulation does not apply to loans less than NIS 800,000.
- May 2011: limiting the adjustable-interest-rate component of housing loans to 1/3 of the total loan. Intended to reduce the likelihood that borrowers' repayment ability would be impaired as interest rates rise.
- Detailed reporting requirement on residential mortgage loans including: loan-to-value, payment-to-income etc.
- Collecting and analyzing stress tests results conducted by banks on residential mortgage portfolio; enhancing supervision of banks practices (off-site and on-site) and a monthly monitoring of developments in consumer market and residential mortgage loans' market; and enhancing BOI cooperation with the Ministry of Finance and the Ministry of Construction & Housing concerning the residential housing market and its potential impact on financial stability.
- Increasing the supply of land by Israel Land Authority, and raising taxation of the second property.

Box 3.: BoI Foreign Exchange Policy 2010–11

After a long period without intervention, the BoI resumed the purchase of foreign currency from March 2008, in an effort to moderate the pace of currency appreciation and maintain orderly conditions in markets. However, no purchases have been made since August 2011. Over this period, the shekel has weakened against the dollar, sliding by more than 9 percent.

At the beginning of 2011 the Bank of Israel introduced additional measures in the foreign currency market:

- It imposed reporting requirements on swaps and NIS/foreign currency forwards, and on nonresidents' transactions in makam and short-term government bonds.
- The Bank also announced the imposition of a 10 percent reserve requirement on nonresidents' NIS/foreign currency swap transactions and foreign currency forwards. This was done to reduce the profitability of nonresidents' short-term capital inflow into Israel, and thereby to moderate the appreciation caused by such inflows.
- At the same time, the Ministry of Finance announced that it intended to abolish the tax exemption of nonresidents' profits from investments in makam and short-term government bonds—thus bringing this taxation in line with that on Israeli residents—with the intention of making such investments less attractive.

Box 4. Exchange Rate Assessment

In 2011 the shekel experienced moderate volatility relative to peers amid strong capital inflows. Israel's real effective exchange rate (REER) appreciated throughout 2010 and the first half of 2011, apart from a temporary weakening in January 2011 that resulted from heightened geopolitical uncertainty in the region. Currency interventions and the introduction of macro prudential measures to limit short-term capital inflows helped stabilize the exchange rate in the rest of 2011. Overall, the shekel weakened by 3½ percent in real effective terms from December 2011 to October 2011.

The real exchange rate is broadly in line with its 1987-2010 average, but its equilibrium value has depreciated further below the historical mean due to worsened terms of trade. The equilibrium exchange rate approach based on staff's panel-data CGER estimates indicates that the exchange rate is

overvalued 18 percent, largely reflecting the expectation of a significant decrease in public consumption relative to GDP in the staff's forecast—which pushes up the long-run current account norm as this is expected to reduce the price of non-tradables relative to tradables over time. Given hefty spending on defense relative to non-defense as well as the high share of tradables in defense spending in Israel, the CGER-ERER based estimates may be overstating the effect of public consumption on the real exchange rate and thus this misalignment should be interpreted with care. On the other hand, the projected medium-term CA balance is broadly in line with the CA balance norm and is larger than the NFA-stabilizing CA balance, implying a broadly balanced MB estimate and a moderate undervaluation according to the ES approach.

Real Exchange Rate CGER Assessment

<i>Approach</i>	2010 AIV (Fall)	2012 AIV
Equilibrium Exchange Rate	10 pc	18 pc
Macro Balance	-10 pc	-7 pc
External Stability	-15 pc	-1 pc

Staff's view is that the shekel is around the rate suggested by fundamentals. Although the formal CGER indicators of competitiveness remain dispersed as they have been since 2009, the gap between the various measures is closing, with two out of three measures now indicating that the shekel is at or above fundamentals. Besides, both the macro

balance and external stability indicators 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.

Box 5. Medium Term Fiscal Projections and the Fiscal Rules

In 2010 Israel adopted a new framework of fiscal rules, with the implicit aim of reducing the ratio of public debt to 60 percent GDP by 2020. These rules are:

- An expenditure rule, which limits real expenditure growth to average real GDP growth over the past 10 years adjusted downwards for the gap between public debt and the desired target of 60 per cent. Thus, with public debt at 75 percent of GDP compared to the target of 60 per cent, the average real GDP growth of 4 percent is adjusted down by one-third to provide the 2.6 percent real expenditure growth limit for 2010.
- A deficit ceiling rule, with the central government deficit limited to 3 percent of GDP in 2011, 2 percent in 2012, 1½ percent of GDP in 2013 and 1 percent thereafter.

Given the revenue outlook, the latter rule binds on the determination of the deficit target in practice. But deficit outturns in 2011 breached the ceiling because with expenditures as appropriated, revenue shortfalls have occurred. These are expected to continue in 2012. Accordingly, securing the deficit target for 2013 would require a significant fiscal adjustment – 2 percentage points of GDP equivalent to a 4 percentage point increase in the VAT rate.

If this fiscal adjustment was implemented, the ratio of public debt to GDP would continue to fall as the authorities originally projected, with debt ratios eventually falling to the implicit 60 percent target (Box 5 Figures 1 and 2). However, such a fiscal adjustment could hurt growth in the context of global slowdown—a pro-cyclical fiscal action. Given Israel's relatively sound fiscal outcomes over the past few years and the degree of market confidence, a procyclical policy of this magnitude does not seem warranted.

If instead, the authorities simply focused on meeting the expenditure rule in 2013 and beyond, while keeping revenue ratios at the 2012 levels, debt would still remain on a downward trajectory, but deficits would remain elevated for some time, with a much shallower trajectory of debt reduction (Box 5 Figures 2 and 3).

However, the downside risks to potential growth over the medium-term from demographic factors (SIP Chapter I), can cause major problems on the fiscal side. If potential growth fell to 3.2 percent (as the Bank of Israel currently assumes), deficits would remain above 3 percent for another 5 years before the real expenditure growth rule began to bite, and public debt would remain largely unchanged (Chart 4). If trend growth was reduced further to 2.6 percent, due for instance to demographic issues, debt would actually resume an upward trajectory.

A middle path is suggested. Staff projections are based on the continuation of the real expenditure growth rule, combined with an assumed 1 percent of GDP revenue adjustment in 2013—still a significant adjustment. A fiscal adjustment of this magnitude would be sufficient to bring medium-term deficits within the 1-2 percent of GDP range that results in public debt falling to the 60 percent target within the decade (Charts 1 and 2).

The evolution of public debt under a no-policy change scenario (where the assumed revenue adjustment does not occur), as well as a range of other standard fiscal shocks, including interest rate, exchange rate, GDP growth and contingent liability shocks are presented in Figure 9 and Table 8. These shocks demonstrate that while debt to GDP is fairly robust to shocks in Israel (particularly if the expenditure rule is implemented, which requires any increase in interest expenditure to be offset by savings elsewhere), there is considerable sensitivity to lower GDP growth, as well as from any realization of contingent liabilities (as of end 2009, direct government guarantees were equivalent to around ½ a percent of GDP).

Box 5. Medium Term Fiscal Projections and the Fiscal Rules (Concluded)

Figure 1. Budget Balance Under Alternative Rules
(Percent of GDP)

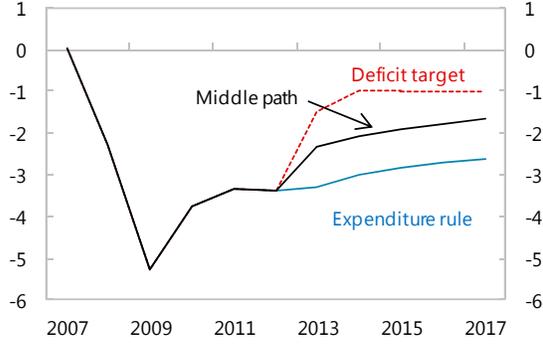


Figure 2. Debt Trajectory Under Each Rule
(Percent of GDP)

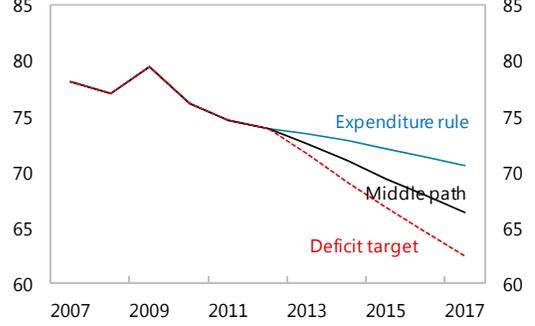


Figure 3. Real Expenditure Growth Limit
(Percent)

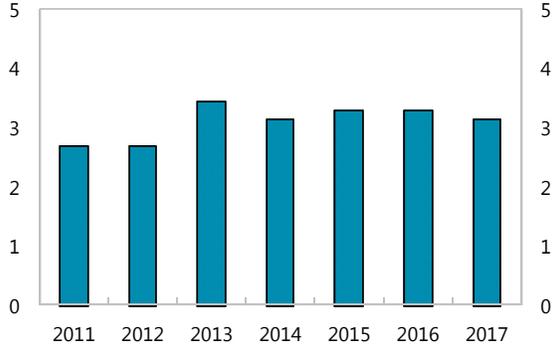


Figure 4. Debt Trajectory with Expenditure Rule Alone Under Different Growth Assumptions (percent of GDP)

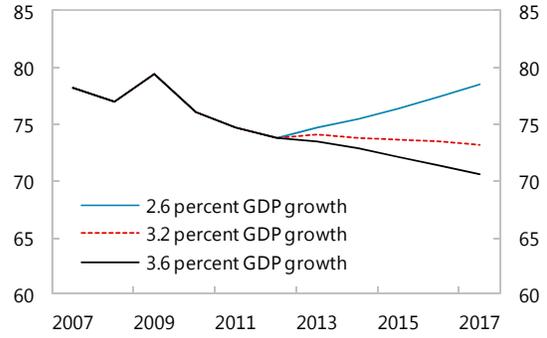
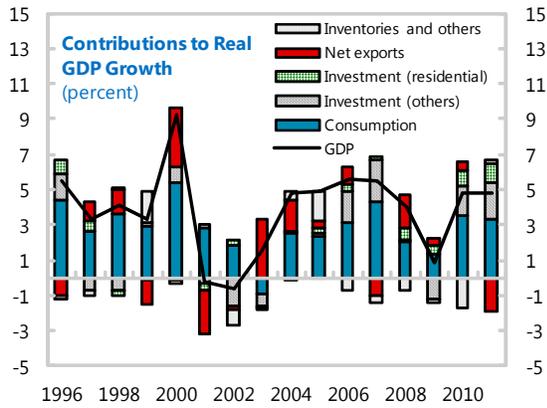
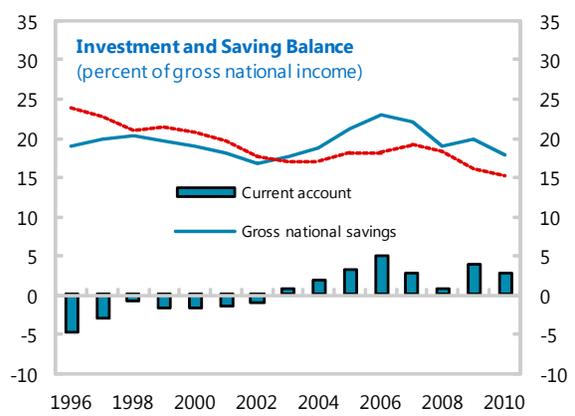


Figure 1. Israel: The Long-Term View, 1996–2011

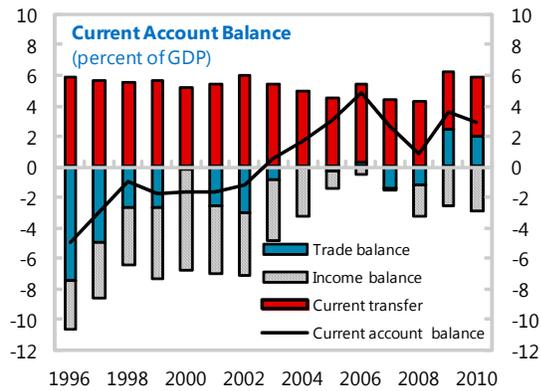
Growth was impressive, even in 2008–09.



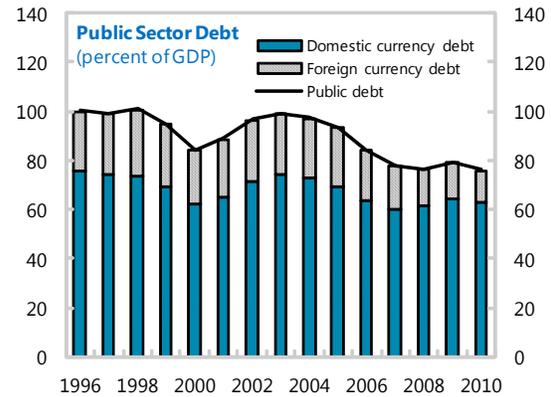
Investment and saving rates remained high...



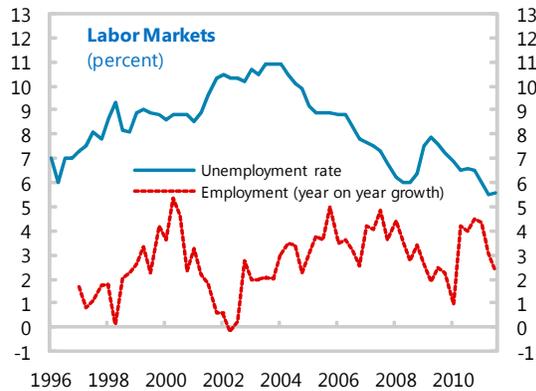
...and the current account balance shifted to surplus.



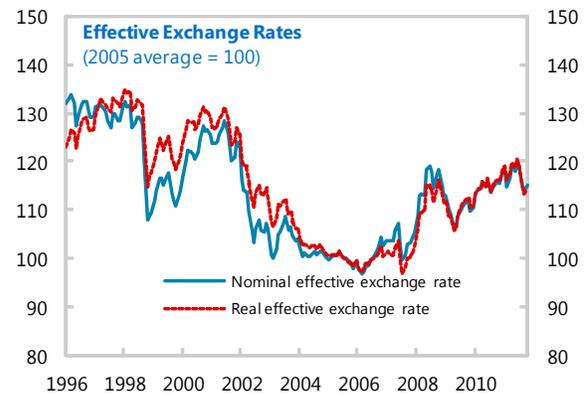
Public debt declined...



...and unemployment fell to a historic low...



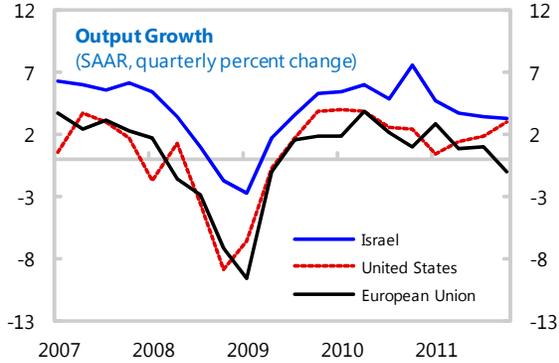
...all in the context of sizable swings in the shekel.



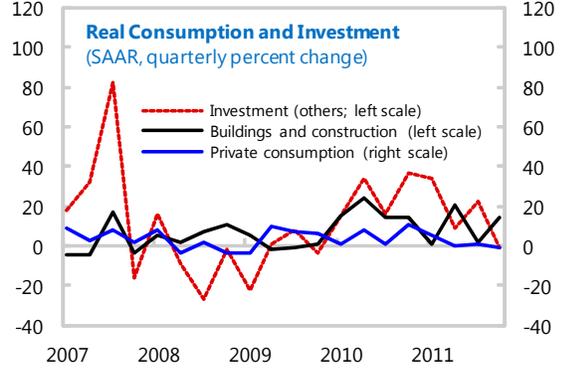
Sources: Haver Analytics; Bank of Israel; and IMF staff calculations.

Figure 2. Israel: Recent Economic Developments, 2007–11

Output growth has slowed in late 2011...



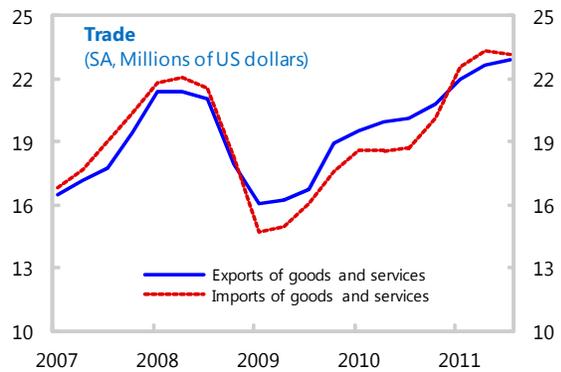
...as have consumption and investment...



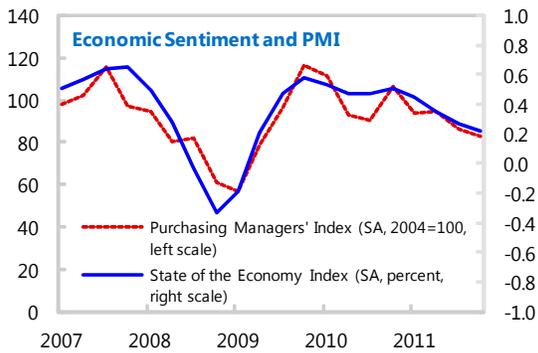
...and production and retail sales...



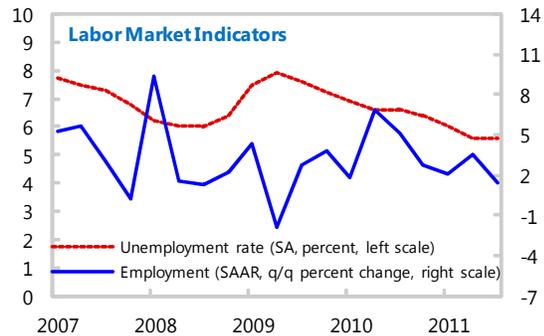
...and external trade.



Sentiment and business cycle indicators are also weakening...



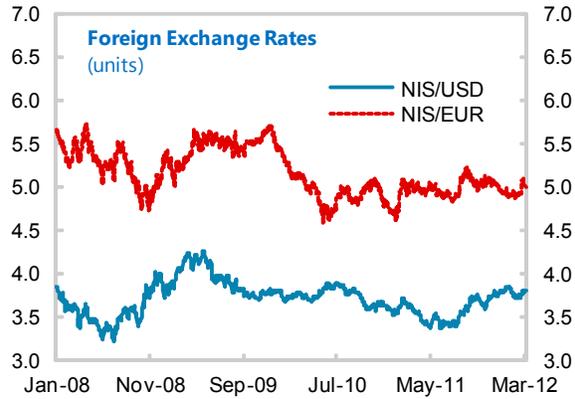
...and the downward trend of unemployment has recently halted, with employment also slowing.



Sources: Bank Hapoalim/Israeli Purchasing and Logistics Managers Association; Bureau of Economic Analysis; Central Bureau of Statistics; and Statistical Office of the European Communities.

Figure 3. Israel: Selected Financial Market Indicators, 2008–12

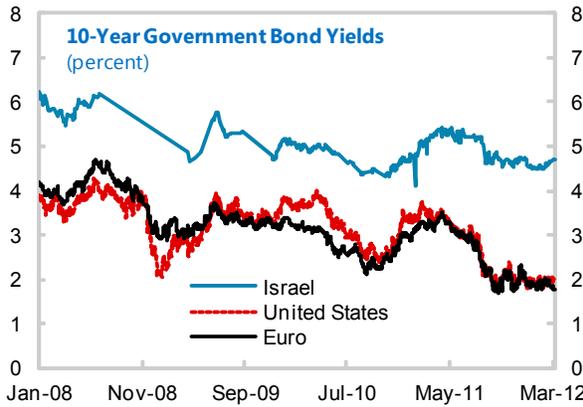
The shekel has dropped in recent months...



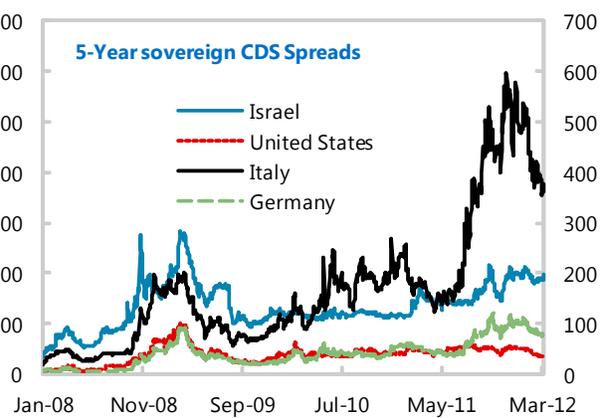
...as have stock markets,...



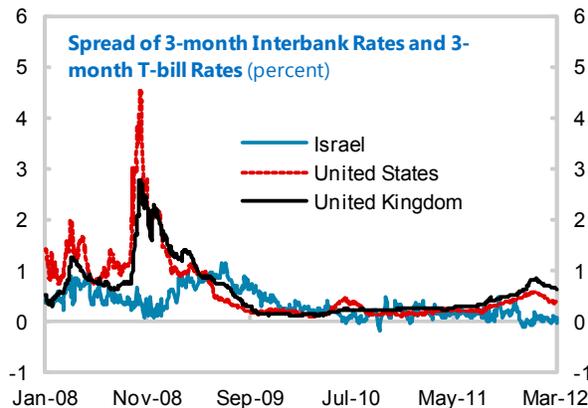
...and Israeli sovereign bond yields.



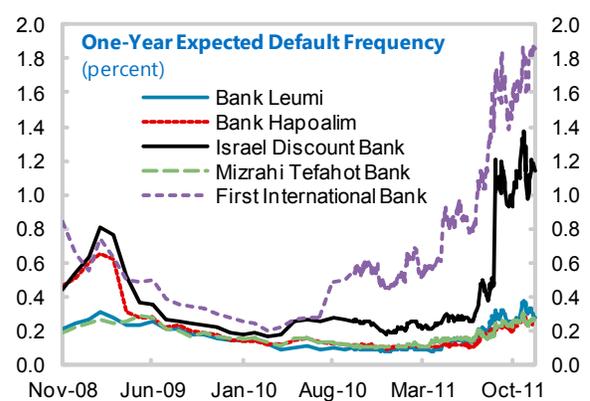
...despite a moderate increase in Israeli sovereign CDS spreads.



Interbank markets remain stable.

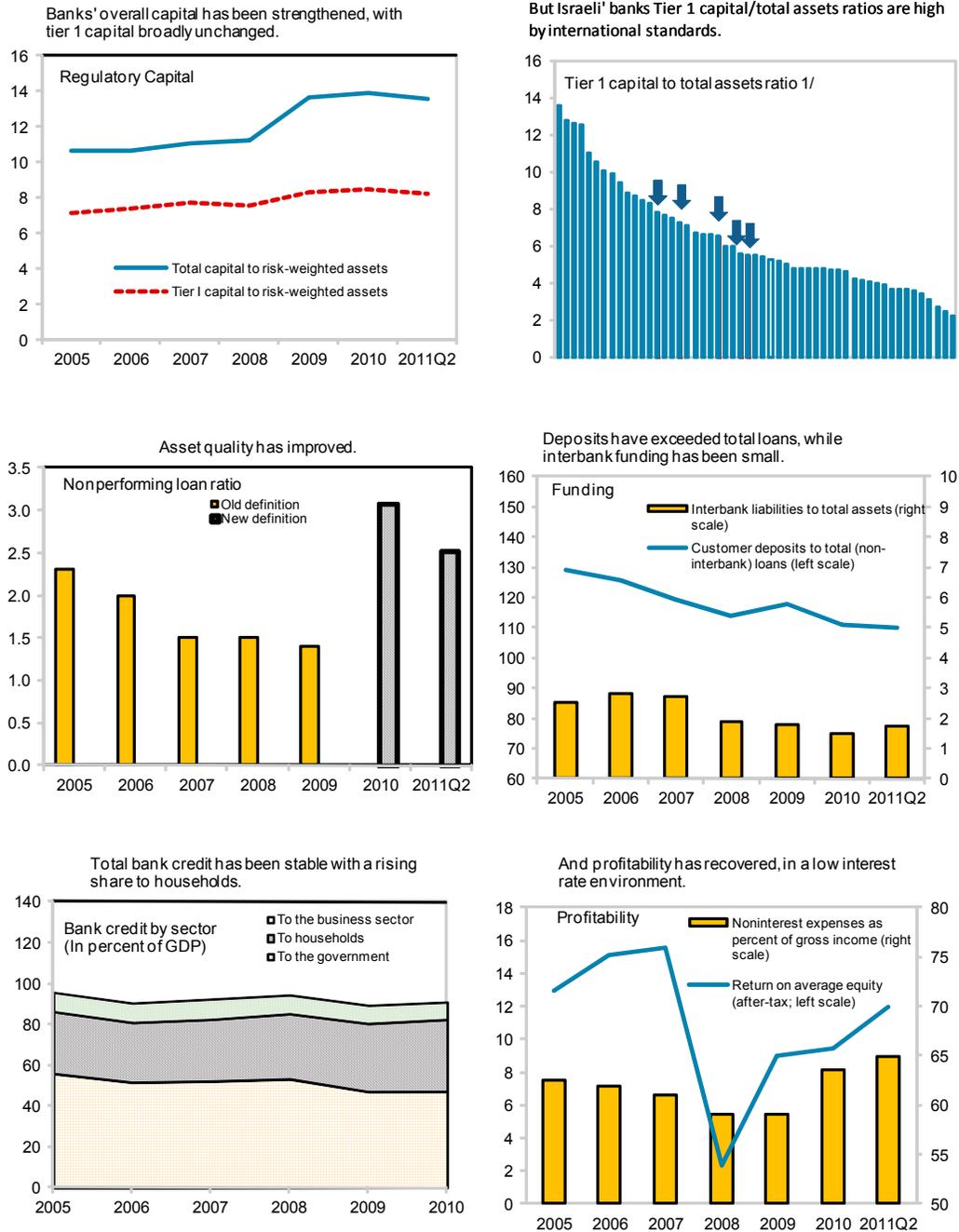


...but market indicators for default probabilities for some banks have risen.



Sources: Bloomberg; Datastream; Moody's KMV; and Tel Aviv Stock Exchange.

Figure 4. Israel: Performance of Banks, 2005–11

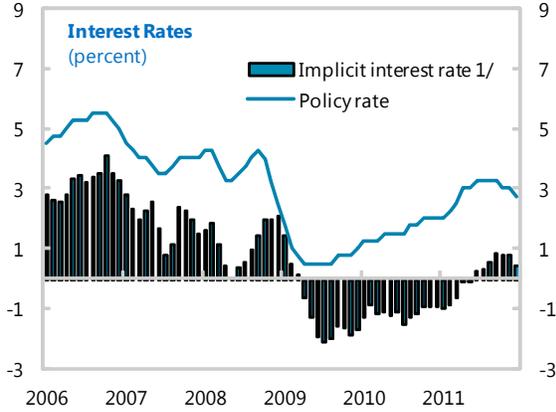


Source: The Bank of Israel; and SNL database.

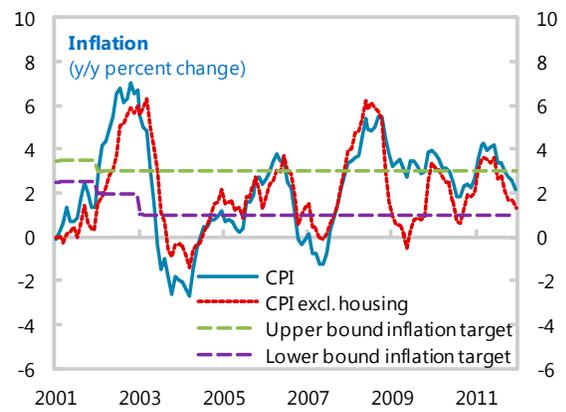
1/ Israeli banks are colored in red; the comparator samples consist of major banks in Europe, US, and Canada.

Figure 5. Israel: Inflation and Monetary Policy, 2007–11

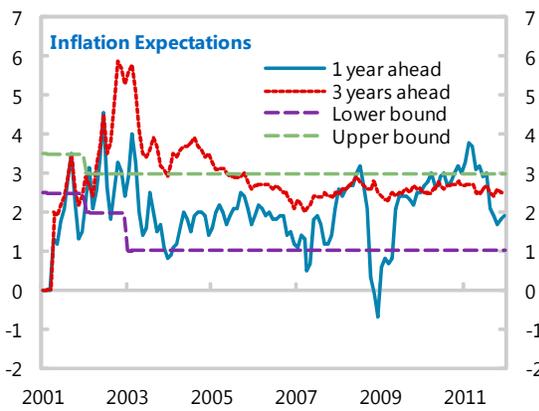
Recently, the BoI began a loosening cycle...



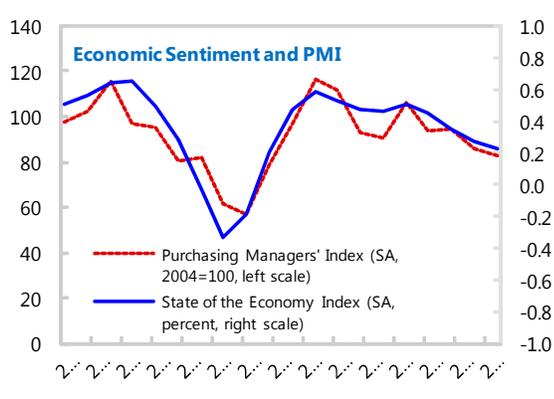
...with inflation back in its target range...



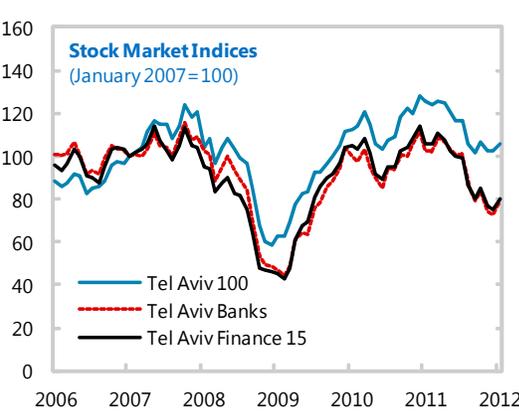
...and expected to remain there...



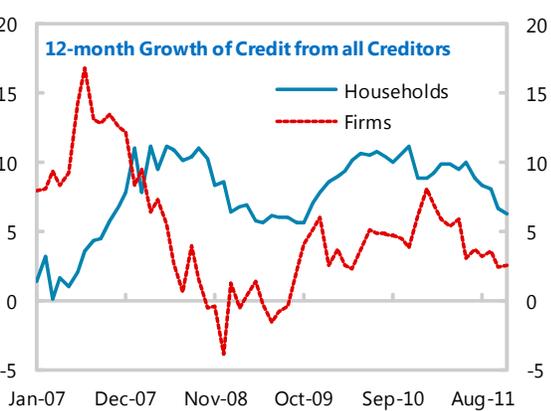
...thus supporting activity...



...economic prospects,...



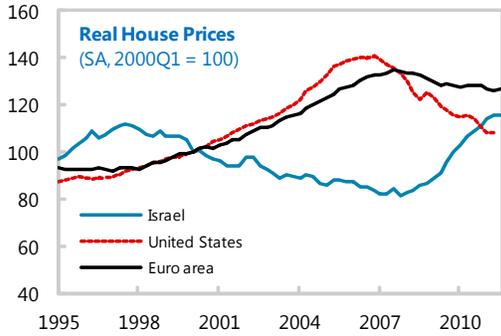
...and credit to the private sector.



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

Figure 6. Israel: Housing Markets, 2007–11

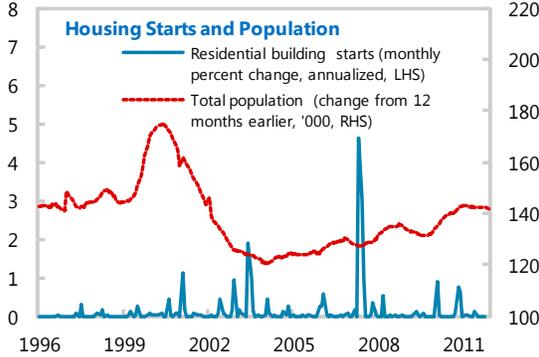
House prices rose sharply in 2007–10 but have stabilized recently...



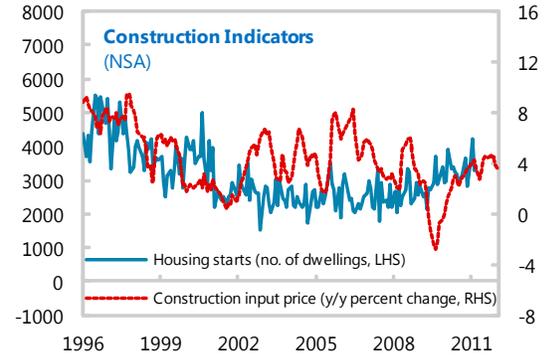
...while rental prices continue to rise.



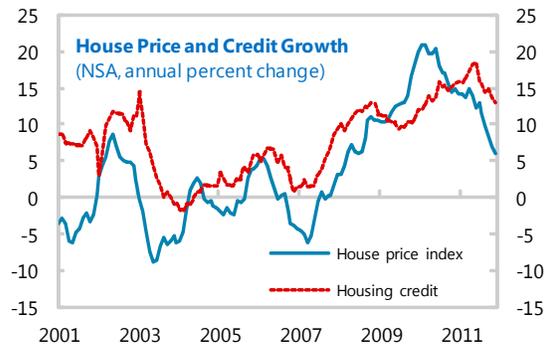
Housing starts are erratic....



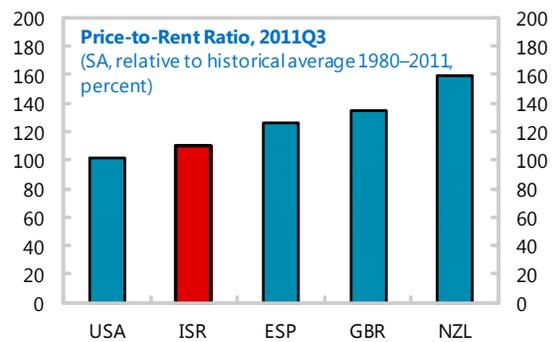
...with construction costs falling recently.



But demand...



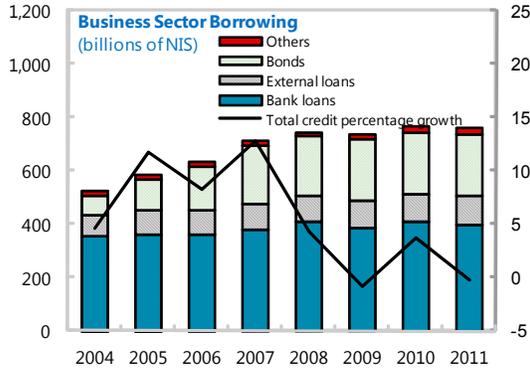
...and price-to-rent ratios remain elevated.



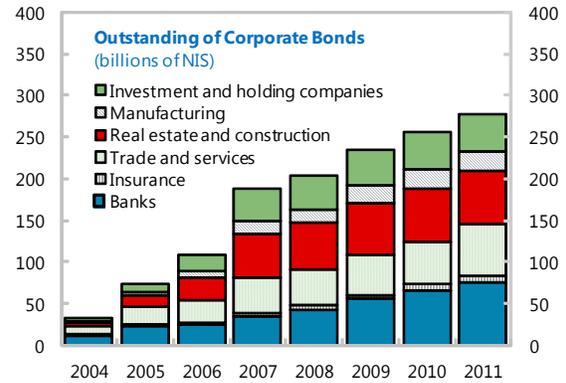
Sources: Bank of Israel; Central Bureau of Statistics; and Haver Analytics.

Figure 7. Israel: Corporate and Household Sectors, 2004-11

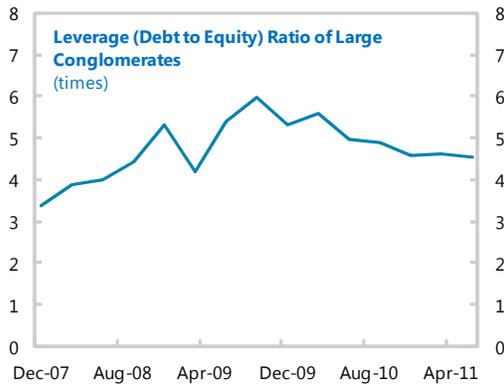
Corporate bond financing has grown sharply...



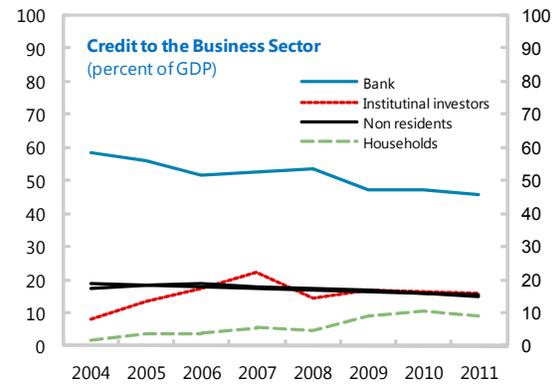
...particularly in the real estate and construction sector...



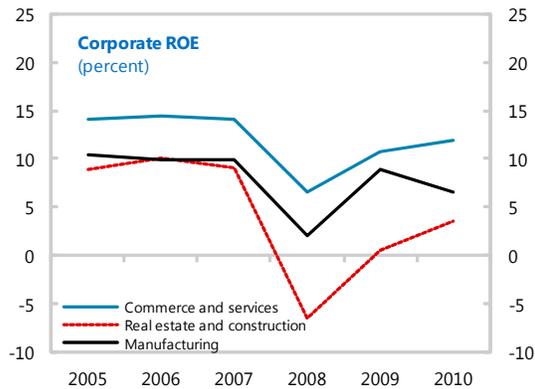
...and large conglomerates raised leverage, until recently.



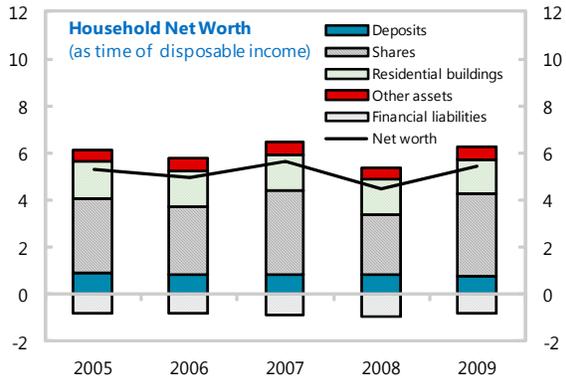
Institutional investors and households now play a large role in providing credits to business.



Corporate profitability has recovered but remains weaker than pre-crisis levels.



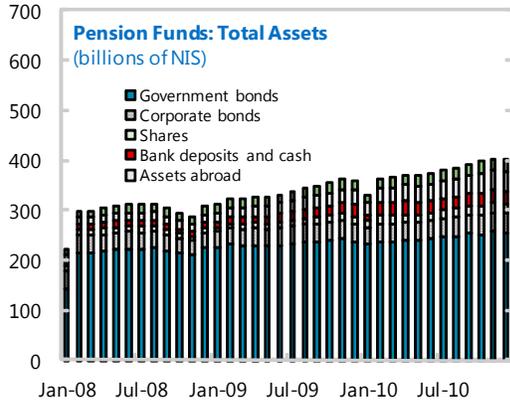
...while households' net worth position stayed at 6 times their disposable income.



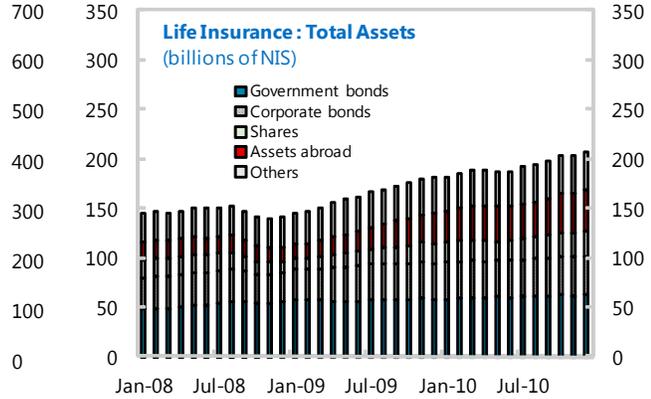
Sources: Bank of Israel; Israel Central Bureau of Statistics, and Haver Analytics.

Figure 8. Israel: Performance of Non-Bank Financial Sector, 2005-11

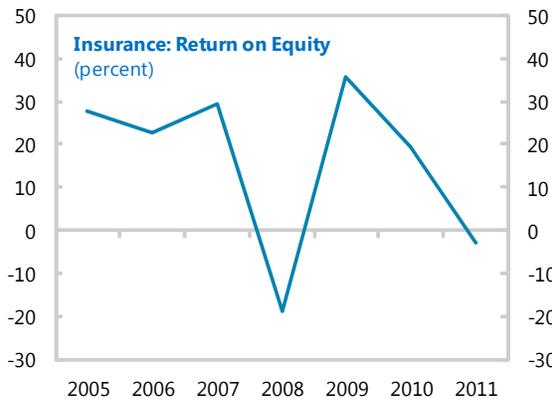
The value of pension fund assets slowly increased...



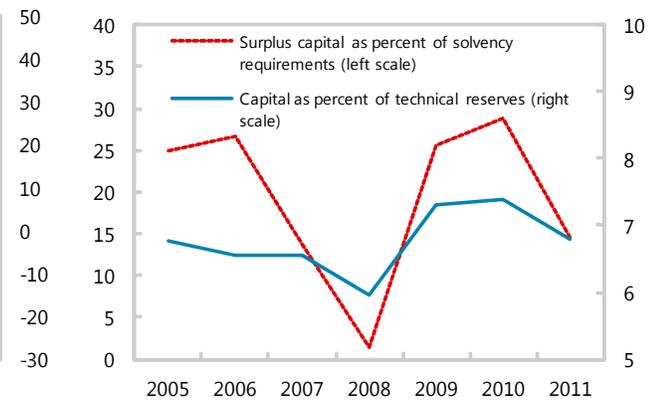
...as did the value of life insurance assets.



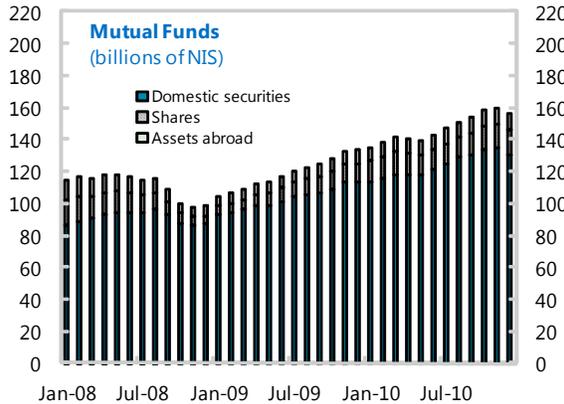
Insurance companies' profitability has weakened again...



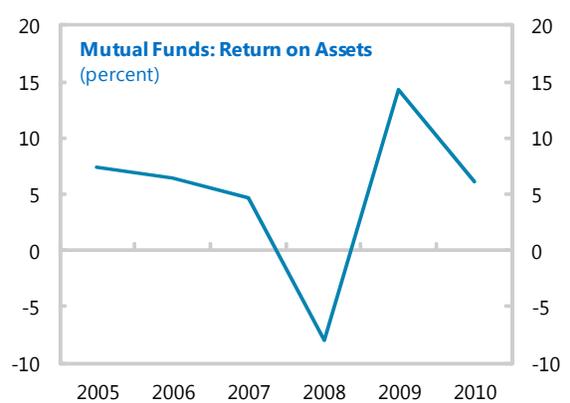
...as have their capital positions.



The value of mutual funds increased.

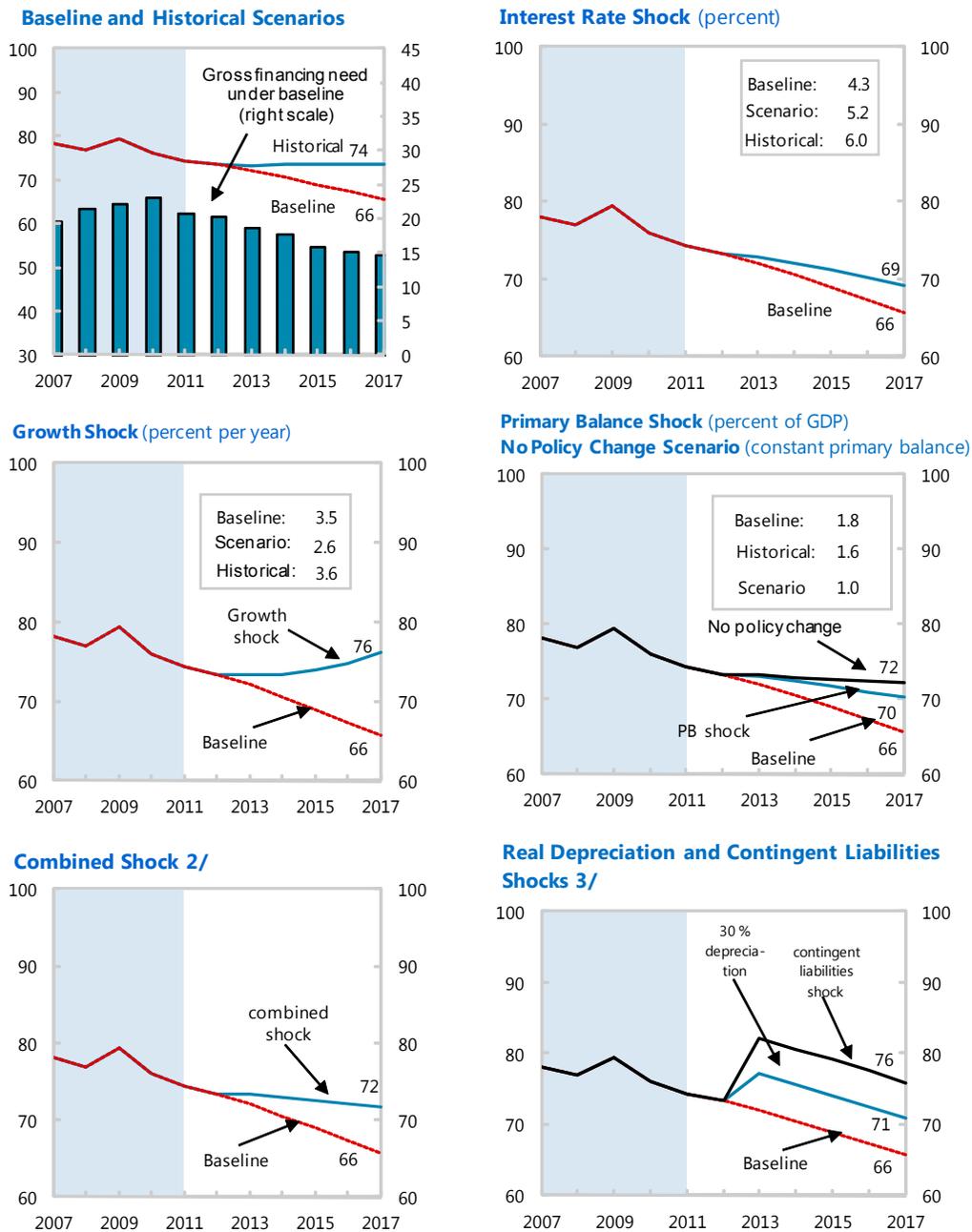


...despite some weakening in asset returns.



Sources: Bank of Israel; Israeli Ministry of Finance's Capital Markets, Insurance, and Savings Department; and Haver Analytics.

Figure 9. Israel: Public Sector Debt Sustainability Analysis, Bound Test 1/
(In percent of GDP; unless otherwise indicated)



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

Table 1. Israel: Selected Economic Indicators, 2007–13
(Percent change; unless otherwise indicated)

	2007	2008	2009	2010	2011 Est.	2012 Projections	2013
Real economy							
Real GDP	5.5	4.0	0.8	4.8	4.7	2.8	3.8
Domestic demand	6.6	2.2	0.0	4.4	7.2	3.3	2.9
Private consumption	6.3	2.8	1.4	5.3	3.6	1.5	2.5
Public consumption	3.3	1.9	2.4	2.5	3.7	3.4	2.1
Gross capital formation	11.7	0.9	-7.0	4.0	22.8	7.8	4.9
Foreign demand (contribution to real GDP growth)	-1.0	1.9	0.4	0.5	-2.2	-0.3	0.9
Unemployment rate (percent)	7.3	6.2	7.6	6.6	5.7	6.0	5.8
Overall CPI (end period)	3.4	3.8	4.0	2.6	2.2	2.0	2.0
Saving and investment balance							
Gross national saving (percent of GDP)	23.1	19.6	20.3	18.1	18.1	18.7	19.7
Foreign saving (percent of GDP)	-2.7	-0.9	-3.6	-2.9	0.6	1.0	0.2
Gross domestic investment (percent of GDP)	20.3	18.7	16.7	15.2	18.7	19.7	19.9
Money and credit (period average)							
M1	15.4	14.2	50.8	12.1	4.0	...	...
M3	12.9	8.0	14.1	6.6	...	...	...
Interest rates (percent)							
Bank of Israel policy rate (end year)	4.00	2.50	1.00	2.00	2.75	...	...
10-year government bond yield (average)	5.55	5.92	5.06	4.68	4.98	...	...
Public finance (percent of GDP)							
Central government							
Revenues and grants	34.0	31.4	28.0	28.8	29.6	29.8	30.8
Total expenditure	34.0	33.7	33.3	32.6	32.9	33.2	33.1
Overall balance	0.0	-2.3	-5.3	-3.7	-3.3	-3.4	-2.3
General government							
Overall balance	-1.3	-3.3	-6.0	-4.6	-4.0	-3.5	-2.6
Debt	78.1	77.0	79.4	76.1	74.4	73.5	72.3
Of which: foreign currency external debt	17.2	14.9	14.4	12.7	12.8	11.2	10.9
Balance of payments (percent of GDP)							
Exports of goods and services	42.4	40.3	34.7	36.9	36.9	33.6	33.8
Real growth rate (percent)	9.2	6.6	-12.6	13.4	4.9	-4.4	6.0
Imports of goods and services	43.9	41.6	32.3	34.9	37.8	35.1	34.4
Real growth rate (percent)	11.7	2.3	-14.0	12.6	10.6	-3.7	3.7
Trade balance	-1.5	-1.3	2.4	1.9	-1.2	-1.6	-0.8
Oil Imports (billions of U.S. dollars)	8.9	12.8	8.1	10.4	13.6	14.2	14.3
Current account	2.7	0.9	3.6	2.9	-0.6	-1.0	-0.2
Foreign reserves (end period, billions of U.S. dollars)	28	43	61	71	75	77 2/	77
Exchange rate							
Exchange rate regime				Free floating			
NIS per U.S. dollar	4.1	3.6	3.9	3.7	3.6	...	...
Nominal effective exchange rate (2005=100)	103.6	115.1	109.8	115.1	...	...	...
Real effective exchange rate (2005=100)	100.6	112.1	109.9	115.4	...	...	...

Social Indicators (reference year)

GDP per capita (current U.S. dollars, 2009): 27,656; Population density (2009): 343.9 inhabitants per square kilometer; Poverty rate (2008)^{1/}: 19.9 percent; Fertility rate (2009): 3.0 per woman; Life expectancy at birth (2009): 79.7 (male) and 83.5 (female); Infant mortality rate (2009): 3.4 per 1,000 births; Physicians (2007): 3.6 per 1,000 people; CO2 emissions (tons per capita, 2007): 9.3.

Sources: Haver Analytics; Bank of Israel, Central Bureau of Statistics; World Bank; and IMF staff estimates and projections.

1/ Poverty rate from National Insurance Institute of Israel.

2/ As at end-February 2012.

Table 2. Israel: Balance of Payments Accounts, 2007–17
(In billions of U.S. dollars; unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					Est.	IMF staff projections					
Current account balance	4.6	1.8	7.0	6.3	-1.5	-2.4	-0.5	0.7	1.5	2.4	3.3
Merchandise	-5.2	-6.7	0.3	-1.9	-7.3	-8.1	-6.9	-6.4	-6.3	-6.2	-6.2
Exports, f.o.b.	50.8	57.7	46.3	56.1	65.7	61.0	64.0	68.9	73.6	79.1	85.4
Imports, f.o.b.	-56.0	-64.4	-46.0	-58.0	-73.0	-69.1	-70.9	-75.2	-79.9	-85.3	-91.6
Civilian imports	-53.6	-61.9	-44.1	-56.0	-71.1	-67.2	-69.0	-73.3	-78.0	-83.4	-90.7
Military imports	-2.4	-2.5	-1.9	-2.1	-1.9	-1.9	-1.9	-1.9	-1.9	-1.9	-0.9
Services	2.7	4.1	4.3	6.2	4.4	4.2	4.9	5.6	6.3	7.1	8.0
Exports	20.3	23.9	21.4	24.2	26.3	26.0	27.8	30.4	33.3	36.7	40.5
Imports	-17.5	-19.8	-17.1	-18.1	-22.0	-21.8	-22.9	-24.8	-27.1	-29.6	-32.5
Factor Income	-0.3	-4.1	-5.1	-6.3	-6.0	-6.0	-6.0	-6.0	-6.0	-6.0	-6.0
Receipts	10.9	7.2	5.7	5.8	6.5	6.5	6.5	6.5	6.5	6.5	6.5
Payments	-11.1	-11.4	-10.8	-12.1	-12.5	-12.5	-12.5	-12.5	-12.5	-12.5	-12.5
Net transfers	7.3	8.5	7.4	8.4	7.5	7.5	7.5	7.5	7.5	7.5	7.5
Official	3.9	4.4	3.7	4.3	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Private	3.4	4.1	3.7	4.1	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Capital and financial account balance 2/	-3.6	13.8	6.1	2.6	4.5	4.6	0.5	-0.7	-1.5	-2.4	-3.3
Capital account	0.8	1.1	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial account 2/	-4.4	12.7	5.2	1.6	3.5	3.6	-0.5	-1.7	-2.5	-3.4	-4.3
Direct investment, net	0.2	3.7	2.7	-2.8	3.9	3.2	1.5	1.0	1.0	1.0	0.8
Foreign direct investment abroad	-8.6	-7.2	-1.7	-8.0	-4.2	-3.0	-4.5	-5.0	-5.0	-5.5	-5.7
Foreign direct investment in Israel	8.8	10.9	4.4	5.2	8.1	6.2	6.0	6.0	6.0	6.5	6.5
Portfolio investment, net	-1.5	-0.6	-5.9	0.1	0.2	0.5	-0.7	-1.2	-1.6	-2.0	-2.3
Other investment	-3.1	9.7	8.3	4.3	-0.6	-0.1	-1.3	-1.5	-1.9	-2.4	-2.8
Change in reserves 3/	1.7	-14.2	-16.6	-11.8	-4.0	-2.2	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-2.7	-1.5	3.5	2.9	1.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Memorandum items:</i>											
Current account balance (percent of GDP)	2.7	0.9	3.6	2.9	-0.6	-1.0	-0.2	0.3	0.5	0.8	1.1
Gross external debt (percent of GDP)	54.4	43.8	47.9	48.7	44.2	44.9	44.4	43.9	43.6	43.3	42.5
Foreign reserves (billions of US dollars) 4/	28	43	61	71	75	77	77	77	77	77	77
GDP (billions of U.S. dollars)	167	202	195	218	243	248	259	271	284	299	315

Sources: Central Bureau of Statistics.

1/ IMF staff estimates and projections.

2/ Excludes reserve assets.

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

4/ Data for 2012 is as at end-February 2012.

Table 3. Israel: International Investment Position, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011 Sept.
(In billions of US dollars)									
Israeli assets abroad	91.1	107.8	125.2	163.7	190.6	187.9	220.3	250.3	257.0
Of which: reserve assets	26.2	26.9	27.9	29.0	28.4	42.5	60.6	70.9	76.3
Israeli liabilities abroad	121.6	135.7	153.2	177.2	207.7	191.8	226.9	251.2	241.7
Net international investment position	-30.5	-27.9	-28.0	-13.5	-17.1	-3.8	-6.6	-0.9	15.3
(In percent of GDP)									
Israeli assets abroad	76.7	85.2	93.5	112.5	114.0	93.2	113.1	114.9	106.0
Direct investment	11.0	14.6	17.2	27.0	29.8	27.0	29.4	30.4	28.6
Portfolio investment	12.6	14.7	19.8	24.3	25.2	16.6	25.4	28.4	23.6
Equity securities	3.0	4.0	6.5	9.2	10.1	6.4	13.0	16.0	13.1
Bonds and notes	9.7	10.7	13.4	15.1	15.1	10.2	12.4	12.4	10.5
Other investment	30.9	34.6	35.5	41.2	42.0	28.6	27.2	23.6	22.5
Net financial derivatives	...	...	...	0.1	0.0	0.0	0.0	-0.1	-0.1
Reserve assets	22.0	21.3	20.8	19.9	17.0	21.1	31.1	32.6	31.5
Israeli liabilities abroad	102.4	107.2	114.3	121.8	124.3	95.1	116.4	115.4	99.7
Direct investment	22.5	23.4	27.3	36.1	36.2	30.9	35.5	35.7	32.9
Portfolio investment	36.7	42.6	48.6	47.8	52.1	35.4	48.8	49.5	38.2
Equity securities	19.8	24.1	31.0	27.9	35.7	22.3	35.2	32.7	23.5
Bonds and notes	17.0	18.5	17.6	19.9	16.4	13.1	13.6	16.8	14.7
Other investment	43.1	41.3	38.5	37.9	35.9	28.8	32.1	30.1	28.6
Net international investment position	-25.7	-22.0	-20.9	-9.3	-10.2	-1.9	-3.4	-0.4	6.3
(In percent of GDP)									
<i>Memorandum items:</i>									
Gross external debts	62.3	62.0	58.4	60.1	54.4	43.8	47.9	48.7	44.9
Of which: short-term debts	...	...	...	25.4	23.9	20.0	21.7	25.0	...
Net external debts	-3.9	-8.3	-15.1	-20.9	-24.1	-20.2	-27.6	-25.3	-24.2

Source: Haver Analytics.

Table 4. Israel: Financial System Structure, 2005–10

	2005			2008			2009			2010				
	Number of Institutions/ funds	Total assets In billions of NIS	Percent of GDP	Number of Institutions /funds	Total assets In billions of NIS	Percent of GDP	Number of Institutions/ funds	Total assets In billions of NIS	Percent of GDP	Institutions /funds	Number of Branches	Employees	Total assets In billions of NIS	Percent of GDP
A. Banks														
Five major banks, consolidated	5	859.2	142.9	5	1,012.8	140.0	5	1,042.2	136.0	5	1,208	47,690	1,068.8	131.5
Bank Leumi Le Israel	1	272.8	45.4	1	310.8	43.0	1	321.8	42.0	1	322	13,339	328.2	40.4
Bank Hapoalim	1	273.3	45.5	1	306.8	42.4	1	309.6	40.4	1	295	13,875	320.9	39.5
Israel Discount Bank	1	154.8	25.7	1	182.2	25.2	1	187.8	24.5	1	252	10,219	185.8	22.9
Mizrahi Tefahot Bank	1	86.3	14.4	1	114.0	15.8	1	118.4	15.5	1	163	5,170	133.3	16.4
First International Bank of Israel	1	71.9	12.0	1	98.9	13.7	1	104.6	13.6	1	176	5,087	100.7	12.4
Other banks	3	42.1	7.0	3	49.0	6.8	3	46.2	6.0	3	51	1,666	52.8	6.5
B. Non-bank financial institutions		667.7	111.1		765.2	105.8		959.8	125.3				1,068.0	131.4
Provident and severance pay funds	104	165.6	27.5	87	145.4	20.1	66	187.1	24.4	66	...	...	194.1	23.9
Advanced study funds	...	72.0	12.0	...	72.6	10.0	...	98.1	12.8	...	...	...	112.0	13.8
Old pension funds	18	142.5	23.7	18	237.2	32.8	18	267.0	34.8	18	...	...	287.2	35.3
New pension funds	18	44.7	7.4	13	71.0	9.8	10	93.5	12.2	10	...	...	111.3	13.7
Mutual funds	918	124.6	20.7	1,185	98.1	13.6	...	133.2	17.4	1,247	...	...	156.6	19.3
Assured yield life insurance plans	...	47.3	7.9	...	54.9	7.6	...	60.7	7.9	...	...	...	66.1	8.1
Profit sharing life insurance plans	...	71.1	11.8	...	86.1	11.9	...	120.1	15.7	...	...	...	140.7	17.3
Total financial system (A+B)	...	1,526.9	254.0	...	1,778.0	245.7	...	2,002.0	261.3	...	...	...	2,136.8	262.8
Memorandum items:														
GDP (NIS billions)	...	...	601	...	...	724	...	...	766	...	...	...	...	813

Sources: Bank of Israel, Ministry of Finance, and Israel Securities Authority.

Table 5. Israel: Financial Soundness Indicators—Five Major Banks, 2005–11
(In percent; unless otherwise indicated)

	2005	2006	2007	2008	2009	2010	2011 Q2
Capital Adequacy							
Regulatory capital to risk-weighted assets 2/	10.6	10.7	11.1	11.3	13.6	13.9	13.6
<i>Highest bank minus lowest bank</i>	2.4	0.7	1.2	2.0	2.2	1.6	1.1
Regulatory Tier I capital to risk-weighted assets 2/	7.2	7.4	7.7	7.5	8.3	8.5	8.3
<i>Highest bank minus lowest bank</i>	1.6	1.2	2.0	2.0	1.8	1.1	1.0
Capital as percent of assets (leverage ratio)	5.6	5.9	6.1	5.8	6.3	6.5	6.3
<i>Highest bank minus lowest bank</i>	1.5	1.5	1.0	1.3	1.4	1.6	1.7
Asset quality and exposure							
Nonperforming loans to total gross loans	...	...	...	...	...	3.1	2.5
<i>Highest bank minus lowest bank</i>	...	...	...	...	...	3.0	2.4
Nonperforming loans net of loan-loss provisions to capital	...	...	...	...	...	23.3	20.4
<i>Highest bank minus lowest bank</i>	...	...	...	...	...	22.7	19.5
Sectoral distribution of bank credit (percent)							
Industry	13.7	13.0	12.4	13.0	11.1	10.5	10.6
Construction and real estate	15.7	15.2	15.8	16.9	16.8	16.7	16.5
Commerce	9.5	8.7	8.4	8.5	7.5	7.5	8.0
Finance services	12.4	13.0	15.8	12.5	11.8	11.7	10.6
Households	30.3	33.5	31.2	32.8	37.1	38.3	39.4
Of which: mortgages	19.3	20.5	18.7	19.8	22.8	24.2	25.3
Others	18.4	16.7	16.4	16.3	15.7	15.2	15.0
Earnings and profitability							
Return on average assets (after tax)	0.7	0.9	0.9	0.1	0.5	0.6	0.7
<i>Highest bank minus lowest bank</i>	0.8	0.7	0.4	0.9	0.2	0.3	0.4
Return on average equity (after tax)	13.0	15.1	15.6	2.3	9.0	9.4	12.0
<i>Highest bank minus lowest bank</i>	11.8	8.4	3.3	15.2	3.5	4.8	4.7
Net interest income as percent of gross income	62.5	61.9	61.1	59.0	59.0	63.5	64.9
<i>Highest bank minus lowest bank</i>	3.4	3.9	7.5	28.3	5.2	7.8	5.1
Trading and fee income as percent of gross income	30.2	32.0	34.6	40.0	38.5	35.3	34.6
<i>Highest bank minus lowest bank</i>	3.1	3.7	4.9	28.8	5.2	7.2	4.8
Noninterest expenses as percent of gross income	62.5	61.9	61.1	59.0	59.0	63.5	64.9
<i>Highest bank minus lowest bank</i>	19.8	22.7	16.1	41.8	10.0	16.2	15.4
Personnel expenses as percent of noninterest expenses	60.0	62.3	59.6	58.0	57.1	57.4	60.6
<i>Highest bank minus lowest bank</i>	4.2	4.5	1.0	1.0	7.6	3.7	4.4
Liquidity							
Liquid assets as percent of total assets	...	...	...	30.1	32.4	28.9	59.6
<i>Highest bank minus lowest bank</i>	...	...	...	4.4	7.3	7.2	24.8
Liquid assets as percent of short-term liabilities	...	...	...	63.6	65.6	28.8	30.4
<i>Highest bank minus lowest bank</i>	...	...	...	22.3	19.0	8.7	11.4
Customer deposits as a percent of total (non-interbank) loans	129.2	125.7	119.5	113.8	117.6	111.0	110.0
<i>Highest bank minus lowest bank</i>	45.0	40.4	26.3	15.8	22.7	15.9	18.0
Interbank assets to total assets	10.6	11.5	9.8	4.3	2.8	2.3	...
<i>Highest bank minus lowest bank</i>	1.6	4.3	2.9	2.9	2.9	1.4	...
Interbank liabilities to total assets	2.5	2.8	2.7	1.9	1.8	1.5	1.7
<i>Highest bank minus lowest bank</i>	2.6	3.2	1.9	1.5	0.9	1.0	0.9
Foreign exchange risk							
Foreign currency-denominated loans as percent of total loans	...	...	18.1	16.7	14.1	12.5	...
Foreign currency-indexed loans as percent of total loans	...	...	1.0	0.7	0.7	0.7	...
Foreign currency-denominated deposits as percent of total loans	...	...	31.2	28.1	26.9	24.4	...
Of which: non-residents	...	...	12.4	11.0	10.2	8.5	...
Foreign currency-indexed deposits as percent of total loans	...	...	0.8	0.5	0.3	0.2	...
Liquid foreign currency assets to short-term foreign currency liabilities:	...	...	...	64.6	44.0	44.4	44.7

Sources: Bank of Israel, and IMF staff estimates.

1/ The market share of five major banks (in assets) is about 95 percent of the whole banking system.

2/ From 2009, the calculation of capital base follows rules under Basel II.

Table 6. Israel: Central Government Accounts, 2007–14
(In percent of GDP; unless otherwise indicated)

	2007	2008	2009		2010		2011		2012		2013	2014
	Act.	Act.	Budget	Act.	Budget	Act.	Budget	Staff proj.	Budget	Staff proj.	Staff proj.	Staff proj.
Revenues and grants	34.0	31.4	28.8	28.0	29.1	28.8	30.3	29.6	30.8	29.8	30.8	30.9
Tax revenues	27.8	25.3	23.2	23.2	23.5	24.0	24.9	24.3	25.5	24.8	24.6	24.7
Income Tax revenues	13.5	11.4	...	9.6	...	9.8	...	10.0	...	10.5	10.4	10.4
Taxes on Goods and services	11.9	11.8	...	11.6	...	12.1	...	12.1	...	12.1	12.1	12.2
Value Added Tax	7.8	7.8	...	7.7	...	8.0	...	7.6	...	7.6	7.7	7.7
Grants	2.0	1.9	...	1.5	...	1.7	...	1.7	...	1.4	1.4	1.4
Other revenue 2/	2.2	2.0	...	1.7	...	1.6	...	1.7	...	1.7	1.9	1.9
Loans from NII	2.1	2.1	...	1.6	...	1.4	...	1.8	...	1.9	1.9	1.9
Assumed Adjustment											1.0	1.0
Total Expenditure	34.0	33.7	34.7	33.3	34.6	32.6	33.3	32.9	32.8	33.2	33.1	32.9
Expense	34.1	33.8	...	33.4	...	32.7	...	33.0	...	33.9	33.9	34.0
Compensation of employees	5.8	5.7	...	5.6	...	5.6	...	6.5	...	6.6	6.6	6.6
Use of goods & services	6.3	6.2	...	5.9	...	5.9	...	5.9	...	6.4	6.4	6.6
Consumption of fixed capital (CFC)	0.3	0.3	...	0.3	...	0.3	...	0.3	...	0.3	0.3	0.3
Interest	4.8	4.6	4.8	4.5	4.9	4.4	4.3	4.4	4.2	4.4	4.4	4.3
Subsidies	0.8	0.8	...	0.8	...	0.7	...	0.7	...	0.7	0.7	0.7
Grants	9.4	9.4	...	9.2	...	9.0	...	8.1	...	8.1	8.1	8.1
Social benefits	3.1	3.0	...	3.1	...	3.1	...	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	0.0	0.0
Other	3.5	3.8	...	3.9	...	3.6	...	4.0	...	4.3	4.3	4.3
Net acquisition of nonfinancial assets	-0.1	-0.1	...	-0.1	...	-0.1	...	-0.1	...	-0.1	-0.1	-0.1
Required cumulative adjustment	...	...	...	...	...	...	...	0.0	...	0.5	0.7	0.9
Overall balance	0.0	-2.3	-5.9	-5.3	-5.5	-3.7	-2.9	-3.3	-2.0	-3.4	-2.3	-2.0
Financing	0.2	2.5	6.0	5.2	2.0	3.7	2.9	3.3	2.0	3.4	2.3	2.0
Net acquisition of financial assets	1.8	1.3	0.3	-0.3	0.6	1.6	1.1	1.9	0.7	0.7	0.5	0.5
Net incurrence of liabilities	-1.6	1.1	5.6	5.5	1.4	2.2	1.9	1.4	1.3	2.7	1.8	1.6
Domestic	-0.7	2.4	5.0	4.9	1.5	2.2	1.6	1.1	1.2	2.7	1.7	1.4
External	-0.8	-1.3	4.4	0.6	-0.1	-0.1	0.3	0.3	0.0	0.0	0.1	0.1
<i>Memorandum items:</i>												
Primary spending	29.1	29.0	30.0	28.8	29.8	28.2	29.0	28.5	28.6	28.8	28.8	28.7
Defence spending	7.5	7.3	6.6	6.7	6.9	6.3	6.3	6.8	6.1	6.1	6.1	6.1
Primary civilian spending	21.6	21.8	23.4	22.0	22.9	21.8	22.7	21.7	22.5	22.7	22.6	22.5
Primary balance	4.4	1.9	-1.2	-1.2	-0.6	0.3	1.3	0.8	2.2	0.7	1.8	2.0
General government balance	-1.3	-3.3	...	-6.0	...	-4.6	...	-4.0	...	-3.5	-2.6	-2.3
Cyclically adjusted primary balance	3.1	0.5	...	-0.6	...	-0.2	...	-0.1	...	0.2	1.0	1.3
Deficit limit	...	...	...	6.0	...	5.5	...	3.0	...	2.0	1.5	1.0
Ceiling on the real expenditure growth	...	...	...	...	...	...	...	2.7	...	2.7	3.4	3.1
Public debt to GDP	78.1	77.0	...	79.4	...	76.1	...	74.3	...	73.4	72.1	70.5
GDP growth rate (in percent)	5.5	4.0	-1.0	0.8	1.5	4.8	3.8	4.7	4.0	2.8	3.8	3.6
Inflation (in percent)	0.5	4.6	4.1	3.3	3.0	2.7	2.2	3.4	2.2	1.7	2.0	2.0
Exchange rate (NIS per US\$)	4.1	3.6	...	3.9	...	3.7	3.8	3.6	3.8	3.7	3.7	3.7
GDP (in billions of NIS)	687	724	746	766	780	813	864	869	919	907	958	1,013
Real spending growth	...	-0.8	2.2	1.4	2.8	1.0	4.1	4.4	2.5	3.5	3.4	3.1
Nominal growth in public spending	...	4.39	6.4	4.7	5.9	3.8	6.4	8.0	4.8	5.3	5.4	5.1
Public consumption	15.9	15.9	...	15.7	...	15.5	...	16.7	...	17.6	17.7	17.8
Public savings (Rev-Expense)	0.0	-2.4	...	-5.3	...	-3.9	...	-3.4	...	-4.1	-3.1	-3.1
Public Saving-Investment balance	-0.1	-0.1	...	-0.1	...	-0.1	...	-0.1	...	-0.7	-0.8	-1.1

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

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

2/ Excludes the ILA profits from land sales, which have been recorded in financial transactions since 2009.

Table 7. Israel: Financial Soundness Indicators—Non Banks, 2005–11
(In percent; unless otherwise indicated)

	2005	2006	2007	2008	2009	2010	2011
Insurance sector							
Return on equity	28	23	29	-19	36	19	-3 1/
Net premiums as percent of capital	261	261	252	303	204	193	167 1/
Capital as percent of technical reserves	7	7	7	6	7	7	7 1/
Surplus capital as percent of required solvency 1 capital	25	27	14	1	25	29	15 1/
Liquid assets as percent of total assets	42	44	46	41	49	52	50 1/
Households							
Household assets as percent of disposable income	615	577	650	541	626	...	...
Of which: residential buildings	155	152	150	150	140	...	...
Household debt as percent of disposable income	62	58	59	61	60	62	62
Corporate sector							
Business sector borrowing (in percent of GDP)	97	97	104	103	96	94	89 1/
From residents	79	79	86	85	79	78	74 1/
From non residents	18	19	18	17	17	16	15 1/
Debt to equity ratio							
All nonfinancial corporate	197	188	221	265	226	230	235 2/
Of which: Manufacturing sector	124	118	118	130	111	112	112 2/
Construction corporate	299	275	278	411	374	296	289 2/
Net income to equity ratio							
All nonfinancial corporate	12	12	14	-1	9	12	...
Of which: Manufacturing sector	11	10	13	9	12	13	...
Construction corporate	15	19	25	-41	-2	15	...
Earning before interest and tax to equity ratio							
All nonfinancial corporate	21	19	23	11	14	21	...
Of which: Manufacturing sector	20	19	17	14	14	17	...
Construction corporate	24	18	44	-9	13	32	...
Equity markets							
Tel Aviv Stock Exchange Index 75 (annual percent change)	19	19	6	-68	150	16	-26
Equity prices of financial institutions (annual percent change)	36	8	0	-56	127	9	-34
Equity prices of real estate firms (annual percent change)	41	68	1	-80	125	15	-23
Equity prices of banks (annual percent change)	55	4	6	-56	114	7	-35
Market capitalization in percent of GDP	94	105	132	56	93	99	69
Corporate bond markets							
Corporate bond yields over government bond yields (in basis points)							
Real estate and construction	1.9	1.8	3.5	17.1	8.3	4.4	6.8 1/
Manufacturing	2.7	1.9	2.2	6.8	3.2	3.0	4.3 1/
Corporate bond outstanding (in billions of NIS)	73.3	109.0	188.3	202.3	234.7	255.7	276.0 1/
Average daily turnover (in millions of NIS)	214.6	274.4	672.8	923.8	899.4	882.2	892.0 1/
Real estate markets (prices; annual percent change)							
Average prices of owner occupied dwelling	11.3	-3.2	2.5	6.5	22.4	17.0	-1.2
Jerusalem	5.9	7.3	3.7	13.3	15.5	14.7	7.1
Tel Aviv	14.5	-7.9	14.9	10.7	34.1	16.9	-8.1

Sources: Bank of Israel, and IMF staff estimates.

1/ 2011 Q3.

2/ 2011 Q2.

Table 8. Israel: Public Debt Sustainability Framework, 2006–17

(In percent of GDP; unless otherwise indicated)

	Actual						Projections						Debt-stabilizing primary balance 9/
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
Baseline: Public sector debt 1/	84.7	78.1	77.0	79.4	76.1	74.3	73.4	72.1	70.5	69.0	67.4	65.7	0.0
Of which: foreign-currency denominated	21.5	17.2	14.9	14.4	12.7	12.8	11.2	10.8	10.5	10.2	9.8	9.5	
Change in public sector debt	-9.0	-6.6	-1.2	2.4	-3.4	-1.7	-0.9	-1.3	-1.6	-1.5	-1.6	-1.7	
Identified debt-creating flows (4+7+12)	-4.2	-4.7	-3.4	2.5	-0.8	-1.7	-1.3	-1.8	-2.1	-2.1	-2.1	-2.1	
Primary deficit	-3.8	-4.6	-1.9	1.0	-0.4	-0.8	-0.7	-1.7	-1.9	-2.1	-2.1	-2.1	
Revenue and grants	44.9	44.8	42.1	39.1	40.2	40.3	40.6	41.4	41.5	41.6	41.8	41.9	
Primary (noninterest) expenditure	41.1	40.1	40.1	40.1	39.8	39.5	39.8	39.8	39.6	39.6	39.7	39.7	
Automatic debt dynamics 2/	-0.6	-0.5	-0.9	2.2	-0.4	-0.6	1.2	0.4	0.3	0.4	0.4	0.4	
Contribution from interest rate/growth differential 3/	-0.4	1.2	1.3	0.7	0.4	-0.1	1.2	0.4	0.3	0.4	0.4	0.4	
Of which: contribution from real interest rate	4.5	5.5	4.3	1.3	4.0	3.3	3.1	3.0	2.8	2.8	2.8	2.8	
Of which: contribution from real GDP growth	-4.9	-4.4	-3.0	-0.6	-3.6	-3.3	-2.0	-2.7	-2.5	-2.4	-2.4	-2.3	
Contribution from exchange rate depreciation 4/	-0.2	-1.7	-2.2	1.4	-0.7	-0.5	...	...	...	...	...	...
Other identified debt-creating flows	0.2	0.4	-0.6	-0.6	0.0	-0.3	-1.8	-0.5	-0.5	-0.4	-0.4	-0.4	
Privatization receipts (negative)	0.2	0.9	0.2	0.2	0.5	0.8	0.2	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g., bank recapitalization)	0.0	-0.5	-0.9	-0.8	-0.5	-1.1	-2.0	-0.5	-0.5	-0.4	-0.4	-0.4	
Residual, including asset changes (2–3) 5/	-4.8	-1.9	2.3	-0.1	-2.6	0.0	0.4	0.5	0.5	0.5	0.5	0.4	
Public sector debt-to-revenue ratio 1/	188.5	174.6	183.0	203.3	189.3	184.3	181.0	174.0	169.7	165.7	161.3	156.8	
Gross financing need 6/	20.9	19.7	21.5	22.2	23.1	20.7	20.2	18.6	17.7	15.7	15.1	14.6	
In billions of U.S. dollars	30.5	32.9	43.5	43.3	50.3	50.4	50.1	48.2	48.1	44.7	45.2	45.9	
Scenario with key variables at their historical averages 7/							73.4	73.3	73.4	73.5	73.6	73.6	1.3
Scenario with no policy change (constant primary balance) in 2009–2014							73.4	73.2	72.9	72.7	72.5	72.2	0.1
Key macroeconomic and fiscal assumptions underlying baseline													
Real GDP growth (in percent)	5.6	5.5	4.0	0.8	4.8	4.7	2.8	3.8	3.6	3.6	3.7	3.6	
Average nominal interest rate on public debt (in percent) 8/	7.4	7.3	7.2	6.9	6.6	6.8	5.9	6.2	6.2	6.1	6.1	6.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.2	7.0	5.8	1.9	5.4	4.7	4.4	4.4	4.1	4.3	4.4	4.4	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	0.7	8.5	14.5	-8.8	5.3	4.4	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.1	0.4	1.3	5.0	1.2	2.1	1.5	1.8	2.0	1.8	1.7	1.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.1	3.0	4.0	0.7	4.2	3.9	3.6	3.6	3.2	3.5	3.9	3.9	
Primary deficit	-3.8	-4.6	-1.9	1.0	-0.4	-0.8	-0.7	-1.7	-1.9	-2.1	-2.1	-2.1	

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

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

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

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

5/ For projections, this line includes exchange rate changes.

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

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

ANNEX I: ISRAEL: RISK ASSESSMENT MATRIX

(Scale—low, medium, or high)

Nature/Source of Main Threats	Likelihood of Severe Realization in the Next Three Years	Expected Impact if Threat is Realized	Israel's Preparedness
<p>1. Sharp global growth slowdown and intensification of the Euro zone crisis</p>	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • Global growth momentum, notably in the United States and the euro area, could deteriorate sharply, leading to a decline in global trade. • Activity in the United States might suffer a further blow from a political impasse over fiscal consolidation and a weak housing market. The financial turmoil in the currently most vulnerable European countries could spread to larger euro area countries. 	<p style="text-align: center;">Medium/High</p> <ul style="list-style-type: none"> • As a small open economy, with substantial integration into global financial and goods markets, Israel's growth is highly dependent on the performance of the global economy, although its performance during the global crisis was reassuring. • Highly-leveraged large conglomerates dominate a large share of Israeli economic activities. The multiple failures of these conglomerates would distract supply chains, adversely affecting growth, and would also hit the banking system hard. 	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • Israel has strong fundamentals with foreign exchange reserves amounting to \$76 billion (equivalent to 120 percent of short-term external debts) and a positive net international investment position. • Israel's institutional framework has been strengthened, with a new fiscal rule, and a new central bank law. • Israel has ample space to ease monetary policy, [with use of discretionary foreign exchange intervention.]
<p>2. Failure of an systemically important financial institutions</p>	<p style="text-align: center;">Banks</p> <p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Major banks proved to be resilient through the global crisis. However, sudden failure of one bank for idiosyncratic reasons cannot be ruled out. 	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • 2011 FSAP Update found that the banking system is robust. However, the banking system is concentrated, and bankruptcies of large borrowers would erode bank capital significantly. 	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • The BoI has signaled its intention to raise the minimum capital requirements at a faster pace than Basel III timeline. • The institutional framework for cooperation among supervisory agencies remains weak. In particular, a formal macroprudential oversight mechanism does not exist. • There also remains ambiguity in crisis management framework, including the BoI's emergency liquidity assistance framework and a financial support mechanism in crisis prevention and resolution.
	<p style="text-align: center;">Non-bank financial institutions</p> <p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Insurers and pension funds experienced losses during the crisis. Their performance remains sensitive to financial market developments and insurance risks. 	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Insurers and pension funds are not prone to acute liquidity crises, and solvency requirements for insurers are being tightened. 	

	<p>Corporate bond markets</p> <p>Medium</p> <ul style="list-style-type: none"> Corporate bonds markets, which froze in late 2008, have not fully recovered. 	<p>High</p> <ul style="list-style-type: none"> Many firms, which relied heavily on bond financing, would face credit crunch. 	
3. Sharp reversal of a housing boom	<p>Low/Medium</p> <ul style="list-style-type: none"> House prices have risen sharply, while construction has boomed. Evidence of a housing bubble is mixed. A Bank of Israel study suggests that the level of prices reflect fundamentals, such as the policy interest rate, population growth, and a supply shortage. 	<p>Low/Medium</p> <ul style="list-style-type: none"> A sharp fall in house prices would dampen real estate demand, leading to financial difficulty in the construction sector. Banks' loan losses would increase and their profitability will fall through: (i) the direct impact of an increase in nonperforming loans to households and construction sectors; and (ii) an indirect impact through weaker economic growth. On the contrary, expected monetary easing could risk a further increase in house prices. 	<p>Medium</p> <ul style="list-style-type: none"> If house prices fall sharply, reversing macroprudential policies that the BoI implemented in recent years could help support housing markets. If house prices continue to rise, a further tightening in macroprudential policies would be required.
4. Severe escalation in regional geopolitical security concerns	<ul style="list-style-type: none"> The political and security situation in the Middle East and North Africa region remains highly uncertain. 	<p>Low/High</p> <ul style="list-style-type: none"> The Israeli economy has proven resilient to past episodes of heightened regional tensions. Severe escalation in regional security concerns could hit the Israeli tourism sector, consumer confidence, and possibly capital inflows. In the extreme, banks could face deposit withdrawals. 	N/A
5. Re-escalation in social protests	<p>Medium</p> <ul style="list-style-type: none"> In the summer of 2011, a nationwide protest movement erupted. Protestors also demanded for lower indirect taxes and higher direct taxes, free education and childcare, suspension of privatization, and investment in social housing and public transport. 	<p>Low/Medium</p> <ul style="list-style-type: none"> The government is formulating a package of new fiscal measures to address part of protestors' demand, although it remains committed to the fiscal rule. Were social protests to re-escalate, the government would expand fiscal policy. The government could abandon the existing fiscal rules, undermining fiscal credibility. 	<p>Low/Medium</p> <ul style="list-style-type: none"> Were social protests to re-escalate, the government would expand fiscal policy. The government could abandon the existing fiscal rules, undermining fiscal credibility.

Annex II. Authorities' Response to Past IMF Policy Recommendations

(Scale—fully consistent, broadly consistent, or marginally consistent)

IMF 2010 Article IV Policy Recommendations	Authorities' Response
<p>Background Inflation expectations have risen towards the upper end of the target band, nominal house prices have boomed, and the shekel has appreciated significantly. Against this background, the 2010 Article IV called for additional policy tightening to keep them under control.</p>	
<p>Fiscal policy Fiscal policy should carry the burden of the additional policy tightening, so a stronger than planned structural fiscal consolidation is recommended for 2011 and 2012.</p>	<p>Not consistent The budget outturn underperformed in 2011, in part reflecting optimistic revenue projections.</p>
<p>Monetary policy The policy interest rate should be raised.</p>	<p>Fully consistent The BoI continued to raise the policy through June 2011. Since 2011, the BoI has turned to a monetary easing cycle.</p>
<p>Foreign exchange policy Foreign exchange intervention can play a supportive role, but intervention should be symmetric over a long time horizon</p>	<p>Fully consistent The BoI has stopped intervention since June 2011.</p>
<p>Financial sector policy The development of stress testing procedures focusing on systemic risk, and the enhancement of the collaboration between and within supervisory institutions is strongly encouraged. Supervision of non-banks might be further strengthened by locating it outside the Ministry of Finance.</p>	<p>Broadly consistent For the FSAP Update, stress tests were conducted jointly with IMF staff. An inter-agency Financial Stability Group has been established, although further work is needed to strengthen a cooperation framework. There is no consensus about where to locate the non-bank supervision function.</p>
<p>Structural reform Further strengthening of structural reforms, including in education, research, the business environment, and infrastructure, effective management of natural gas resources will also be necessary.</p>	<p>Marginally consistent The authorities have decided to set up a Sovereign Wealth Fund and review natural resource tax regime. According to OECD, there has not been much progress in education and labor market reform.</p>



ISRAEL

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 9, 2012

Prepared By

The European Department
(in consultation with other departments)

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FUND RELATIONS

(As of February 29, 2012)

Membership Status: Israel became a member of the Fund on July 12, 1954.¹

General Resources Account:

	SDR Million	Percent Quota
Quota	1,061.10	100.00
Fund holdings of currency	735.57	69.32
Reserve position in Fund	325.53	30.68

SDR Department:

	SDR Millions	Percent Allocation
Net cumulative allocations	883.39	100.00
Holdings	827.00	93.62

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund (SDR Million):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.08	0.10	0.10	0.10	0.10
Total	0.08	0.10	0.10	0.10	0.10

Implementation of HIPC Initiative: Not applicable

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.

Exchange Rate Arrangement:

The exchange rate arrangement (*de jure* and *de facto*) is classified as “free floating,” as the authorities have not made discretionary interventions since August 2011.

Israel 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

Article IV Consultation:

The last Article IV consultation was concluded on January 24, 2011. Israel is on the standard 12-month consultation cycle.

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.
- Financial System Stability Assessment Update was conducted in 2011.

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.

Resident Representative:

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

STATISTICAL ISSUES

(As of February 29, 2012)

I. Assessment of Data Adequacy for Surveillance	
<p>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 (<i>IMF Country Report No. 06/125</i>).</p>	
<p>National Accounts: No issues to report.</p>	
<p>Price statistics: No issues to report.</p>	
<p>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. Quarterly data submitted by the Central Bureau of Statistics broadly follows the GFSM 2001 format. However, for financial assets and liabilities, only transaction data are currently submitted, although a financial balance sheet (stocks of financial assets and liabilities) is under preparation. 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.</p>	
<p>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.</p>	
<p>Balance of payments: Balance of payments and international investment position data are compiled on a quarterly basis and follow the fifth edition of the <i>Balance of Payments Manual</i>. External sector data were not examined in the Report on the Observance of Standards and Codes</p>	
II. Data Standards and Quality	
<p>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.</p>	<p>Data ROSC published on March 24, 2006.</p>
III. Reporting to STA (Optional)	
<p>Data are regularly reported for publication in the <i>Government Finance Statistics Yearbook</i> and in the <i>IFS</i>.</p>	

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:	
						Data Quality – Methodological soundness ⁸	Data Quality – Accuracy and reliability ⁹
Exchange Rates	Same day	Same day	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Jan-12	7-Feb-12	M	M	M		
Reserve/Base Money	Jan-12	14-Feb-12	M	M	M	LNO, LO, NO, LO	O, O, O, NA, NA
Broad Money	Nov-12	12-Feb-12	M	M	M		
Central Bank Balance Sheet	Nov-12	20-Dec-11	M	M	M		
Consolidated Balance Sheet of the Banking System	Q3-2011	12-Dec-11	Q	Q	Q		
Interest Rates ²	Same day	Same day	D	D	D		
Consumer Price Index	Jan-12	15-Feb-12	M	M	M	O, O, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	2010	29-Sep-11	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	Jan-12	9-Feb-12	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Q3-2011	29-Dec-11	Q	Q	Q		
External Current Account Balance	Q3-2011	14-Dec-11	Q	Q	Q	NA	NA
Exports and Imports of Goods and Services	Jan-12	12-Feb-12	M	M	M		
GDP/GNP	Q4-2011	16-Feb-12	Q	Q	Q	O, O, O, LO	LO, O, LO, O, LO
Gross External Debt	Q3-2011	19-Dec-11	Q	Q	Q		
International Investment Position ⁶	Q3-2011	14-Dec-11	Q	Q	Q		

¹ Any reserve assets that are pledged or 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, extra budgetary, 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 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).

⁹ 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

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FOR IMMEDIATE RELEASE
April 2, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Israel

On March 27, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the 2012 Article IV consultation with Israel.¹

Background

Israel's economy remains strong with GDP growing 4.7 percent in 2011, led by robust private consumption and buoyant investment. However, the global downturn is slowing Israeli growth, with 2012 GDP growth expected at 2.8 percent. Nevertheless, Israel's fundamentals are strong: inflation and inflation expectations are squarely within the 1–3 percent target range, unemployment is at historic lows, the net international investment position is a surplus, and public debt has fallen steadily to below 75 percent of GDP. These strengths are also underpinned by Israel's sound institutional frameworks, including fiscal rules and a new central bank law. Furthermore, following recent discoveries of natural gas fields, Israel may become a net energy exporter in coming years.

With the global and domestic economy slowing, the Bank of Israel (BoI) began monetary easing cycle from September 2011, cutting the policy interest rate from 3.25 percent to 2.5 percent in steps. On the fiscal side, automatic stabilizers are operating fully, and the economic slowdown in the latter half of 2011 resulted in lower-than-projected revenue collections and a smaller-than-targeted headline fiscal consolidation. The budget deficit was 3.3 percent of GDP in 2011 and is projected at around 3.4 percent of GDP in 2012, exceeding the target almost 1½ percentage

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>.

points of GDP. Meanwhile, appreciation pressures on the shekel have eased, and now the shekel is judged at around equilibrium.

The Financial Stability Assessment Program (FSSA) Update concludes that the financial system is stable, with the BoI maintaining strongly proactive supervisory practices, which have preempted the systemic risks. Banks' cross border activities are limited, with negligible direct exposures to peripheral advanced European countries. However, real estate markets boomed over the past several years, and banks have significantly increased their exposures to housing and construction sectors. Moreover, some large corporate groups face rising risk premia in bond markets and sizable debt refinancing needs in the coming period.

Poverty remains among the highest in OECD countries, despite strong growth. This primary reflects low labor force participation rates among the Arab-Israeli and Haredi minority populations.

Executive Board Assessment

Executive Directors commended the authorities for sound macroeconomic management and policy frameworks that have underpinned Israel's strong economic performance in recent years. Directors noted, however, that global uncertainties and elevated regional strains pose risks to the outlook, and that longer-term domestic challenges underscore the need to push ahead with the reform agenda.

Directors considered that near-term economic prospects remain favorable. In the face of a weak external environment, reductions in the policy interest rate and the free play of the automatic stabilizers in the context of the two-year budget have appropriately supported activity, although the 2012 deficit target will be overshot.

Directors stressed that fiscal policy should remain focused on reducing the debt-to-GDP ratio over the medium term. Accordingly, the total spending limits in this year's budget and the ceilings under the expenditure rule for the 2013 and 2014 budgets should be respected, and a sizeable consolidation should be secured in 2013–14. In that context, further revenue mobilization would be appropriate.

Considering further reforms to the fiscal frameworks, Directors recommended that the deficit targets should be adjusted to take account of cyclical factors. Most Directors supported establishing an autonomous Fiscal Council to reinforce the momentum toward medium-term sustainability. In addition, Directors commended the authorities' plan to place natural resource revenues in a sovereign wealth fund.

Directors noted that the FSSA Update confirmed the soundness of Israel's financial institutions. However, given global risks, high concentration in the financial sector, and elevated house prices, they welcomed continued proactive supervision and plans to raise bank capital ratios. Directors also encouraged a review of the financial crisis management framework, as well as the establishment of a Financial Stability Committee to improve the coordination of supervisory agencies.

Directors noted that fiscal tightening would create space for further monetary easing. However, such easing would have to be evaluated against wage trends and second round effects of rising oil prices, with house price concerns addressed via macroprudential tools. Directors encouraged further strengthening of the monetary framework, including enhancement of central bank autonomy over remuneration of its staff and lengthening the horizon of published forecasts. They also agreed that, with the exchange rate broadly at its equilibrium level, a de facto free floating exchange rate regime should be maintained, although the option to intervene to sustain orderly conditions continues to be viable.

Directors emphasized macro-social concerns, notably that labor participation among the Arab-Israeli and Haredi populations is low, with adverse effects on growth prospects, poverty reduction, and fiscal sustainability. They welcomed recent reforms to address these concerns, while emphasizing that more is needed.

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 2012 Article IV Consultation with Israel is also available.

Israel: Selected Economic and Social Indicators, 2007–13
(Percent change; unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013
					Est.	Projections	
Real economy							
Real GDP	5.5	4.0	0.8	4.8	4.7	2.8	3.8
Domestic demand	6.6	2.2	0.0	4.4	7.2	3.3	2.9
Private consumption	6.3	2.8	1.4	5.3	3.6	1.5	2.5
Public consumption	3.3	1.9	2.4	2.5	3.7	3.4	2.1
Gross capital formation	11.7	0.9	-7.0	4.0	22.8	7.8	4.9
Foreign demand (contribution to real GDP growth)	-1.0	1.9	0.4	0.5	-2.2	-0.3	0.9
Unemployment rate (percent)	7.3	6.2	7.6	6.6	5.6	6.0	5.8
Overall CPI (end period)	3.4	3.8	4.0	2.6	2.2	2.0	2.0
Saving and investment balance							
Gross national saving (percent of GDP)	23.1	19.6	20.3	18.1	18.8	18.8	19.8
Foreign saving (percent of GDP)	-2.7	-0.9	-3.6	-2.9	-0.1	1.0	0.2
Gross domestic investment (percent of GDP)	20.3	18.7	16.7	15.2	18.7	19.8	20.0
Money and credit (period average)							
M1	15.4	14.2	50.8	12.1	4.0	...	...
M3	12.9	8.0	14.1	6.6	...	...	...
Interest rates (percent)							
Bank of Israel policy rate (end year)	4.00	2.50	1.00	2.00	2.75	...	...
10-year government bond yield (average)	5.55	5.92	5.06	4.68	4.98	...	...
Public finance (percent of GDP)							
Central government							
Revenues and grants	34.0	31.4	28.0	28.8	29.6	30.0	31.0
Total expenditure	34.0	33.7	33.3	32.6	32.9	33.4	33.3
Overall balance	0.0	-2.3	-5.3	-3.7	-3.3	-3.4	-2.3
General government							
Overall balance	-1.3	-3.3	-6.0	-4.6	-4.0	-3.5	-2.6
Debt	78.1	77.0	79.4	76.1	74.4	73.5	72.3
Of which: foreign currency external debt	17.2	14.9	14.4	12.7	12.8	11.2	10.9
Balance of payments (percent of GDP)							
Exports of goods and services ^{1/}	42.4	40.3	34.7	36.9	36.9	33.5	33.5
Real growth rate (percent)	9.2	6.6	-12.6	13.4	4.9	-4.4	6.0
Imports of goods and services ^{1/}	43.9	41.6	32.3	34.9	37.8	35.6	34.8
Real growth rate (percent)	11.7	2.3	-14.0	12.6	10.6	-3.7	3.7
Trade balance	-1.5	-1.3	2.4	1.9	-0.8	-1.7	-0.8
Oil Imports (billions of U.S. dollars)	8.9	12.8	8.1	10.4	13.6	15.5	15.4
Current account	2.7	0.9	3.6	2.9	0.1	-1.0	-0.2
Foreign reserves (end period, billions of U.S. dollars)	29	43	61	71	75	77 ^{2/}	77
Exchange rate							
Exchange rate regime				Free floating			
NIS per U.S. dollar	4.1	3.6	3.9	3.7	3.6		
Nominal effective exchange rate (2005=100)	103.6	115.1	109.8	115.1	116.4	...	...
Real effective exchange rate (2005=100)	100.6	112.1	109.9	115.4	116.7	...	...

GDP per capita (current U.S. dollars, 2009): 27,656; Population density (2009): 343.9 inhabitants per square kilometer; Poverty rate (2008)^{3/}: 19.9 percent; Fertility rate (2009): 3.0 per woman; Life expectancy at birth (2009): 79.7 (male) and 83.5 (female); Infant mortality rate (2009): 3.4 per 1,000 births; Physicians (2007): 3.6 per 1,000 people; CO2 emissions (tons per capita, 2007): 9.3.

Sources: Haver Analytics; Bank of Israel, Central Bureau of Statistics; World Bank; and IMF staff estimates and projections.

1/ National Accounts data.

2/ As at end-February 2012.

3/ Poverty rate from National Insurance Institute of Israel.

**Statement by Menno Snel, Executive Director for Israel
and Amit Friedman, Senior Advisor to the Executive Director
March 27, 2012**

We would like to thank staff participating in both the FSAP and Article IV missions for their professional and candid assessments and their constructive recommendations.

Macroeconomic performance and outlook

The Israeli economy grew by 4.7 percent in 2011, which is substantially higher than the average in other advanced economies. A mild recession in 2009, followed by high growth rates in 2010 and 2011, resulted in a near-potential level of economic activity. The rate of unemployment fell to 5.4 percent in the fourth quarter, the lowest level since the early 1980s.

The relatively good performance in recent years is the result of many factors, including successful economic policies before and during the crisis. Fiscal discipline, a responsive monetary policy, a conservative banking sector, and a strong external position had positioned the economy at a strong starting point as the global crisis unfolded, and these factors also supported the rapid recovery.

The local and international trust in the Israeli economy was reflected in the relatively low CDS spreads throughout 2011 and in a substantial increase in the level of Foreign Direct Investment. The credit rating upgrade to A+ by S&P in September, in a period when credit ratings in many countries were downgraded, stands out.

However, as the slowdown in global markets intensified, export growth stopped and even turned negative in the last quarter of 2011, and growth slowed. The growth rates decreased monotonically throughout the year to 3.2 percent in 2011Q4. The current account, which had been in surplus since 2003, turned slightly negative in the fourth quarter.

The sentiment at the Tel-Aviv Stock Exchange deteriorated during the year. Geopolitical developments and the inability of some large borrowers to service their debt led to a series of debt restructurings, which resulted in higher spreads in the corporate bond market. Share prices declined by about 20 percent relative to the levels in early 2011.

Although the unemployment rate fell to a 30-year low, and although the economy was at that point growing at nearly 4 percent, a surge of social unrest swept the country during the summer. The protest focused on rising housing costs and food prices. Mass peaceful demonstrations led to the establishment of the Trajtenberg committee – a public committee that recommended a comprehensive set of policy measures to respond to the

demands of the protestors. The government announced its intention to implement the proposals of the Trajtenberg committee, and has begun to do so.

Following the negative local and international developments during the year, the Israeli authorities have revised the outlook for 2012 downward, and it currently ranges between 3.2 percent (MOF) and 2.8 percent (BOI), which bracket the Fund's 2.9 percent outlook. As these rates are lower than potential growth, unemployment is expected to increase. Additional risks to the forecast include geo-political risks, possible further increases in oil prices, and an intensifying recession in Europe, as Israel is an export-led economy.

Fiscal Policy

Fiscal consolidation in 2011 was broadly on track, as the budget deficit in 2011 declined to 3.3 percent of GDP, after reaching 5.1 percent in 2009. Although the deficit was reduced substantially, lower than expected tax revenues led to a slightly higher deficit than the originally planned 3 percent target. Public debt fell to 74.2 percent of GDP, lower than the OECD average.

The robustness of the fiscal position was well reflected in the bond issuance of US\$1.5 billion for 10.5 years at yield as low as 4.1 percent, in January 2012 in New York. This yield spread, at 205 bp spread over 10-year US treasury bonds, is the lowest-ever pricing achieved by Israel in issues of dollar-denominated bonds.

Fiscal policy in Israel is currently implemented through a two-year budget framework. This mechanism, first adopted in 2009-2010, has proven to be an important instrument to restore market confidence during the economic crisis, while at the same time allowing governmental units, as well as the parliament, to focus on longer-term issues.

Thus, fiscal expenditure in 2012 is executed according to the 2011-2012 budget, which was approved in late 2010. As tax revenue projections today are lower than originally envisaged and automatic stabilizers are fully at work, the deficit for 2012 is expected to be higher than the 2 percent ceiling. The current projection is that it will reach 3.4 percent.

The deficit targets for 2013 and 2014 pose a complicated challenge. It seems that the deficit targets for these years, previously set at 1.5 and 1 percent, respectively, may be too contractionary, given the lower growth outlook. The new targets, which balance the need to consolidate, support economic activity, and comply with previous obligations, will be set in place in the next few months.

Although a decrease in the pace of consolidation is expected, the authorities are fully aware of the importance of continued consolidation, and have reiterated that reducing the public debt-to-GDP ratio remains a major goal of the government's economic agenda. This commitment is backed-up by an effective fiscal toolkit that includes an expenditure

cap along with a deficit target. The expenditure rule, introduced in 2010, sets the increase in real government spending to be lower than potential growth, which is calculated as 10-year average growth, as long as the debt-to-GDP ratio is above its target. This rule is designed to reduce the debt-to-GDP ratio to 60 percent by 2020.

As noted above, in response to the social unrest that emerged last summer, the government established the Trajtenberg committee. Following its recommendations, the tax cut program, according to which tax rates were to have been further reduced from 2012 on, was cancelled. This, along with other measures, will allow financing a series of steps that will address social demands, at least partially. However, the authorities do not envisage at this stage increasing the VAT.

Large natural gas fields were discovered in recent years. In 2011, a new 'superprofit' tax was legislated, and in February 2012, the government approved the general framework for establishing a sovereign wealth fund, which is expected to begin to accumulate revenues by the end of the decade. This fund, which will be invested in international capital markets, will restrain the possible "Dutch disease" effects and strengthen the fiscal position.

Monetary Policy

Monetary policy changed course in 2011. In the first half of the year, the Bank of Israel continued its policy of restoring the nominal interest rate to "normal" levels, which had begun in 2009. The increases were justified by the relatively high - above target - actual and expected inflation rates and a near-potential level of economic activity. In addition, the housing market was showing signs of overheating. By June, the Bank of Israel interest rate had reached the level of 3.25 percent.

However, as the severity of the European debt crisis intensified, the market sentiment in global and local markets turned negative, and economic activity showed signs of weakness, the BOI has gradually reduced its key rate to 2.5 percent. The inflation rate decreased from 4 percent in early 2011 to 1.7 percent today, below the midpoint of the inflation target range. Expected inflation for the next 12 months, as derived from capital markets, is now 2.5 percent, implying that the real interest rate is about zero. The Bank of Israel (BOI) assesses that given the evident slowdown in growth, the current interest rate, which is expansionary, is consistent with inflation being around the midpoint of the target range, while at the same time leaving ample 'firepower' in case further risks materialize.

In order to curb capital inflows, the BOI and the Ministry of Finance (MOF) took a few coordinated measures in 2011. In January, the BOI imposed a 10 percent reserve requirement on banks, when engaging in currency swaps and forward foreign exchange transactions with non-Israeli residents. In March, the MOF canceled the tax arbitrage between local and foreign investors in the *makam* - a short-term zero-coupon debt instrument issued by the BOI, targeted by the carry-trade foreign investors who were tax

exempt. In July, the BOI imposed a regulation, according to which forward foreign exchange transactions above a threshold have to be reported. These policy measures contributed to lowering the pressure on the new Israeli shekel (the NIS), which has eased further as the BOI reduced its key rate and a ‘risk-off’ mood started to take over markets. Consequently, foreign exchange purchases, which were used to restrain overvaluation forces in recent years, have stopped, and since August 2011, the NIS has been freely floating.

A new and modern Bank of Israel Law was legislated by the Knesset In March 2010. The new law, which formally defines the *de-facto* independence of the BOI, states that price stability is the prime goal of the central bank. Based on the new law, a Monetary Policy Committee (MPC), which includes the Governor of the BOI as chairmen, two additional BOI members and three external members, began operating in October 2011. The BOI will carefully study the staff’s suggestions regarding possible improvements in the practices and procedures of the MPC’s work. On the subject of emphasizing the midpoint of the inflation target band of 1 to 3 percent, given the high volatility of inflation, the band allows the BOI to credibly balance between its objectives.

Financial Sector Stability Assessment

Overview

The financial sector was assessed thoroughly by the FSAP team, after more than a decade since the previous (and first) FSAP was conducted. At the outset, the Israeli authorities would like to express their appreciation to staff for their dedicated work, and to the Fund for devoting resources to this task, given the current condition of the global economy.

The Israeli supervising authorities – the MOF, the BOI and the Israeli Securities Authority (ISA) – have all found the process useful and effective. The worldwide experience of the IMF and the use of common methodologies have delivered important insight into the current state of financial markets and supervision.

The authorities generally share the overall assessment. The results indicate a high level of observance of the international standards of supervision. The stress tests that were jointly conducted by the authorities and the FSAP team reaffirm the robustness of the financial system, banks and nonbanks alike, and confirm that the current buffers can shield the system even from severe shocks. However, the risks facing the financial system are exceptionally high.

Market Structure and Concentration

The financial system has changed considerably since the previous FSAP assessment. The Bachar reform of 2005 – which required the banks to divest their asset management

activities – triggered a structural change, which led to the rapid growth of the non-bank sector. At the same time, a flourishing corporate bond market has evolved.

The soundness of the new structure and institutes was stress-tested during the economic crisis. The stability of the major financial players – banks, insurance companies, and institutional investors – was maintained. Some weaknesses in the corporate bond market emerged, as the primary market dried up in late 2008 and the spreads rose dramatically. Following the crisis, the Treasury in 2010 established a committee (the Hodak committee) to suggest measures to strengthen the robustness of the market. These measures were implemented and increased the degree of transparency in the market and the quality of issuers. In addition, the supervisor of Capital Markets Insurance and Savings Division (CMISD), located in the Treasury, issued tougher regulations regarding the investment of institutional investors in corporate bonds.

The banking industry, the nonbank financial sector, and the nonfinancial sector are all relatively concentrated. Therefore, many financial institutions, and even nonfinancial business groups, can have systemic importance. The supervisors are well aware of risks that stem from this market structure, and apply “hands-on”, stringent and sometimes intrusive policies to offset the excess risk. The CMISD will strengthen group supervision as part of the adoption of the Solvency II regulatory paradigm, following the publication of global supervisory standards in this matter.

The Concentration Committee, an ad-hoc public committee that has recently finalized its report, has recommended that no individual can be a controlling shareholder in both a financial and a real company, and has in addition recommended steps to limit the extent of pyramidal structures that in the past have enabled shareholders to in effect operate with extremely high leverage in controlling companies.

The adoption of the committee’s recommendations will lead to a reduction of excess concentration in the future, and to a flattening of pyramidal ownership structures. However, given clear evidence of economics of scale in many industries, some degree of concentration is almost inevitable in a small economy. Excessive market fragmentation could eventually lead to an even less efficient industrial structure.

Institutional Changes

The new Bank of Israel Law (2010) strengthened the institutional framework by defining financial stability as a major objective of the BOI, and by giving it the authority to act as lender of last resort to non-bank financial institutions if it should judge that to be necessary for financial stability.

Following the previous FSAP recommendations, the BOI has set up a real time gross settlement (RTGS) payment system, which is now operational. This has enabled the BOI

to strengthen its control over the payment systems, and to join the CLS system, turning the NIS into a fully convertible currency.

As part of a strategic plan to strengthen the supervision of nonbanks, the CMISD has tightened its regulation, monitoring, and oversight. Manpower and budget increased, and two new departments, Solvency II implementation and enforcement, were established.

The authorities realize the importance of strengthening the framework for conducting coordinated macroprudential policy. The Banking Supervision Department (BSD), CMISD and ISA are currently examining possible ways to implement the Fund's recommendation to institutionalize their cooperation, which has improved since the crisis, by establishing an FSC in a way that will add real value to the supervisory frameworks while adhering to the existing legal structure of three separate supervisory bodies.

The BOI concurs that the framework for early intervention and orderly resolution of problem banks, including the legal basis, should be overhauled. The overhauled framework for dealing with problem banks, which should include early intervention, going-concern resolution, and gone-concern resolution, would allow the BOI to deal effectively with emerging problems and to address major problems promptly and decisively.

The ISA has proposed to amend the securities law so that underwriters will be subject to broader scrutiny at the time of registration, and that underwriters acting as distributors in the offering process will be subject to liability for misleading or defective statements in a prospectus. In addition, ISA has established an internal working group dedicated to examine and propose a legislative framework to regulate the broker-dealer activity in Israel.

Banking System Stability and Basel III implementation

Israel's banking system is conservative, tightly regulated and closely monitored, all of which helped the system remain sound and resilient throughout the global financial crisis. The banks are well capitalized and profitable, especially when taking into account that Israeli banks use the conservative standardized approach to calculating CAR's; their asset portfolios are of high quality; and their operation consists mostly of traditional banking. As the Israeli banks are net lenders to foreign banks abroad, the opening of spreads and difficulties in attracting wholesale funding did not much affect them in the global crisis.

The banks' buffers have increased following the crisis. In June 2010, the Supervisor of Banks issued a directive ordering banks to increase core capital to at least 7.5 percent by the end of 2011, and prohibiting dividend distribution before this target is met. By the end of September 2010, all five of the largest banking groups achieved the target.

As of 2011Q3, the total capital ratio was 13.5 percent, Tier 1 core capital was 7.8 percent and ROE was 10 percent, similar to the long-term average. Banking credit grew by 7 percent in the first 3 quarters of 2011. The banks' credit portfolio quality is high, as indicated by the low, 2.0 percent, non-performing loans ratio and by the low provision expense for credit losses, 0.4 percent of total loans. The total exposure to the Euro zone is 1.6 percent, and to the most vulnerable countries only 0.2 percent.

The new draft rules for implementation of Basel III were published on March 14, 2012. The minimum core capital requirement will be raised to 9 percent by January 1st, 2015. For banks holding more than 20 percent of total banking sector assets, it will be further raised to 10 percent as of January 1st, 2017. This differential treatment, which is driven by macroprudential considerations, is expected to affect the two largest banks in Israel, which currently each hold about 30 percent of the assets in the banking system.

The gradual increase in core capital is designed to balance the need to strengthen the banking system with minimizing the negative macroeconomic effects of deleveraging. According to the BSD's assessment, banks will be able to meet the new capital requirements while expanding their credit portfolios at a rate that is similar to or slightly below potential growth.

The Housing Market

The BOI assesses that the risk related to elevated house prices is contained. House prices have risen considerably during the past few years; this can be attributed in part to initial levels in 2007, when house prices relative to wages or rent prices were exceptionally low, and to the very low interest rates in place during and after the global crisis. The current price-rent ratio implies a rate of return of 4 percent.

That said, the BOI took active macro-prudential measures to contain the risks of price correction, the Ministry of Housing and Construction has taken steps to increase the supply of land, and the MOF has increased the purchase tax on second properties. These policies seem to have been effective in easing the pressure in the housing market, as house prices leveled off since April 2011 and the share of second-property transactions fell sharply.

In March 2011, the BSD limited the floating interest rate component of housing loans to 1/3 of the total loan. Competition among the banks in supplying this type of mortgage, linked to the Bank of Israel rate, had led to the spread over the BOI rate falling to only 60 bp. The constraint on the share of this type of loan in the total financing package for a house was imposed to reduce the risks attendant with this type of financing when the Bank of Israel rate would rise. The issuance of this directive was immediately followed by on-site supervisory actions that ensured that it is fully implemented.

This step has slowed the growth of mortgages, decreased the share of non-indexed floating rate loans, and decreased LTVs to previous levels. Since it was implemented, 58 percent of new residential loans are at an LTV of up to 60 percent, and only 7.1 percent of loans are at an LTV of over 75 percent. High-risk mortgages, with high LTV combined with high payment-to-income ratio, amount to 0.5 percent of the outstanding balance. Thus, the tails of LTV ratios are not significant.

Limited lending on floating interest rates, combined with low LTVs, implies that the banking sector most likely will remain unscathed in the event of a price correction in the housing market.

Long-run issues: Participation of minorities in the Labor Force

In this report, staff has expanded the review to one of the most difficult socio-economic challenges that Israel is likely to face in the years to come – how to integrate minority groups, which are becoming relatively larger over time, into the labor market. Staff has done a service to Israeli society by adding its considerable weight to the discussion and analysis of the issues, and by emphasizing the urgency of accelerating the pace of reforms.

The Israeli authorities as well as the Israeli public – including the minority groups – fully understand that the current rates of participation of the ultraorthodox men and Arab women in the labor force are unsustainable.

The low participation rate of ultraorthodox men is a complicated phenomenon. A combination of the strong desire to ring-fence themselves from the influences of the Jewish secular society – including through not doing military service – and economic incentives, have resulted in a full-time entrenchment to religious studies – for life. As this starts from a very young age, ultraorthodox boys do not acquire basic knowledge and skills that are necessary in the modern labor market.

Although political difficulties and a feeling that the issue could be put off to a future date resulted in slow progress, recent evidence suggests that employment rates of ultraorthodox men have increased from 39 percent in 2009 to 45 percent in 2011.

In order to speed up this process, and to achieve the 63 percent by 2020, a target that was set by the government in 2008, the incentives for the community have to change. The community also has to take responsibility by introducing core secular subjects, including science, mathematics and English into its school curricula and by signaling to its members that participating in the labor market is not inferior to being a full-time student of religion.

A Supreme Court ruling in February 2012 that the law under which ultraorthodox men can work while being exempted from military service (the ‘Tal law’) does not comply

with Israeli Fundamental laws, which have a constitutional status, has given the political system six months to come up with a solution. This also creates an opportunity to better incentivize the community to speed up the pace of reform.

In addition, the Ministry of Education intends to acknowledge the special external exams in ultraorthodox girls' high schools, where the curriculum covers also general studies, as eligible for credit towards completing either the matriculation exams or professional exams in the public education system. This will allow ultraorthodox women to apply for tertiary education.

A number of policy steps were taken recently in order to encourage the participation of Arab women in the labor force. The Prime Minister's Office and the Ministry of Transportation added public transportation lines within major Arab towns, and between Arab towns and central cities. Following the Trajtenberg committee recommendations, the government decided that mandatory and free education will be gradually provided from age 3 on (vs. 5 today) and to expand the public provision of subsidized and regulated daycare services for younger children, especially from low-income families. These steps will increase female labor supply in general, and will be particularly beneficial to Arab women, who have more children, and whose participation rates are found to be substantially affected by childcare support.