March 2006
IMF Country Report No. 06/120

Israel: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Israel

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Israel, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 12, 2005, with the officials of Israel on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 27, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of March 22, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 22, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Israel.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the 2005 Consultation with Israel

Approved by Ajai Chopra and Juha Kähkönen

February 27, 2006

- Consultation discussions were held in Jerusalem and Tel Aviv during November 30−December 12, 2005. The staff team—Messrs. Haas (head) and Epstein, Ms. Moreno-Badia (all EUR), Mr. Laxton (RES), and Mr. Pratt (MFD consultant)—met with Minister of Finance Olmert, Bank of Israel Governor Fischer, and other senior officials of the government, the Israeli Securities Authority, and the Bank of Israel. It also met with academics, and representatives of the private sector, including financial institutions, the manufacturing association, and a labor union. Mr. Klein (OED) participated in the meetings.

- The Staff Report also reflects the findings of an MFD mission to Israel on January 8−15, 2006. The mission assessed the quality and effectiveness of bank supervision and was comprised of Messrs. Fiechter (head) and Moore (both MFD), and Messrs. Palmer and Ryback (both MFD consultants).

- A Data Module ROSC mission took place in November 2005.

- Israel has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I). It subscribes to the SDDS and is in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars. The exchange rate regime is free of restrictions on the making of payments and transfers for current international transactions.

- Exchange Rate Arrangement: As of June 9, 2005 Israel's exchange rate regime is officially classified as floating.

- Parliamentary elections are scheduled for March 28, 2006.

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EXECUTIVE SUMMARY

Background: Real GDP growth accelerated to an estimated 5.2 percent in 2005, driven by strong exports and consumption, prudent policies, and improvement in the security situation. Inflation is slightly higher than a year ago, but remains in check, while unemployment continues to fall, albeit from a high level. The sheqel has remained broadly stable over the past year. Financial system indicators have strengthened, but credit risks remain high, and the rapid development of the capital markets has introduced new regulatory and supervisory challenges.

Outlook: The macroeconomic outlook is broadly positive, but there is further scope to enhance growth and reduce vulnerabilities. More can be done to improve the soundness of fiscal and monetary policies, reduce vulnerabilities in the financial system, and increase the economy's flexibility. Poverty alleviation has become a top priority in the political agenda and may require some reallocation of resources within the fiscal envelope.

Policy Discussions

Fiscal consolidation remains a priority. The ceilings on real expenditure growth and the deficit, as a percent of GDP, have strengthened fiscal consolidation efforts. However there is a strong case for more ambitious fiscal consolidation, particularly by targeting a deficit below the 3 percent of GDP ceiling in order to achieve a meaningful reduction in the debt-to-GDP ratio. The staff stressed that the authorities should resist taking additional measures, such as the tax cuts introduced in 2005, that would impede lowering public debt relative to GDP.

The stance of monetary policy is appropriate. However, the staff's view is that the policy rate is below the neutral rate and will, therefore, have to rise over time as excess capacity is gradually eliminated, an assessment the authorities broadly agreed with. A proposed new Bank of Israel Law will strengthen the independence of the central bank.

A rapidly changing financial system requires greater scrutiny. In view of the accelerated developments in the capital markets, the staff encouraged the authorities to refine their supervisory and regulatory activities to focus more on key risks associated with the transformation of the financial system. The authorities shared this view. The staff cautioned that the actual implementation of Basel II will require a significant resource commitment.

Poverty alleviation. Despite the strong economic recovery, the incidence of poverty and income inequality have increased. The authorities are considering various remedial measures. The staff noted that any such measures should be within the current fiscal framework, be targeted, provide the right incentives to work, and be consistent with growth-promoting policies.

I. Overview

1. **Following a strong performance in 2004, the economic expansion accelerated in 2005, supported by a relatively favorable global economic environment, an improvement in the security situation, and prudent policies.** The Article IV consultation occurred against the backdrop of robust output growth, low inflation, falling unemployment—albeit from a high level—and a steady improvement in the external position. The current account is in a small surplus, the sheqel has remained broadly stable, and foreign investment has reached record levels.

2. **The macroeconomic outlook is positive, but there is further scope to enhance growth and reduce vulnerabilities.** The macroeconomic policies and structural reforms of recent years have opened up the economy, increased its competitiveness, and attracted foreign investment. However, more can be done to improve the framework for fiscal and monetary policies, reduce vulnerabilities in the financial system, and increase the economy's flexibility. A key challenge is to sustain the ongoing fiscal retrenchment and thereby reduce the large stock of public debt relative to GDP. While banking system indicators have strengthened recently, credit risks remain high and the development of capital markets has created new regulatory and supervisory challenges. Poverty alleviation has become a top priority in the political agenda and may require some reallocation of resources within the fiscal envelope.

Box 1. Israel: Key Policy Recommendations and Implementation

Fiscal policy: The Fund has considered the fiscal stance over the past several years as appropriate and welcomed the introduction of expenditure and deficit ceilings. At the same time, the public debt as a share of GDP remains very high and the Fund has emphasized the importance of accelerating debt reduction by abstaining from further tax cuts. In this regard, the passage of the 2005 legislation of multi-year tax cuts may risk slowing the path of debt reduction.

Structural Fiscal Reform: The Fund has urged the authorities to adopt a multi-year budget framework to help ensure that future budgets are better insulated from political pressures and reflect long-term priorities. The authorities are concerned about loss of budget flexibility, but have agreed in principle to explore this recommendation further.

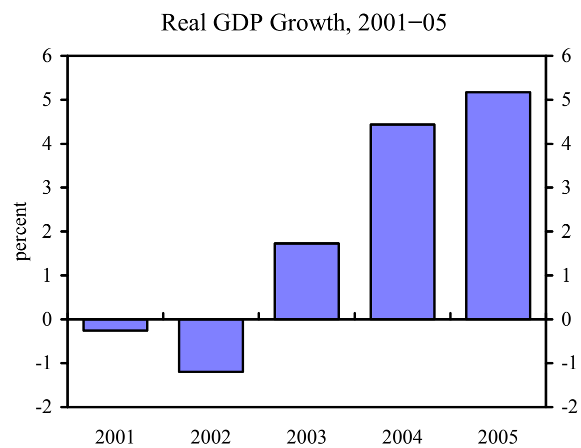
Monetary policy: In line with the Fund's recommendation, the authorities are working to enhance their policy tools and procedures for implementing inflation targeting. The authorities have also continued to take steps to increase the transparency of the Inflation Report, including by giving more attention to the dynamics of the inflation forecast. Key parameters of the proposed new Bank of Israel Law are consistent with previous Fund recommendations.

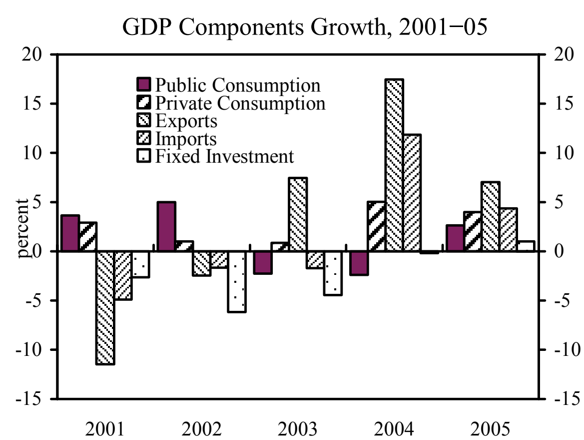
Capital Market Reforms: During the 2004 Article IV consultation, Executive Directors welcomed the authorities' commitment to strengthen competition in the financial sector and the steps being taken to remove obstacles to capital market development. Banks' divestiture of their mutual and provident funds has so far increased competition in these instruments. Directors also noted, however, that the capital market reforms would require the supervisory and regulatory functions to be enhanced to mitigate systemic risk that could arise from the transfer of mutual and provident funds to the non-bank sector. The authorities have recognized the risks posed by these reforms and are taking action to address them, in particular, by introducing new laws and regulations and developing new proactive approaches to enforcement.

3. **The fallout from the Gaza disengagement, which included the resignation of the finance minister and the creation of a new centrist party, has significantly altered the political landscape.** Prime Minister Sharon's illness has added to the political turmoil. Deputy Prime Minister and Minister of Finance Ehud Olmert has been serving as Acting Prime Minister in the run-up to the March 28 elections. Because the Knesset was dissolved prior to approving the 2006 budget, the government has been operating using the (relatively tight) 2005 budget framework, which allows 1/12 of that budget to be spent each month until a new 2006 budget is approved. The staff suggested a follow-up staff visit to assess the proposed new budget following the elections. This suggestion was welcomed by the authorities. The new political landscape is not expected to adversely affect economic policy in the near term, but may well have implications over the longer term.

II. Macroeconomic Background and Outlook

4. **After three years of depressed activity, real GDP growth recovered strongly in 2004 and increased further in 2005.** The strong and sustained growth experienced since the mid-1980s came to a halt in 2001−02 as a result of the high-tech slump, the global slowdown, and the deterioration in the Israeli security situation (Figure 1). The economy has since recovered; real GDP grew by 4.4 percent in 2004, and by an estimated 5.2 percent in 2005. The expansion is being driven by exports, which rose by an average of 10 percent annually over the past three years, and private consumption (Table 1). Staff analysis suggests that investment has lagged other indicators in recent years partly because of high corporate leverage.[1] However, as the financial health of the corporate sector improved, investment began to rise in 2005. Inflation is slightly higher than a year ago, but remains contained, while unemployment continues to fall, although from a high level (Figure 2, Table 1).





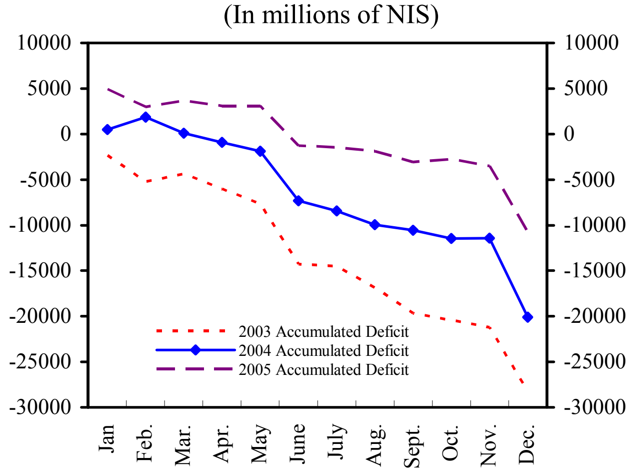
Source: Central Bureau of Statistics.

[1] See Selected Issues paper – "Corporate Balance Sheets and Firm Investment: Empirical Estimates for Israel."

5. **There is broad agreement that economic growth will remain strong in the short term**. In line with the authorities' views, the staff projects output to expand by slightly more than 4 percent in 2006−07, driven by private consumption, in turn supported by strong employment and income growth, and a favorable external environment. The staff expects the recovery of business investment to strengthen, reflecting increased profitability and liquidity as well as lower debt ratios; while residential investment will likely still lag given the continued high leverage in the real estate sector. Export growth is projected to remain strong, while imports should rise in line with the recovery in investment. As the output gap closes, inflation is expected to pick up, albeit moderately. The main risks to the outlook are related to weakness abroad, especially in the United States and Europe, a sustained rise in oil prices, political volatility, and a deterioration in the security situation.[2]

6. **Improved confidence in the macroeconomic outlook has been helped by the authorities' fiscal consolidation efforts, which are critical to putting the public debt to GDP ratio on a firm downward path.** After a prolonged period of fiscal laxity, the authorities have embarked on fiscal consolidation over the past two years. Legislation in 2004 limiting the central government's fiscal deficit to no more than 3 percent of GDP and real expenditure growth to no more than 1 percent a year was key to this retrenchment.[3] To allow for Gaza disengagement costs, the 2005 fiscal deficit target was raised to 3.4 percent of GDP. In the event, lower than projected expenditure and stronger than expected revenue helped bring down the deficit to an estimated 1.9 percent of GDP (Figure 3, Table 2). Of the estimated 1.5 percent of GDP improvement in the fiscal deficit relative to the budget target, about 1.2 percent of GDP was attributed to lower expenditure while 0.3 percent of GDP to higher revenue. The lower than expected expenditure was mostly reflected in reduced interest costs, while the larger-than-anticipated revenue reflected

Deficit/Surplus Progression, 2003-05
(In millions of NIS)



Source: Ministry of Finance

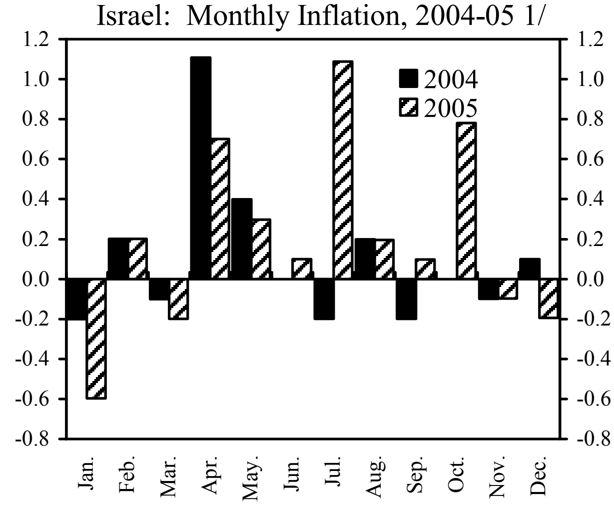
[2] Nevertheless, the Israeli economy has been relatively resilient to recent increases in oil prices, partly because of its low oil intensity.

[3] The real expenditure ceiling refers to budget-to-budget growth rates.

the higher-than-projected GDP growth. This is a welcome development, although the low deficit achieved in 2005 will be difficult to repeat in an election year.[4]

7. **Given the renewed emphasis on fiscal consolidation, and inflation within the Bank of Israel's (BoI) target range of 1–3 percent, monetary policy has been appropriately accommodative, notwithstanding recent increases in the policy rate (Figure 5).** Interest rates were lowered in 2004, as inflationary pressures eased amid sheqel appreciation against the U.S. dollar. For most of 2005, the BoI kept its policy rate unchanged at 3.5 percent, as inflation remained subdued. In September, and again in October, the BoI raised the rate by 25 basis points to 4 percent, and by a further 50 basis points in November, citing increasing signs of upward pressure on prices, including those emanating from global oil prices, and a rise in inflation expectations. By the end of the year, the December-over-December inflation rate reached 2.4 percent—twice the rate in 2004—but only slightly above the mid-point of the target range (Table 1). The 4.5 percent policy rate was not changed in December but was increased by 25 basis points in January as the Bank of Israel became concerned about the closing of the output gap and the narrowing interest rate differential with the United States.

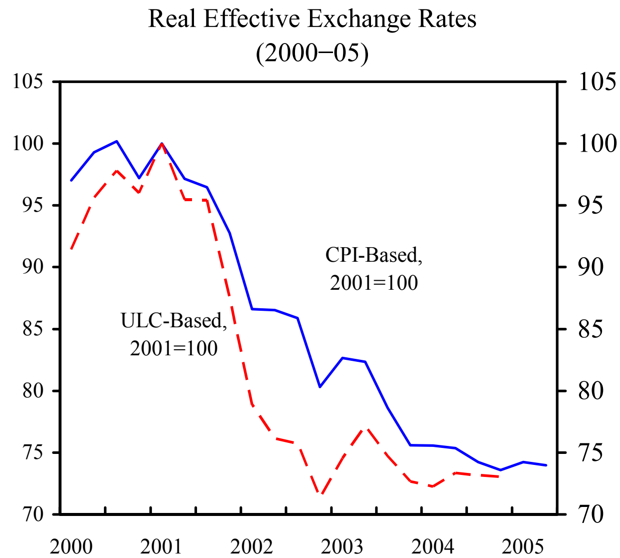
Israel: Monthly Inflation, 2004-05 1/

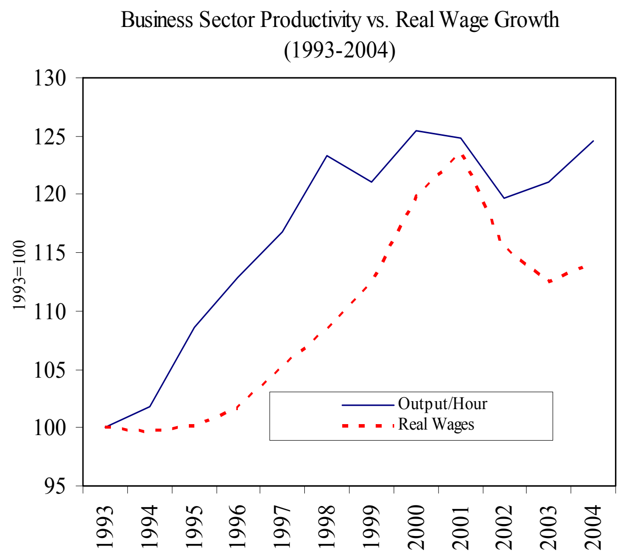


Source: Central Bureau of Statistics.
1/ Month on month percent change.

8. **The Israeli sheqel, a freely floating currency, has remained broadly stable over the past year, balanced by strong economic activity on the one hand and relatively low interest rates on the other**. The improved economic outlook helped attract strong foreign capital inflows in 2005 amounting to a record US$9.7 billion of direct and portfolio investment, an increase of 66 percent over the 2004 level. The US$5.7 billion of foreign direct investment, in particular, has helped mitigate downward pressure on the sheqel stemming from the historically low interest rate differential with the U.S. Owing largely to the continued low inflation, Israel's competitive position has remained relatively strong, as evidenced by the depreciation of the real effective exchange rate (REER) in recent years (Figures 1, 4). The improved competitiveness can also be seen in the strength of private sector productivity growth, which averaged 2 percent in the period 1993−2004, compared to the growth in real wages, which averaged 1.3 percent over the same period. This is confirmed by the depreciation in recent years in the unit labor cost (ULC) based REER.

[4] The initially proposed 2006 budget projected a deficit of 3.0 percent of GDP.





Looking ahead, staff expects capital inflows to remain strong, although below the record levels reached last year, provided the security situation remains relatively calm, productivity continues to strengthen, and the economy expands further. In the event that these favorable conditions fail to materialize, there is the risk that capital inflows would reverse, as happened in 2001−02, and the sheqel could come under pressure.

9. **The current account continued to show a small surplus in 2005, further enhancing confidence and mitigating external risks.** After ten consecutive years of current account deficits, Israel has run surpluses for the past three years, largely reflecting the strong recovery in exports (Figure 4, Table 3). The staff expects the improvement in the current account to continue over the medium term, reflecting past gains in productivity and competitiveness. The improved balance of payments position is also reflected in the country's net external asset position (on debt instruments), which is close to US$23 billion as of end-2005. Moreover, foreign reserves, totaling about US$27 billion (22 percent of GDP), cover roughly 90 percent of total gross short-term external debt or about 5 months of imports. Rollover risks of public-sector external debt—currently at about 25 percent of GDP—are mitigated by two key factors; about 80 percent of this debt is held by the Jewish Diaspora or backed by U.S. government guarantees,[5] while short-term external public debt remains low, at around 2 percent of GDP. Indeed, the relatively low level of sovereign risk is reflected in the low risk premium of about 80 basis points over U.S. treasuries on 10-year foreign-currency denominated sovereign bonds (Figure 5). This risk premium compression and the sharp rise in the equity market over the past two years (Figure 5) were in part driven by foreign investors' appetite for emerging market assets generally and Israeli assets in particular.

[5] Under the 2003 U.S. government's guarantees program, Israel is eligible to issue US$9 billion of sovereign guaranteed debt spread between 2003 and 2007. As of end-October, 2005, the remaining balance was US$4.6 billion, of which US$2.6 billion is available immediately.

10. **While the economic recovery has led to a strengthening of the financial system, the banking system continues to hold a stubbornly high level of problem loans**.[6] Despite the growing economy, problem loans as a percentage of total loans averages about 10 percent for the banking system. The construction and real-estate sectors, which have been in a persistent slump since the beginning of the 2001−02 recession, account for a significant share of the banks' problem loan exposure. Risk-based capital adequacy ratios for the five largest banks range from 9.7 to 12.2 percent.

11. **Post recession bank earnings have improved, but remain low despite a strong economy.** Through end-September 2005, the banking system reported net income of NIS5.3 billion or a 0.8 percent annualized return on assets compared to a 0.6 percent rate for 2004. The banks expect to realize one-time gains from the divestiture of their funds management businesses, which temporarily will augment income. The banking system enjoys ample liquidity provided primarily through deposit funding, including from the foreign offices of Israeli banks. Foreign currency funding averaged 43 percent of liabilities for the five largest banks.

Israel: Financial Soundness Indicators
(In percent)

	2000	2001	2002	2003	2004	2005 1/
Regulatory capital to risk weighted assets	9.2	9.4	9.9	10.3	10.8	10.9
Problem loans to total gross loans	6.9	8.2	9.8	10.5	10.5	10.3
Return on assets	0.5	0.2	0.1	0.4	0.6	0.8

Source: Bank of Israel.

1/ As of end-June.

12. **The recent passage of new capital market reforms has led to rapid changes in the structure of the capital market.** The Knesset approved the capital market reforms in mid-2005 with the objective of fostering a stable, competitive financial system with well-developed capital markets. The main reform measures included the requirement that banks divest themselves of their mutual and provident fund business, regulations on banks' securities-related activities to reduce potential conflicts of interest, and restrictions on the maximum market share of individual firms. Contrary to expectations, the sale of the mutual and provident funds proceeded rapidly, with banks selling most of the funds, primarily to insurance companies, within three months of the passage of legislation. Separately, the authorities have also taken actions that have led to an expansion in the corporate bond market

[6] Problem loans are loans that are under special supervision, rescheduled, overdue or otherwise non-performing, or considered doubtful either in part or in total, and problem off-balance sheet exposures. The BoI does not deduct collateral from problem debts.

and in capital markets more generally. This has provided further opportunities for businesses to obtain credit and more choice for investors.

III. Policy Discussions

13. **Discussions focused on four main areas: fiscal policy, monetary policy, financial stability, and poverty alleviation.** There was broad agreement on the key issues, particularly on the need to continue fiscal consolidation.

A. Fiscal Policy

14. **The authorities instituted in 2004 a new budgetary framework intended to ensure medium-term fiscal consolidation.** This framework, which, provides a welcome sign of increased commitment to fiscal consolidation, is based on two rules: a cap on the growth rate of budgeted real expenditures of 1 percent a year and a ceiling on the deficit of 3 percent of GDP. When growth is weak, as was the case when the framework was adopted, the framework is binding. However, when growth is strong, the deficit ceiling becomes non-binding and scope emerges to use revenue over-performance to either reduce the stock of public debt or cut taxes. This possibility arose early in 2005, and a 5-year tax reduction package was enacted (Box 2). Staff had urged that the revenue over-performance be used to reduce the deficit and debt. In the event, both happened because of unexpected favorable one-off shocks to expenditure late in the year.

15. **Turning to prospects for 2006, the authorities reiterated their commitment to fiscal consolidation.**[7] In particular, they noted that the budget adhered to the 1 percent ceiling on the growth in real expenditure as well as the 3 percent of GDP ceiling on the deficit. The staff noted that a 3 percent of GDP deficit outturn in 2006 would be expansionary relative to the estimated 1.9 percent deficit in 2005. The authorities observed that the 2005 fiscal over-performance reflected a number of one-off factors that amounted to expenditure reduction estimated at 1.2 percent of GDP.[8] More generally, they noted the importance of keeping the framework during a political transition. The staff agreed and welcomed the broad parameters of the proposed 2006 budget and shared the authorities' view that, once a new government is formed, a budget which adheres to the expenditure and deficit ceilings should be approved without delay.

16. **Maintaining a deficit of 3 percent of GDP in the years ahead, however, implies only a modest decline in public debt as a share of GDP, and the staff recommended more ambitious consolidation.** The staff argued that the 1 percent real expenditure growth ceiling ought to be the binding constraint, and the authorities should allow any unanticipated

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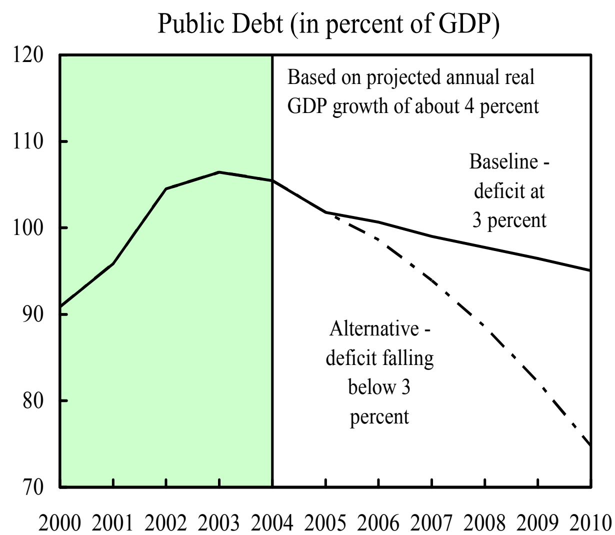
[7] The budget that had been proposed to the cabinet was fully in line with the framework (Table 2).

[8] Moreover, a 3 percent of GDP deficit in 2006 would be an improvement over the roughly 4 percent average deficit reached in the previous five years.

increase in revenues to bring the fiscal deficit below the ceiling of 3 percent of GDP. The authorities reiterated that the expenditure and deficit targets should be seen as ceilings, and thus lower-than-targeted deficits are indeed possible. The debt sustainability analysis illustrated in Figure 6 shows that, under the baseline scenario of 3 percent of GDP deficit and 4 percent real GDP growth, the public debt to GDP ratio would fall only slightly, from about 101 percent today to about 95 percent by 2010.[9] Furthermore, the debt ratio is vulnerable to interest rate and growth shocks. For example, if growth were to average only 2.8 percent, [10] the debt ratio would rise to 111 percent of GDP in five years. Alternatively, given a reasonable assumption about revenue growth (e.g., a revenue/GDP elasticity of one), no new tax cuts, combined with the binding limit on real expenditure growth, would imply a fall in the stock of public debt by about 20 percent of GDP over five years, compared to the baseline scenario.[11] There is a strong case for more ambitious fiscal consolidation—e.g., to achieve and maintain fiscal balance over the medium term—in order to achieve a meaningful reduction in the debt-to-GDP ratio.



17. **The staff, therefore, stressed that the authorities should resist taking additional measures, such as the tax cut measures introduced in the middle of last year, that would impede lowering the public debt to GDP ratio**. The authorities argued that these multiyear tax rate reductions need not hinder the pace of debt reduction, since stronger growth is expected to compensate for any revenue shortfall resulting from the tax cuts. The staff was unconvinced and noted that possible offsetting measures should be identified. As regards 2006, the authorities indicated that currently there are no plans for any additional tax reductions. Turning to the expenditure side, while there is broad agreement among the authorities on the need for sustained fiscal consolidation, there is less agreement about the best rule for the medium term. Some officials have the view that the real expenditure growth

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[9] For more details on the debt sustainability and fiscal policy analyses, see the accompanying Selected Issues paper – "Fiscal Policy in Israel: Trends and Prospects."

[10] This would be a shock scenario, whereby real GDP is assumed to grow at the baseline level minus one-half standard deviation.

[11] In this analysis, we assume that the subnational governments run a collective annual budget deficit of 0.5 percent of GDP, which is in line with the authorities' projections. The DSA also reflects the tax cuts approved in 2005 to cover the period 2006−10.

target should be closer to Israel's population growth rate, currently at about 1.7 percent. The staff acknowledged the potential difficulties in meeting the 1 percent expenditure rule, but stressed the importance of adhering to the original ceiling over the medium term, so as to further cement policy credibility.

Box 2. Israel: Multi-Year Tax Plan

On July 25, 2005, the Knesset approved a multi-year tax plan covering the next five years. The plan expands some of the measures introduced in the 2003 tax reform,[1] and its stated goal is to stimulate private sector growth. The key measures are:

- Lowering the top marginal income tax rate, from 49 percent to 44 percent by 2010.
- Cutting the corporate tax rate, from 34 percent to 25 percent by 2010.
- Reducing the VAT rate from 17 percent to 16.5 percent.
- Establishing a uniform 20 percent capital gains tax rate.
- Widening the tax base and strengthening enforcement through a proposal for taxation of trusts.

Schedule of Tax Cuts

	2006	2007	2008	2009	2010
Income tax rate	49	48	47	46	44
Corporate tax rate	31	29	27	26	25

The fiscal cost of the tax plan is estimated at NIS 11.2 billion (or 0.4 percent of GDP annually over the five-year period). The authorities are very confident that the plan will be financed through the increase in tax receipts stemming from stronger economic growth and the progressiveness of the tax brackets.

Annual Cost Relative to Current Trajectory (NIS billions, 2005 prices)

	2006	2007	2008	2009	2010	Total (% GDP)
Personal income tax	-0.8	-1.8	-4.0	-5.6	-8.1	-1.5
Cutting VAT to 16.5%	-1.2	-1.2	-1.2	-1.2	-1.2	-0.2
Cutting corporate tax to 25%	-0.4	-0.4	-1.3	-1.8	-2.3	-0.4
Capital: unification of rates at 20%	0.6	0.6	0.6	0.6	0.4	0.1

Source: Ministry of Finance.

1/ See IMF Country Report No. 03/75.

18. **The introduction of a medium-term budget framework, with a detailed expenditure breakdown consistent with the overall expenditure ceiling, is unlikely to be implemented in the near-term.** The staff noted that international experience has shown that multi-year budget plans reinforce fiscal consolidation, minimize expenditure growth, and strengthen adjustment. The staff pointed out that the government already has a medium-term tax plan as well as a plan for capital expenditures over several years and that broadening this approach to current expenditures would provide additional benefits by raising the government's credibility and lessening political pressures to deviate from the expenditure ceiling. The authorities agreed, in principle, with multi-year budgeting, but were concerned that it would reduce budget flexibility. The staff also stressed the importance of presenting

mid-year reports covering the execution of the budget and progress in achieving the rest of the economic agenda.

B. Monetary Policy

19. **The policy rate has risen, in line with higher inflation, but remains accommodative.** Over the past two years, both the headline and core CPIs have increased, although at a gradual pace, while inflation expectations have remained within the target range. The rise in oil prices has yet to result in appreciably higher consumer prices, but the authorities agreed that it will be important to monitor closely the degree of pass-through from oil prices to wages and core inflation. There was also broad agreement that, in light of the historically strong pass-through from the sheqel/dollar exchange rate to inflation, exchange rate developments and their impact on prices should also be closely monitored. The staff noted that other factors, such as high unemployment and excess capacity in the construction sector, argued against aggressive tightening.

20. **The policy rate was agreed to be broadly appropriate, but below the long-run neutral rate, and would need to be raised as the employment and output gaps close (Box 3).** At present, the staff's view is that the neutral policy rate is around 5.25 percent and the policy rate will have to rise over time as the excess capacity, currently estimated at around 1 percent of GDP, is gradually eliminated. The authorities broadly shared this assessment, but there was no agreement about the estimated value of the output gap. Indeed, experience has shown in many countries that there is considerable uncertainty in such estimates so it will be important to monitor measures of core inflation and inflation expectations as well as other indicators of slack so that these estimates are updated in a timely manner.

21. **Israel has a well-established inflation-targeting framework—and the fully floating exchange rate that it requires—but there is scope for improving the analytical framework used to formulate policy and to communicate with the public.** In the past, the BoI largely relied on measures of market-based inflation expectations to adjust the policy rate, rather than developing a forecast based on the BoI's own views about the fundamentals driving the inflation process. It is widely recognized that over-reliance on market expectations can give rise to an indeterminacy problem as market participants look to the central bank to provide an anchor for inflation and inflation expectations. For this reason, increased emphasis has recently been given to communicating the BoI's views about future inflation developments and how the BoI will likely respond to new information. The development of a model-based framework will greatly facilitate the process of developing baseline forecasts and risk assessments as well as communicating the logic of current and possible future policy actions to the public. The development of a model-based framework has recently become an important priority at the BoI.

22. **As part of a more general effort to improve surveillance of inflation targeting countries, the staff developed a small model of the Israeli economy and received feedback on its structure and properties from the authorities.**[12] This model was used to organize monetary policy discussions with the authorities and to construct a baseline forecasts and undertake risk assessments. The authorities welcomed this initiative, as well as the discussions that took place concerning state-of-the-art modeling techniques and how they are being used in other central banks that face similar sorts of challenges with short data samples.[13]

Box 3. Israel: Inflation Targeting, Modeling, and Risk Assessment

The mission developed a small simulation model to construct baseline forecasts of key macroeconomic variables and undertake risk assessments. The model is based on a conventional view of the transmission of monetary policy which focuses on the output gap as the major driving force of underlying inflation, but allows for exchange rate pass-through to play a significant role in the shorter term. The model enforces consistency on the largely judgmental baseline forecast and allows for risk assessment under uncertainty.

The baseline is predicated on the assumption of an output gap of 0.7 percent of GDP in the first quarter of 2006 that closes by 2007. Under these circumstances, the current policy rate of 4.75 percent is below the neutral rate of 5.25 percent and will thus have to rise as the output gap closes. This, in turn, implies that headline inflation will gradually fall to the mid-point of the target range–2 percent–by the end of the year and remain there in 2007. As in all inflation targeting countries, it will be important to monitor economic and financial developments and update the baseline in response to new information.

Baseline Forecast on February 14, 2006

	2006Q1	2006Q4	2007
Policy Rate	4.75	5.00	5.21
Inflation	3.6	2.1	2.0
Sheqel per $US	4.60	4.53	4.49
GDP Gap	-0.7	-0.3	-0.1

There are three major sources of uncertainty underlying the baseline: the size of the risk premium and thus the level of the neutral rate; the size of the output gap; and the future price of oil. The tables below show how the baseline forecast would be altered if the risk premium and thus the neutral rate were 50 basis points higher (table 2a), if the output gap were 1 percent larger (table 2b), and if the price of oil were to be permanently 50 percent higher than in the baseline.

Weaker Sheqel and Higher Neutral Rate
Deviation from Baseline

	2006Q1	2006Q4	2007
Policy Rate	0.6	1.2	0.8
Inflation	0.3	0.5	0.2
Sheqel (%Δ)	1.6	1.2	0.9
Output Gap	0.0	0.0	0.0

Effects of More Excess Capacity
Deviation from Baseline

	2006Q1	2006Q4	2007
Policy Rate	-0.4	-0.2	-0.1
Inflation	0.0	-0.1	0.0
Sheqel (%Δ)	0.1	0.4	0.5
Output Gap	-1.0	-0.1	0.1

Effects of 50% Hike in Oil Prices
Deviation from Baseline

	2006Q1	2006Q4	2007
Policy Rate	0.3	0.8	0.7
Inflation	0.3	0.4	0.2
Sheqel (%Δ)	-0.5	-1.6	-1.8
Output Gap	0.0	-0.2	-0.4

[12] For more details on the features and properties of the model, see the accompanying Selected Issues paper—"A Simple Forecasting and Policy Analysis System for Israel: Structure and Applications."

[13] BoI staff is planning to visit the Fund to continue the work that was started during the December mission.

23. **A proposed new Bank of Israel Law should strengthen the independence of the central bank.** After years of futile attempts, a proposed new Bank of Israel Law was finally approved by the government in 2005. However parliamentary approval is still required and is not expected until after the March elections. Key principles of the proposed new law include the creation of a monetary committee responsible for interest rate decisions;[14] the formation of a management board responsible for oversight of administrative matters; and the establishment of price stability as a primary policy objective. The staff agreed that other policy goals, for example growth, should be considered only in so far as they do not undermine the primacy of price stability.

C. Financial Sector Stability

24. **Israel has a large and highly concentrated banking system, with the five largest banking groups accounting for 95 percent of system assets.** Banking assets were NIS 875 billion at end-September 2005 (1.7 times 2004 GDP). Against the background of the ongoing economic recovery, the banking system has shown some positive signs: capital ratios have increased and system profitability has recovered to pre-recession levels, though remaining weak. Problem loans have remained elevated, however, particularly in the construction and real estate sectors, which have not yet fully felt the impact of the recovery. The authorities have taken some steps, such as increased bank provisioning, but further action is needed to encourage banks to be more proactive in lowering problem loan levels, including through the greater use of charge-offs and loan sales.

25. **The staff encouraged the authorities to refine their supervisory and regulatory activities focusing more on key risks in the changing financial system.** Additionally, the staff noted that undertaking self assessments against key internationally recognized regulatory standards would help the authorities address the new challenges more effectively. The staff agreed with the decision by the BoI to gradually move towards the more sophisticated risk-based approach within the framework of Basel II. However, the staff cautioned that implementation of Basel II will require a significant resource commitment of staff over a number of years and more extensive dialogue with industry. There is also scope for the BoI to enhance its oversight of group-wide activities of Israeli banks, particularly following actions taken by foreign regulators that have identified deficiencies in the AML programs in foreign offices of Israeli banks. The BoI agreed with the staff that given the significance of foreign currency funding of Israeli banks, this is an area where weak controls in banks' overseas operations pose an AML/CFT vulnerability and that greater coordination with host supervisors should take place.

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[14] According to the current draft of the law, the monetary committee will be made up of equal number of BoI members and outside public representatives. In the event of a tied vote, the Chairman (the governor) will have the casting vote. The minutes of the monetary committee's meetings would be expected to be published after two weeks.

26. **The ongoing reforms in the capital markets have gone well to date**.[15] In particular, forcing banks to divest themselves of mutual and provident funds has contributed to increased competition and market efficiency, as sought by the authorities. The relatively rapid changes in the capital markets have resulted in new participants selling new products to investors under new rules, with financial advisors operating under a new regime.[16] The faster-than-expected sale of mutual and provident funds was welcomed, and was seen, in part, as a by-product of the buoyant financial market environment in Israel during the second half of 2005. [17] There is a particular risk, however, that arises because of the radically changed risk profile of provident funds, as a result of a shift in their asset portfolio away from "risk-free" government bonds to newer capital market instruments. The staff stressed that investors may not be fully aware of the changed risk profile and thus need to be properly advised and protected.

27. **The authorities recognize that these capital market developments pose risks, and agreed that there is a need to strengthen supervision, regulation, and enforcement..** The introduction of new laws and regulations designed to increase competition in the financial services market and the development of new, proactive approaches to enforcement are welcome. But more remains to be done. In many cases, the legislation proposed by the authorities has yet to be enacted. And new regulations for non-bank financial institutions—and the budgets of their regulators—require prior approval of the Knesset Finance Committee. Most importantly, the regulatory infrastructure, although strengthened by recent legislation, needs further attention, particularly in the form of greater independence and additional resources. In particular, the supervisors of insurance companies, provident funds, pension funds and mutual funds require additional resources to undertake the necessary research into the effect of the new developments, collect and analyze the information received from regulated institutions, and conduct on-site inspections.

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[15] For more details on the development and reforms of the capital market, see the accompanying Selected Issues paper – "The Reform of the Capital Markets in Israel."

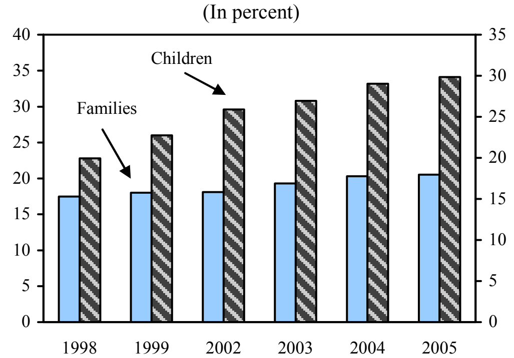
[16] The reduced number of non-tradable, guaranteed government bonds in the portfolios of institutions has encouraged the use of a wider range of financial instruments in order to secure yield and manage risks. The equalization of the tax treatment of overseas investments to match that for domestic investments has widened the investment opportunities. Barriers to the promotion of foreign mutual funds in Israel are being removed and the registration and approval requirements for new issues are being simplified. The corporate bond market is growing rapidly and activity on the stock exchange has increased. The development by the BoI of a real time gross settlement system, which will reduce banks' settlement risks, has prompted an interbank market and proposals for repos.

[17] Some of the regulators and banks believe that the price received by the banks was substantially higher (perhaps up to 50 percent higher) than might have been expected on the basis of the current fee income received by the banks.

D. Poverty and Social Issues

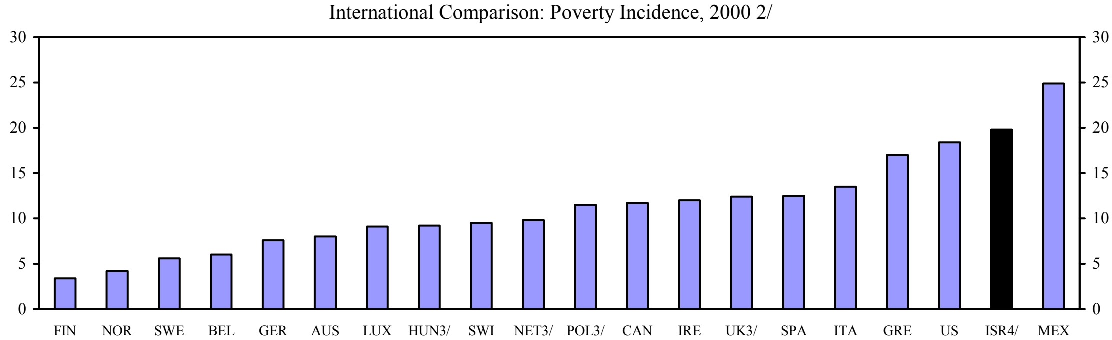
28. **Despite the strong economic recovery, the incidence of poverty increased in 2005 due, in part, to cuts in social spending.** Notwithstanding improvements in employment and income, the poverty rate among families increased to 20.5 percent in 2005, while child poverty rose to 34.1 percent.[18] Moreover, the poverty gap and income inequality have increased over the past five years. The poverty rate in Israel is also high when compared to OECD countries. The rise in the scope of poverty can be partly attributed to the erosion of welfare benefits, particularly those paid to the working-age population (child allowances, unemployment benefits and income support).[19] Poverty alleviation has now become a top priority in the Israeli policy agenda, and the authorities are working on developing new initiatives.

Israel: Poverty Rate 1/
(In percent)



Israel: Gini Index of Inequality 1/

International Comparison: Poverty Incidence, 2000 2/



Sources: National Insurance Institute, and Luxembourg Income Study.
1/ Based on income after transfer payments and taxes.
2/ Population poverty rate under 50 percent of median income, based on Israel's adult equivalence scale.
3/ As of 1999.
4/ As of 2001.

[18] Measured as households living below half the median disposable income, standardized by family size.

[19] Welfare payments for children have declined from 4.7 percent of GDP in 2001 to 2.8 percent in 2004.

29. **Against this background, an advisory group headed by Director General of the Ministry of Finance is examining policy options to reduce the poverty rate**. In mid-December, the Primer Minister, Minister of Finance, and the Central Bank Governor approved a seven year initiative to combat poverty with a total budget of about NIS 14 billion (2.5 percent of GDP) to be spread over the seven years. The authorities are considering a broad range of measures, including the introduction of a negative income tax (NIT).[20] The exact timetable and budget allocation for each measure are still under discussion. In general, it was recognized that a NIT can be a useful mechanism in promoting employment and/or ensuring adequate income for low income earners. However, its effectiveness depends on a variety of factors, and the authorities had some concerns about implementation given its potential high cost and difficulties in its administration. The staff concurred and stressed that any poverty alleviation measures should be within the current fiscal envelope, be targeted, provide the right incentives to work, and be consistent with growth-promoting policies. The staff also noted the importance of an appropriate safety net to protect children, the elderly, and the disabled, particularly given the recent cuts in welfare benefits.

E. Other Issues

30. **The economic reform agenda for 2006 reiterates the government's continued dedication to structural reforms.** The authorities highlighted the privatization of the second largest bank, Bank Leumi, in 2005 as a key accomplishment fundamental to enhancing competition in the financial sector. Looking ahead, in addition to completing the ongoing efforts to streamline the public sector and increase competition in the electricity and water distribution networks, the authorities intend to implement restructuring measures with the objective to privatize the oil refineries. The staff supported the authorities' reform efforts and commended the achievements to-date. Streamlining the public sector and strengthening its efficiency are crucial to fostering growth. However, the staff noted that, given the natural monopoly nature of many of these sectors, care must be taken to ensure that a proper, independent regulatory mechanism is in place.

31. **A recent Data ROSC mission concluded that Israel has a well-developed macroeconomic statistical system, but some shortcomings may impede the accurate and timely analysis of macroeconomic and financial developments.**[21] Foremost among these are deficiencies in the timeliness, methodology, and classification of monetary statistics. There is also room to enhance source data for national accounts, producer prices, and government finance statistics. In this regard, the staff noted the need, especially at the

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[20] The advisory group is considering four different models for implementing negative income tax at a cost of NIS 1−2 billion per year but, as of yet, no specific details have been announced.

[21] See Report on the Observance of Standards and Codes—Data Module.

Central Bureau of Statistics, for adequate and sustained resources to improve the scope and timeliness of data compiled under its mandate.

IV. Staff Appraisal

32. **The Israeli economy is strong and the outlook favorable, but challenges—primarily reducing the public debt stock, strengthening financial supervision, and alleviating poverty—lie ahead.** Growth has largely been driven by high technology exports and private consumption and has been supported by prudent policies, a favorable global environment, and an improvement in the security situation. Inflation remains in check, while unemployment continues to fall. The sheqel has been relatively stable over the past year, and the level of the REER reflects underlying economic fundamentals. Development of the capital market has accelerated bringing with it new challenges to the supervisory and regulatory agencies. Banking system indicators have strengthened, but credit risks remain high. While the macroeconomic outlook is positive, there is further scope to enhance growth and reduce vulnerabilities, especially to external shocks.

33. **Fiscal consolidation and an appropriately accommodative monetary policy have underpinned this strong performance.** Limiting the growth of public expenditures to one percent a year is a strategy that has served Israel well and should be continued. Fiscal retrenchment is crucial in putting debt on a firm downward path and thereby reducing vulnerabilities and allowing future spending to be directed at priority items. Given the renewed emphasis on fiscal consolidation, and with inflation within the Bank of Israel's (BoI) target range, monetary policy has been appropriate. Developing a detailed medium-term budget plan would also enhance credibility and ensure that future budgets are allocated according to long-term priorities. The presentation of mid-year reports covering the execution of the budget and progress in achieving it would strengthen transparency and budget planning.

34. **The authorities should seize the opportunity provided by the strong fiscal outturns in 2005 and strong growth to sustainably reduce the deficit to well below the 3 percent of GDP ceiling and thereby achieve a meaningful decline in the large stock of outstanding public debt.** It is important that, once a new government is formed, the 2006 budget should maintain the expenditure and deficit ceilings and additional tax cut be avoided. Failure to do so would increase uncertainty in the market, lead to a loss of confidence, and increase the country's risk premium. The authorities have made important progress in keeping expenditure under control and strict adherence to the current expenditure ceiling in future budgets will cement the credibility of fiscal policy. As shown in the debt sustainability exercise, this approach would lead to a reduction in the public debt-to-income level of about 20 percent over the next 5 years when compared to a strategy of holding the fiscal deficit to 3 percent of GDP. More ambitious fiscal consolidation would underpin lower interest rates, greater private investment, lower future taxes, and stronger medium-term growth.

35. **Inflation targeting, and the associated floating exchange rate regime, have served Israel well, but there is scope for enhancing the analytical framework used to formulate policy and communicate it to the public.** In particular, the increased emphasis on the development of macroeconomic models at the BoI is welcome. Once this work is completed, practices at the BoI will be among the best of inflation targeting countries. The development of these models is central to implementing a forward-looking approach to monetary policy and will serve to enhance policy deliberations and the communication of policy actions in speeches, press releases, and the Inflation Report.

36. **The proposed new Bank of Israel law will strengthen the independence of the central bank.** Updating the current Bank of Israel Law to reflect international best practices will help reinforce central bank independence, enhance transparency and accountability, and aid in achieving price stability. The proposed creation of a Monetary Committee responsible for interest rate decisions and the formation of a Management Board to oversee the administration of the central bank should aid in meeting these objectives. Adoption of the Law by the Knesset is overdue.

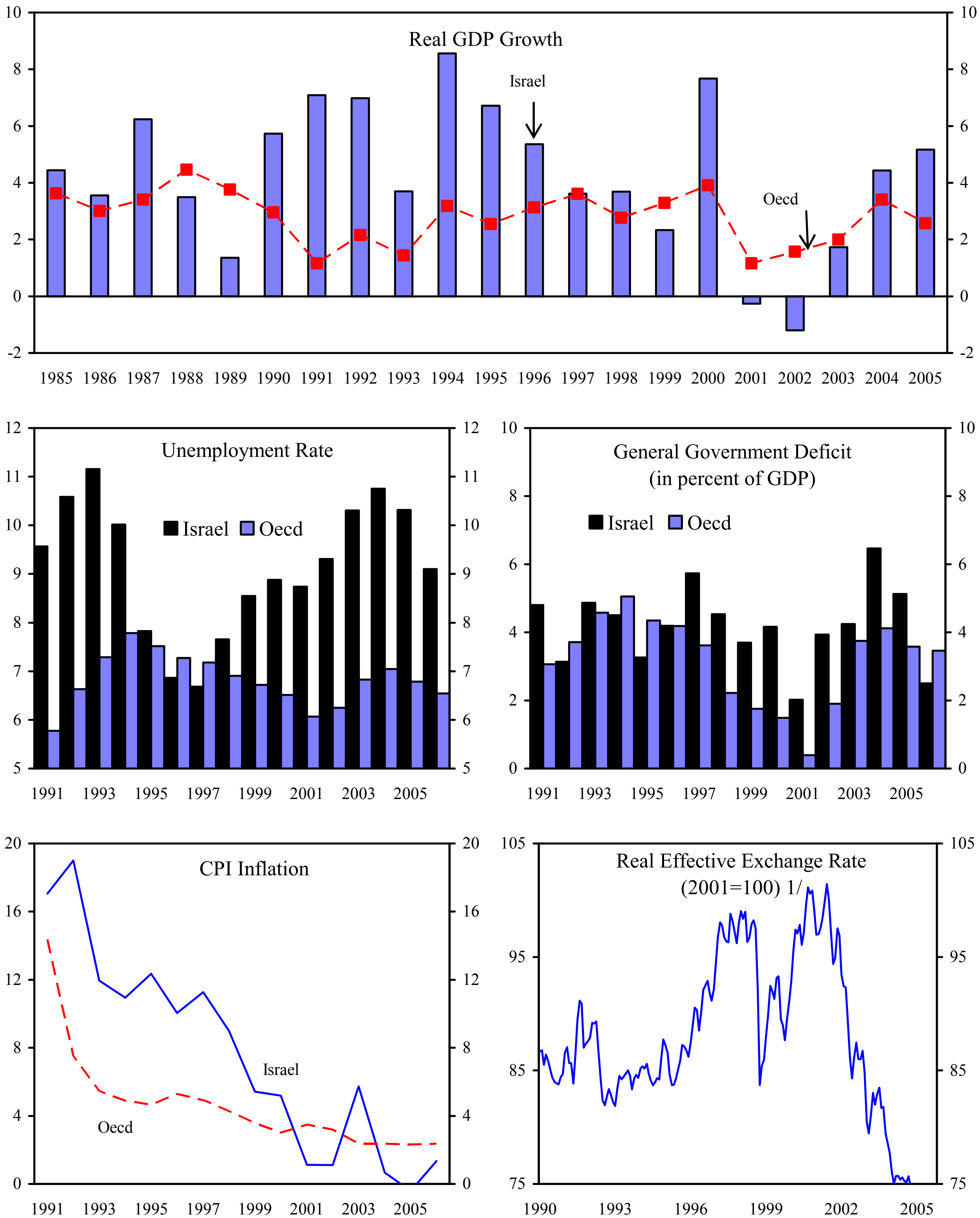
37. **The banking system has strengthened but the level of problem loans remains high, notwithstanding the improving indicators, such as profitability and capital adequacy.** The measures taken by the supervisor to reduce the banks' exposure to credit risk, including by increasing required provisions, are thus welcome. Nevertheless, continued supervisory vigilance of the systemically important financial institutions is essential to maintain financial stability. In light of the recent developments in the capital market, the authorities could benefit from undertaking self assessments against the key internationally recognized regulatory standards. The staff cautioned that actual implementation of Basel II will require a significant resource commitment. There is also scope for the BoI to enhance its oversight by cooperating and coordinating with its foreign counterparts, especially in the area of anti-money laundering. The authorities should undertake a self assessment against the revised Financial Action Task Force (FATF) Recommendations using the assessment methodology.

38. **Efforts to alleviate poverty are welcome.** Notwithstanding improvements in employment and income, the poverty rate among children and families increased last year, and both poverty and income inequality have increased over the past five years. From this perspective, the work of the advisory group headed by director general of the ministry of finance on measures to reduce the poverty rate is welcome. In broad terms, any such measures should be within the current fiscal envelope, be targeted, provide the right incentives to work, and be consistent with growth-promoting policies. The cuts in some welfare benefits have contributed to social hardship, and it is therefore important to ensure that there is a safety net to protect children, the elderly, and the disabled.

39. **Israel has subscribed to the Special Data Dissemination Standards and its macroeconomic statistical system is generally adequate for Fund surveillance.** Nonetheless, there are some shortcomings that may impede the accurate and timely analysis of macroeconomic and financial developments, which need to be addressed.

40. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

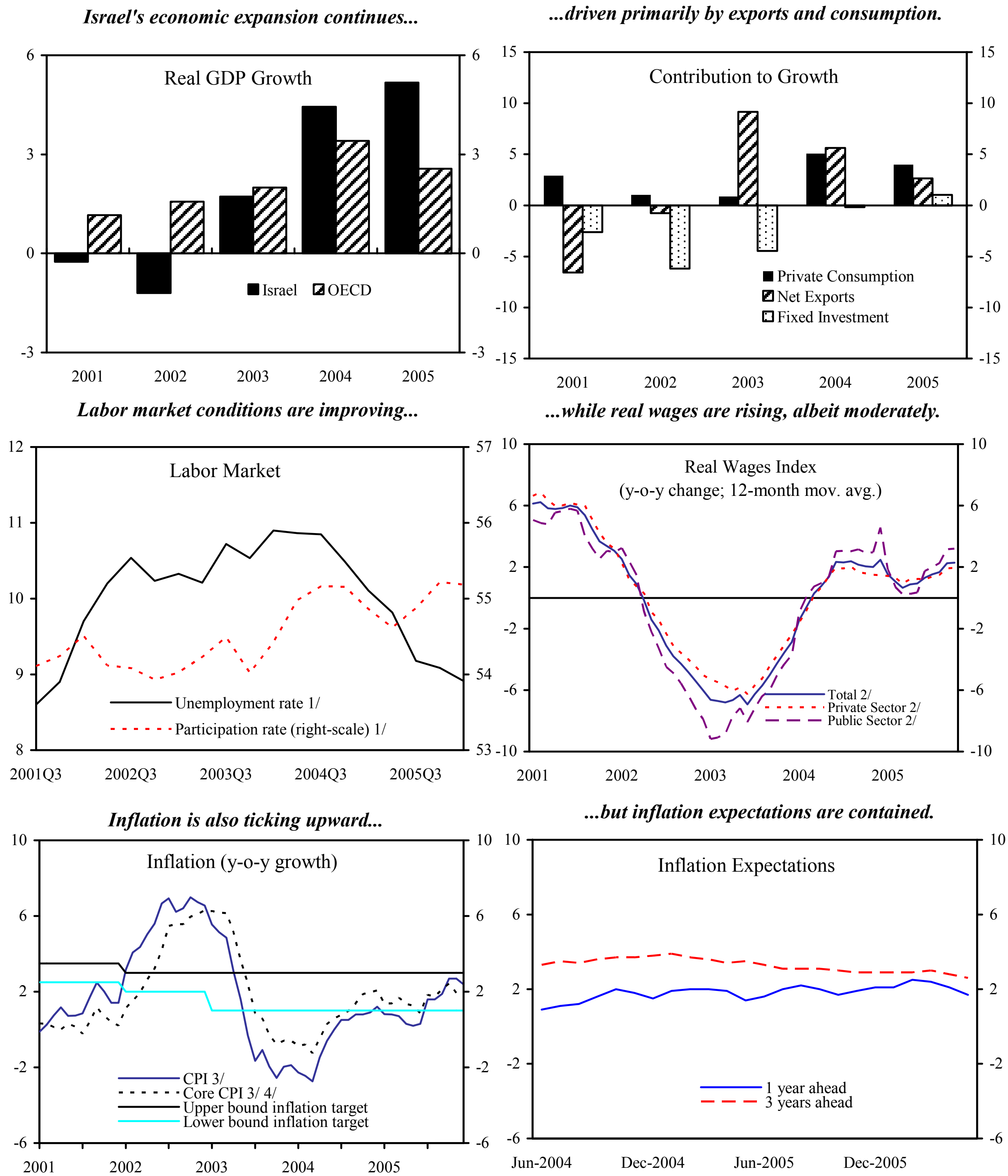
Figure 1. Israel: The Long View, 1985−2005
(In percent)



Sources: IMF, *World Economic Outlook;* and IMF, *Information Notice System.*

1/ As of October, 2005

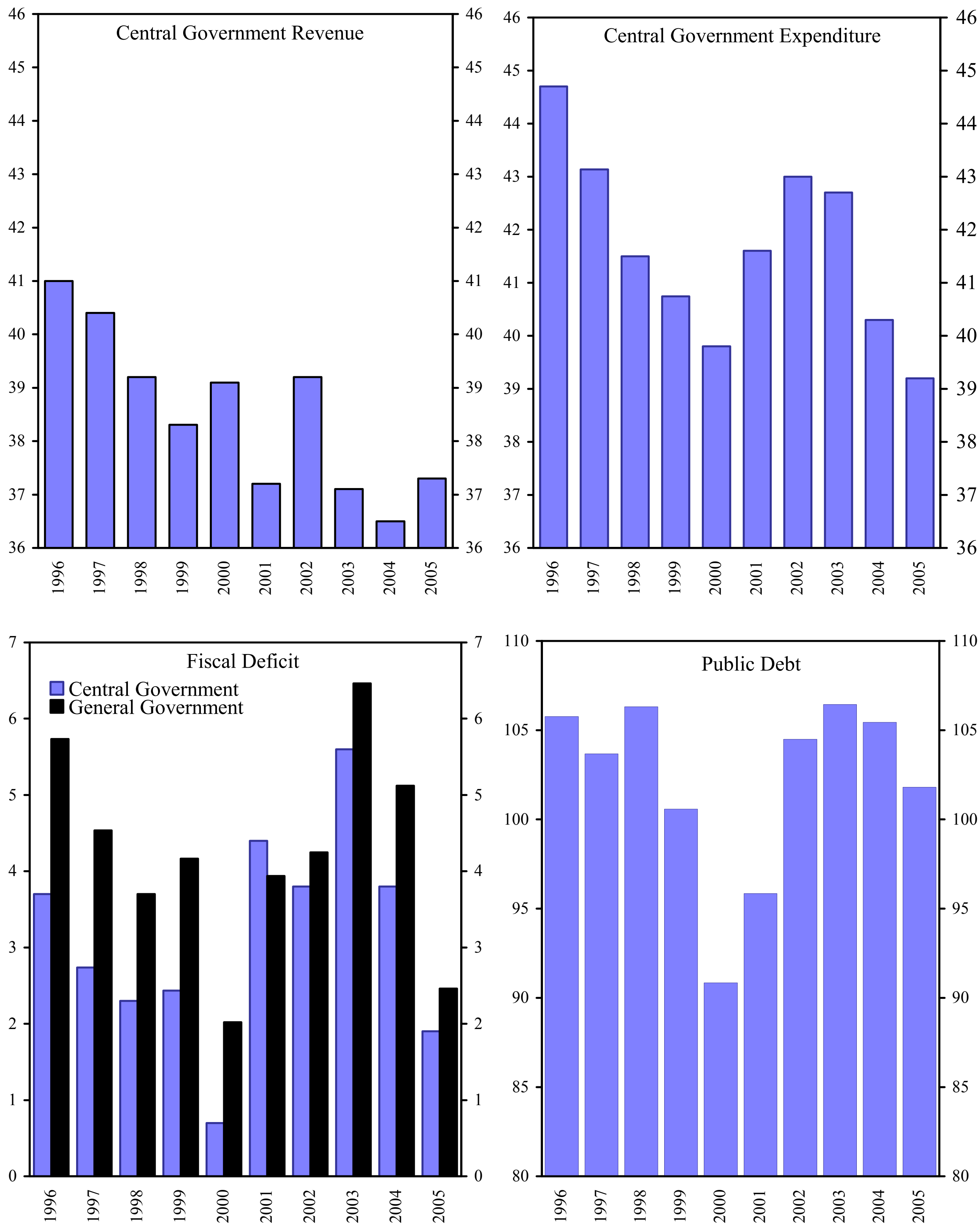
Figure 2. Israel: Recent Economic Indicators, 2001–05
(In percent)



Sources: Central Bureau of Statistics; Bank of Israel; IMF, *World Economic Outlook;* and IMF, staff projections.

1/ As of 3rd quarter, 2005
2/ As of October, 2005
3/ Percentage change from the corresponding period one year earlier.
4/ Core CPI defined without fruits, vegetables, and housing.

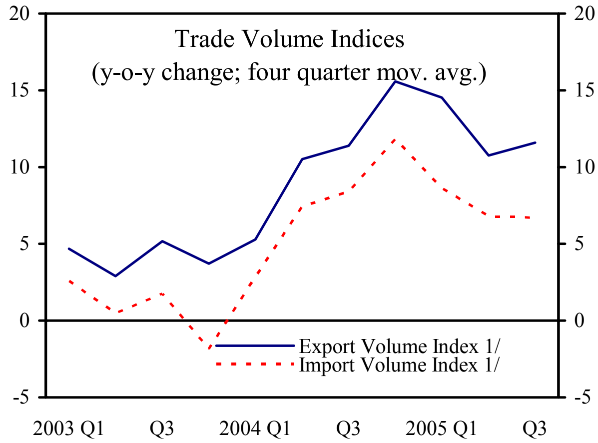
Figure 3. Israel: Fiscal Developments, 1996–2005
(In percent of GDP)



Source: Ministry of Finance.

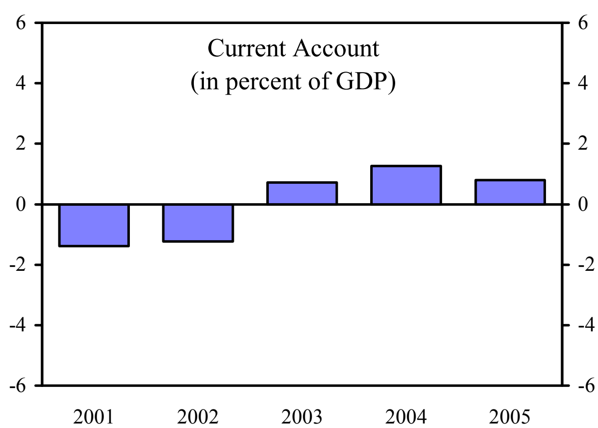
Figure 4. Israel: External Indicators, 2001−05

Exports have outpaced imports...

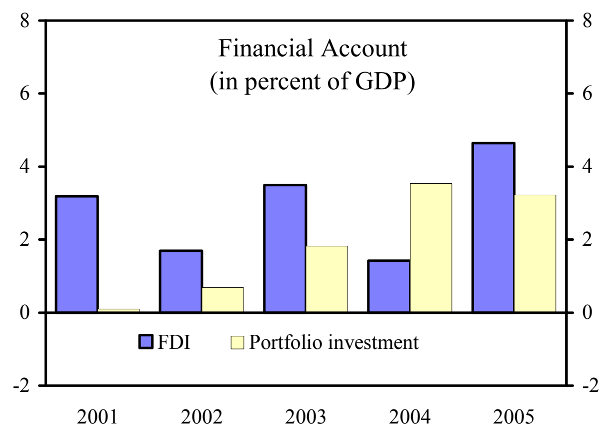


…while tourism pushed export services higher

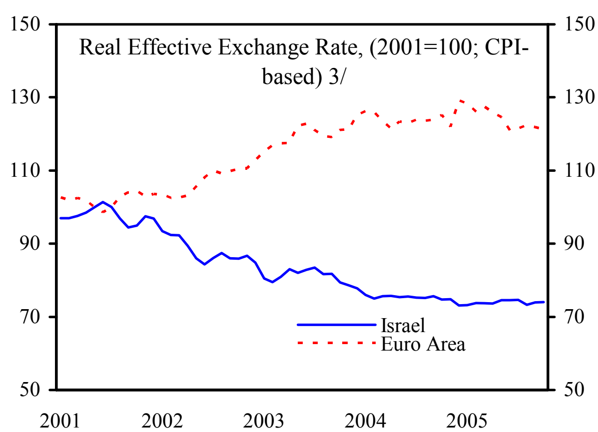
Current account balance steadily improving...



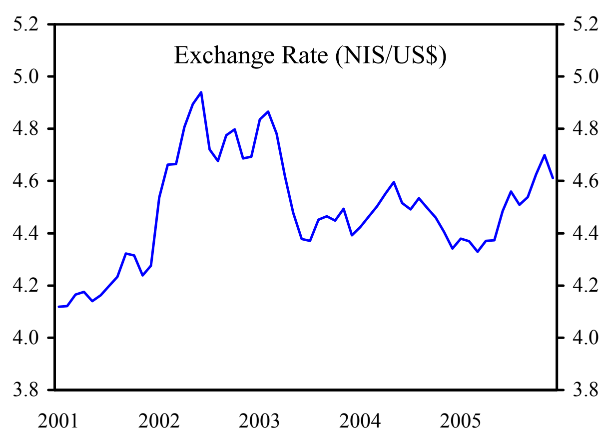
…and foreign capital inflows remain strong.



Improved competitiveness position in check...



...while NIS/US$ remains broadly stable.

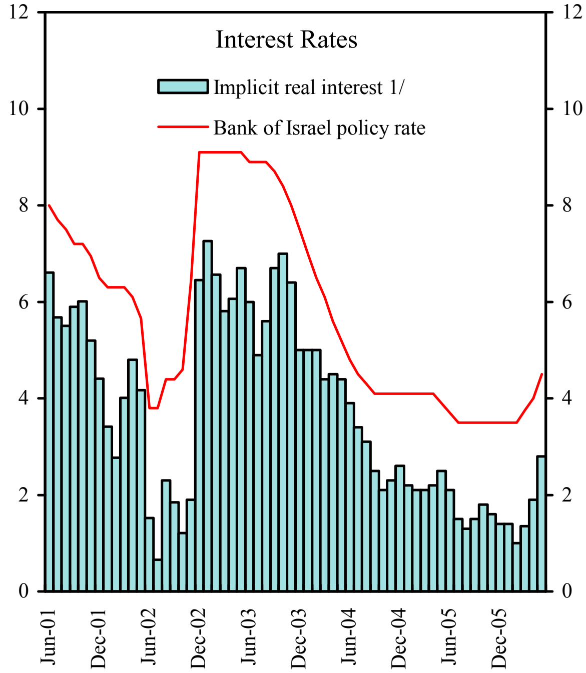


Sources: Central Bureau of Statistics; Bank of Israel; and IMF staff projections.

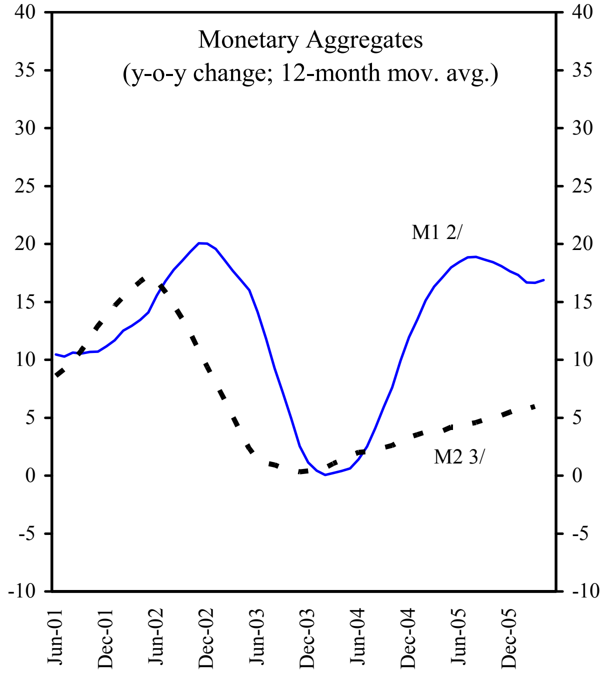
1/ 2005- through end-September.
2/ As of November, 2005.
3/ A decrease represents depreciation. Data through October, 2005.

Figure 5. Israel: Selected Financial Indicators, 2000−05

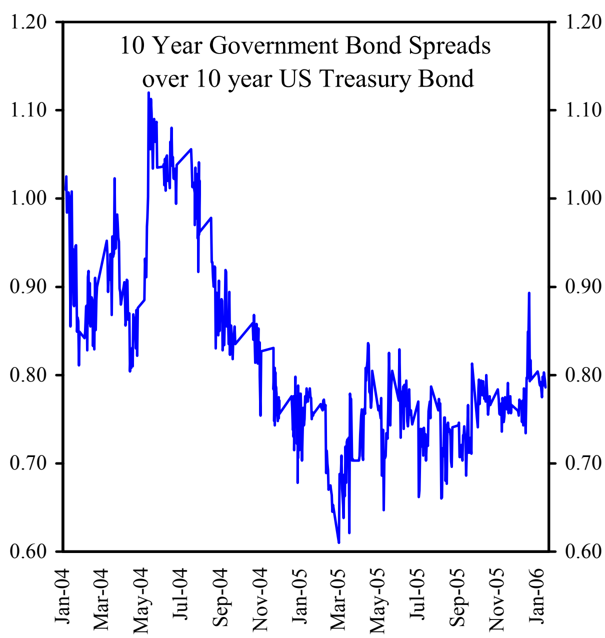
Cost of capital down significantly...



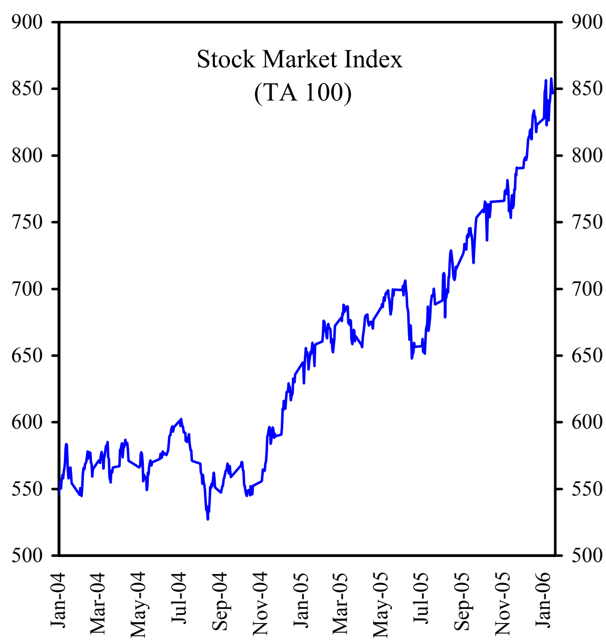
...as monetary aggregates expand.



Improved confidence lowered risk premium...



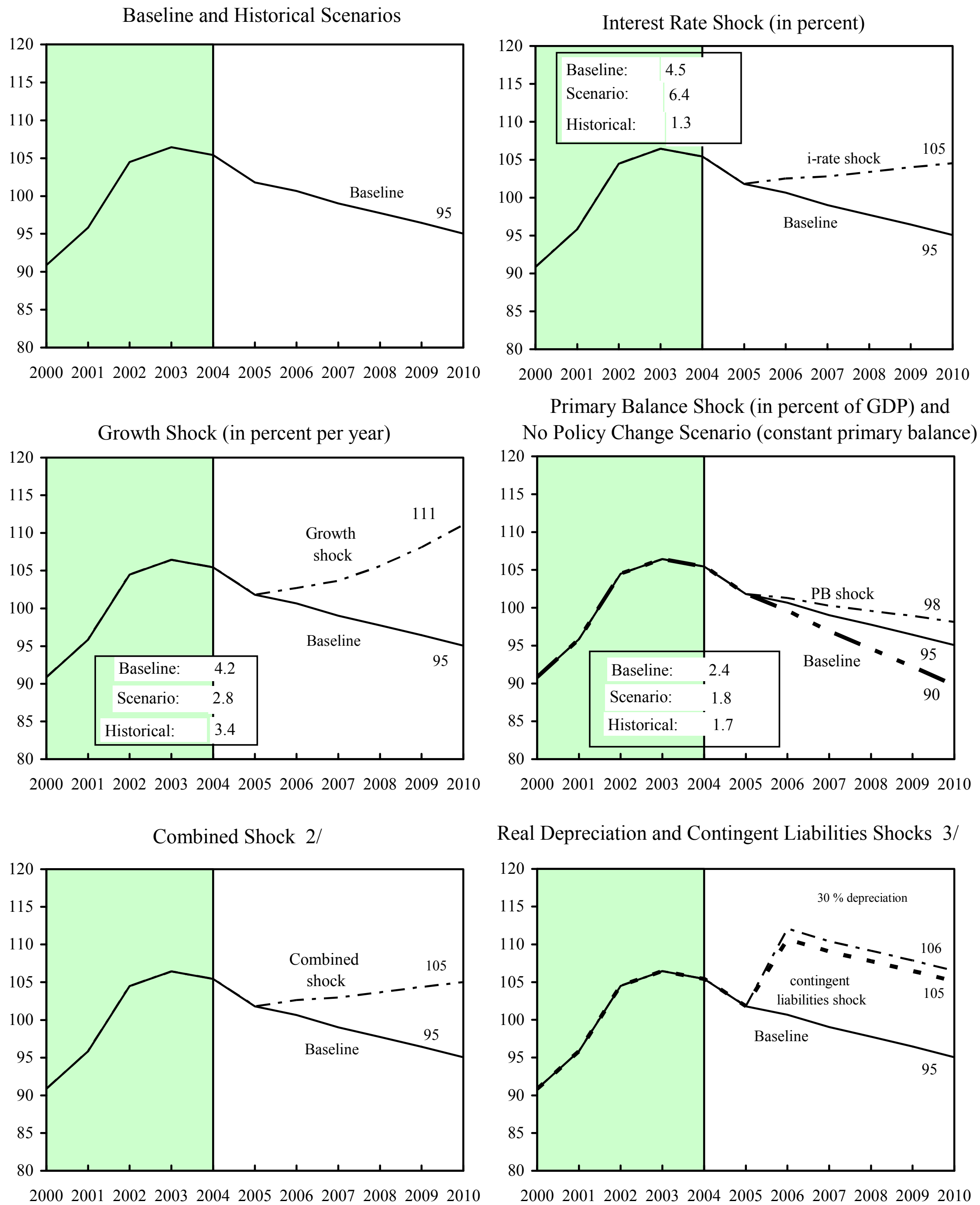
...while equity prices raced to record levels.



Sources: Bank of Israel; IMF, *International Financial Statistics;* and Bloomberg.

1/ Defined as the Bank of Israel policy rate minus inflation expectations. Data through October, 2005.
2/ As of November, 2005.
3/ As of October, 2005.

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



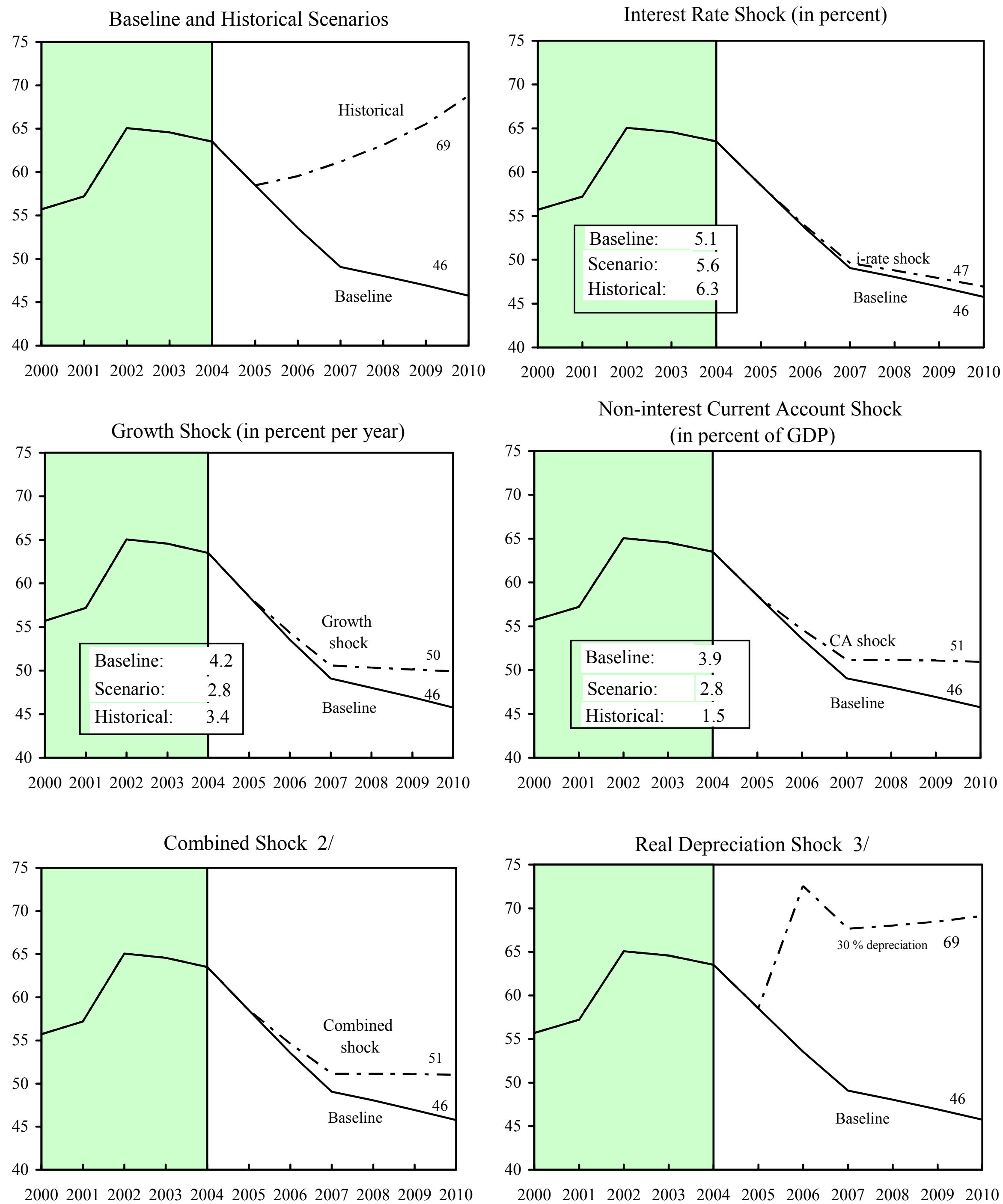
Sources: International Monetary Fund, Country desk data, and staff estimates.

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

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

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



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

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

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

3/ One-time real depreciation of 30 percent occurs in 2006.

Table 1. Israel: Selected Economic and Financial Indicators, 2000−06

Demographic and other data:

Population (2005) 1/	6.3 million
GDP per capita (2004)	US$20,800
Social indicators	
Life expectancy at birth (2005)	79.3
Male (2005)	77.2
Female (2005)	81.6
Infant mortality rate (2005)	7 per 1,000 live births
Physicians per 1,000 people (2001)	3.91
Population per sq. km. (2003)	308.1

	1995		2005	
	Billions of U.S. dollars	Percent of GDP	Billions of U.S. Dollars	Percent of GDP
Private consumption	52.5	58.6	72.9	59.4
Public consumption	26.3	29.3	34.9	28.5
Gross capital formation	23.7	26.4	15.0	12.2
Exports of goods and services	27.6	30.8	56.8	46.3
Imports of goods and services	40.4	45.1	63.3	51.6
GDP	89.6	100.0	122.7	100.0

	2001	2002	2003	2004	2005 5/	2006p 6/ 7/
	(Percent change unless otherwise indicated)					
National accounts indicators (constant prices)						
Private consumption	2.9	1.0	0.9	5.0	4.0	4.0
Public consumption	3.6	5.0	-2.3	-2.4	2.7	2.0
Fixed capital formation	-2.6	-6.2	-4.5	-0.2	1.0	5.8
Imports of goods and services	-4.9	-1.7	-1.7	11.8	4.4	5.3
Exports of goods and services	-11.5	-2.4	7.5	17.4	7.0	7.1
Real GDP	-0.3	-1.2	1.7	4.4	5.2	4.2
Labor market indicators						
Unemployment rate (in percent)	9.3	10.3	10.8	10.3	9.1	8.7
Real wages 2/	-2.6	-6.0	-3.0	2.5	0.8	...
Prices						
CPI (end period)	1.4	6.5	-1.9	1.2	2.4	2.0
CPI (period average)	1.1	5.7	0.7	-0.4	1.3	2.4
Core CPI (excluding housing, fruit and vegetables, end period)	0.2	6.3	-0.6	2.1	1.8	1.2
Interest rates (average, in percent) BOI policy rate 3/	6.8	6.8	7.5	4.2	3.7	4.8
Money and credit (period average)						
Private sector credit 4/	13.1	7.2	-5.5	3.9	10.7	...
Narrow money (M1) 4/	14.2	15.6	0.5	18.0	21.3	...
Broad money (M3) 2/	15.5	6.1	2.2	4.6	8.7	...
Public finance (percent of GDP)						
Central government revenue	37.1	39.2	37.1	37.0	37.3	36.8
Central government expenditure	41.5	43.0	42.7	40.8	39.2	39.8
Central government balance	-4.4	-3.8	-5.6	-3.8	-1.9	-3.0
General government balance	-3.9	-4.2	-6.5	-5.1	-2.7	-3.5
General government debt	95.8	104.5	106.4	105.4	102.0	100.4
Balance of payments						
Trade balance (percent of GDP)	-2.7	-3.5	-2.0	-1.6	-3.1	-3.0
Current account (percent of GDP)	-1.4	-1.2	0.7	1.3	0.8	0.1
Foreign direct investment (percent of GDP)	3.2	1.7	3.5	1.4	3.4	3.3
Exchange rate and terms of trade indices						
NEER (period average) 4/	0.7	-13.5	-7.0	-5.0	-1.3	...
REER (period average) 4/	-0.2	-10.0	-7.9	-7.1	-0.8	...
Terms of trade (2000=100; index level) /8	99.2	99.3	97.8	95.9	92.7	...

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

1/ CAI World Fact Book. Includes Israeli settlers in the West Bank, Gaza Strip and Israeli-occupied Golan Heights
2/ As of October 2005.
3/ The Bank of Israel set the policy rate at 4.75 percent for February 2006.
4/ As of November 2005.
5/ National accounts indicators reflect preliminary estimates.
6/ Public finance figures based on proposed 2006 budget.
7/ Fund staff projections.
8/ As of September 2005.

Table 2. Israel: Central Government Accounts, 2001−06

(In percent of GDP)

	2001	2002	2003	2004	2005 Budget	2005 Estimate 1/	2006 Budget 2/
Revenue (excluding repayment of credit)	**37.1**	**39.2**	**37.1**	**37.0**	**37.0**	**37.3**	**36.8**
Domestic	34.7	34.2	33.2	34.0	33.9	34.1	34.4
Tax	30.6	29.8	28.6	28.9	29.2	29.1	29.4
Of which: On income and profits	17.8	16.2	15.2	15.2	15.2	15.7	15.4
On domestic goods and services	12.8	13.6	13.5	13.7	13.9	13.4	14.0
Nontax domestic	4.2	4.4	4.6	5.0	4.7	4.9	5.0
Of which: Loans from the National Insurance Institute	0.9	1.6	1.8	2.1	2.1	2.2	2.2
Other	3.3	2.8	2.8	3.0	2.6	2.7	2.8
Foreign	2.5	5.0	3.9	3.0	3.1	3.2	2.4
Of which: Grants	2.0	3.0	2.1	2.0	2.1	2.1	2.0
Vat on defense imports	0.3	0.4	0.3	0.2	0.2	0.3	0.2
Interest foreign currency	0.1	0.1	0.1	0.0	0.0	0.1	0.0
Other revenues abroad 3/	0.0	1.5	1.4	0.7	0.7	0.7	0.1
Expenditure (excluding lending and expenditure by public hospitals)	**41.5**	**43.0**	**42.7**	**40.8**	**40.4**	**39.2**	**39.8**
Current expenditure	39.8	41.1	40.6	38.4	36.7	...	...
Wages	8.6	8.8	8.7	8.6	8.2	...	8.2
Subsidies & transfers	14.8	14.4	14.5	13.9	13.1	...	13.1
Interest	5.8	5.6	6.5	6.1	6.6	5.9	6.2
Other	10.6	12.4	11.0	9.8	12.5	...	12.3
Capital expenditure	1.7	1.8	2.1	2.4	3.7	...	...
Budget deficit	**4.4**	**3.8**	**5.6**	**3.8**	**3.4**	**1.9**	**3.0**
Financing	4.3	3.4	5.3	3.3	2.7	1.5	2.5
Domestic (net)	1.4	-1.2	-0.5	2.3	1.5	-0.4	1.7
Foreign (net)	3.5	4.9	4.4	1.5	0.5	-0.3	0.5
Sale of assets (net)	0.0	0.1	0.1	0.2	0.7	1.5	0.3
Change in cash balances and other financing (net)	-0.6	-0.4	1.3	-0.7	0.0	0.6	0.0
Memorandum item:							
Defense expenditure	9.8	11.8	10.8	9.6	8.4	...	8.2
Primary balance	1.4	1.8	0.8	2.3	3.2	4.0	3.2

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

1/ Based on preliminary estimates from the authorities.
2/ This is a proposed budget that was approved by the previous government prior to dissolvent of the Knesset.
3/ These revenues were not classified as a separate item before 2002.

Table 3. Israel: Balance of Payments, 2002−10 1/

(In billions of U.S. dollars)

				Projections					
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Current account balance	-1.3	0.8	1.5	1.0	0.2	1.3	2.1	3.1	4.4
Merchandise	-3.7	-2.2	-1.9	-3.8	-3.9	-2.9	-1.7	-1.1	-0.1
Exports, f.o.b.	27.5	30.1	36.6	39.3	42.9	43.6	45.1	46.8	49.0
Imports, f.o.b.	31.2	32.3	38.5	43.1	46.8	46.5	46.9	47.8	49.1
Civilian imports	28.8	30.3	36.6	41.0	44.5	44.0	44.2	44.9	46.0
Military imports	2.4	2.1	1.9	2.1	2.3	2.5	2.7	2.9	3.1
Services	-0.3	0.7	1.3	1.9	2.5	3.0	3.6	4.3	5.1
Exports	11.3	12.7	14.9	16.9	18.7	20.5	22.4	24.5	26.9
Imports	11.6	12.0	13.6	15.0	16.2	17.5	18.8	20.2	21.8
Factor Income	-4.0	-4.0	-4.2	-3.7	-5.0	-5.3	-6.2	-6.5	-7.0
Receipts	2.4	2.7	2.3	3.1	3.0	3.2	2.8	3.0	3.0
Payments	6.4	6.7	6.5	6.8	8.0	8.5	9.0	9.5	10.0
Net transfers	6.8	6.4	6.2	6.6	6.6	6.4	6.4	6.4	6.4
Capital and financial account balance 2/	-1.2	-0.7	-1.8	2.4	1.2	1.2	1.2	1.0	1.0
Capital account	0.2	0.5	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Financial account	-1.3	-1.2	-2.3	2.1	0.9	0.9	0.9	0.7	0.7
Direct investment, net	0.8	1.8	-1.5	4.5	3.0	3.0	3.0	3.0	3.0
Foreign direct investment (in Israel)	1.8	3.9	1.7	5.7	4.2	4.2	4.2	4.2	4.2
Portfolio investment, net	-2.0	-0.8	3.6	0.0	-0.2	-0.2	-0.2	-0.2	-0.2
Other investment	-0.1	-2.2	-4.4	-2.4	-1.9	-1.9	-1.9	-2.1	-2.1
Errors and omissions	1.8	1.3	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves 3/	0.6	-1.3	-0.3	-3.4	-1.3	-2.4	-3.2	-4.1	-5.4
Memorandum items (percentage of GDP):									
Current account balance	-1.2	0.7	1.3	0.8	0.1	0.9	1.4	2.0	2.6
Civilian trade balance	-1.2	-0.2	0.0	-1.4	-1.2	-0.3	0.6	1.2	1.8
Gross external debt 5/	65.1	64.6	63.5	60.8	57.3	54.0	54.1	53.8	53.5
Net external debt 4/ 5/	-2.0	-5.6	-9.7	-16.8	-16.4	-15.2	-13.6	-11.7	-9.1
Gross external debt (in billions of U.S. dollars)	67.8	71.3	74.2	75.2	75.2	75.4	80.1	84.7	89.5
Net external debt (in billions of U.S. dollars)	-2.1	-6.2	-11.3	-20.7	-21.5	-21.2	-20.1	-18.4	-15.3
GDP (in billions of U.S. dollars)	104.2	110.4	116.9	123.7	131.3	139.6	148.1	157.4	167.4

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

1/ Fund staff estimates and projections.
2/ Excludes reserve assets.
3/ Negative (positive) sign denotes increase (decrease) in reserves.
4/ Gross external debt minus the foreign reserve asset holdings of the Bank of Israel, commercial banks, and the non-financial corporates.
5/ As of September 2005.

Table 4. Israel: Indicators of External and Financial Sector Vulnerability, 2001−06

(In percent of GDP, unless otherwise indicated)

					Latest Data	
	2001	2002	2003	2004	2005	Date
Financial indicators						
Broad money (percent change, 12-month basis)	15.5	6.1	2.2	4.6	8.7	Oct. 2005
Private sector credit (percent change, 12 month basis)	13.1	7.2	-5.5	4.9	10.1	Oct. 2005
External Indicators						
Terms of trade (percent change, average) 1/	-2.1	0.1	-1.4	-1.9	2.7	Jun. 2005
Current account balance	-1.4	-1.2	0.7	1.3	0.8	Dec. 2005
Capital and financial account balance	1.1	-0.5	-1.9	-1.8	-1.0	Sept. 2005
Of which: Inward portfolio investment (debt securities etc.)	-1.4	-1.9	-0.7	3.1	-2.2	Sept. 2005
Other investment (loans, trade credits etc.)	-1.4	-2.6	-2.6	-1.7	-2.1	Sept. 2005
Inward foreign direct investment	3.2	1.7	3.5	1.4	0.3	Sept. 2005
Gross official reserves (in US$ billions; e.o.p.)	23.5	24.2	26.5	27.2	27.5	Dec. 2005
Official reserves in months of imports GNFS	6.5	6.8	7.2	6.3	5.4	Sept. 2005
Ratio of foreign reserves to Broad Money	0.35	0.37	0.36	0.35	0.36	Oct. 2005
Total gross external debt/GDP (in percent)	57.2	65.1	64.6	63.5	60.8	Sept. 2005
Total net external debt/GDP (in percent)	0.1	-2.0	-5.6	-9.7	-16.8	Sept. 2005
Country risk ratings (S. & P. / Moody's) 2/	A- / A2	A- / A2	A- / A2	A- / A2	A- / A2	
Exchange rate (per US$, period average)	4.21	4.74	4.55	4.48	4.49	Dec. 2005
REER appreciation (+) (period average)	-0.2	-10.0	-7.9	-7.1	-0.9	Oct. 2005
Change in Stock Market Index (in percent)	-6.6	-19.9	55.4	17.6	32.8	Dec. 2005
Share of foreign exchange credit in total credit to the public (e.o.p.)	36.0	36.7	34.9	30.2	26.5	Jun. 2005
Share of foreign deposits in total deposits of the public (e.o.p.)	31.1	32.4	32.6	33.0	33.4	Jun. 2005
Share of foreign currency liabilities in total liabilities (e.o.p.)	28.1	29.7	29.4	29.1	29.1	Jun. 2005

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

1/ According to WEO GEE trade deflators.

2/ On foreign currency long-term debt, Moody's upgrade in July 2000.

Table 5. Israel: Medium-Term Scenarios, 2002−10

	2002	2003	2004	2005	2006	2007	2008	2009	2010
	(In percent unless indicated otherwise)								
GDP growth rate	-1.2	1.7	4.4	5.2	4.2	4.2	4.0	4.1	4.3
Inflation (average)	5.7	0.7	-0.4	1.3	2.4	2.0	2.0	2.0	2.0
Fiscal deficit/GDP 1/									
Central government balance (baseline) 2/	-3.8	-5.6	-3.8	-1.9	-3.0	-3.0	-3.0	-3.0	-3.0
Central government balance (alternative) 3/	-3.8	-5.6	-3.8	-1.9	-1.2	-0.2	0.8	1.8	2.8
Public debt/GDP (end of period) 2/	104.5	106.4	105.4	101.8	100.4	98.8	97.5	96.2	94.9
Public debt/GDP (end of period) 3/	104.5	106.4	105.4	101.8	98.6	93.9	88.6	82.2	74.7
Current account/GDP	-1.2	0.7	1.3	0.8	0.1	0.9	1.4	2.0	2.7
Foreign reserves (in billions of U.S. dollars)	24.2	26.5	27.2	27.5	27.6	28.1	29.0	30.1	32.0
	(Percent changes)								
Memorandum Items:									
Aggregate domestic demand	-1.0	-1.7	2.8	4.0	3.7	3.3	3.3	3.3	3.3
Private consumption	1.0	0.9	5.0	4.0	4.0	4.0	4.0	4.0	4.0
Public consumption	5.0	-2.3	-2.4	2.7	2.0	2.0	2.0	2.0	2.0
Gross capital formation	-14.6	-8.7	4.0	6.4	5.7	2.7	2.7	2.7	2.7
Exports of goods and services	-2.4	7.5	17.4	7.0	7.1	6.9	6.4	6.6	6.9
Imports of goods and services	-1.7	-1.7	11.8	4.4	5.3	4.8	4.7	4.7	4.7
Central Govt. expenditure/GDP (in percent) 4/	43.0	42.7	40.3	39.2	39.2	38.2	37.2	36.2	35.2

Source: Fund staff estimates and projections.

1/ For the purpose of its budget deficit targets, the central government excludes net credit.
2/ Baseline scenario (06'-10') assumes real expenditure growth of 1 percent and a deficit of 3.0 percent of GDP, with revenue as the residual.
3/ Illustrative alternative scenario (06'-10') assumes real expenditure growth of 1 percent and a revenue/GDP elasticity of one, with the fiscal balance as the residual. If the central government budget is constrained to be in balance over 2008−10, the public debt / GDP would decline to 80.2 percent by 2010.
4/ Applies to both baseline and alternative scenarios.

ISRAEL—FUND RELATIONS

(As of December 31, 2005)

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

II. **General Resources Account**:	**SDR Millions**	**% Quota**
Quota	928.20	100.00
Fund holdings of currency	787.04	84.79
Reserve position in Fund	141.17	15.21

III. **SDR Department**:	**SDR Millions**	**% Allocation**
Net cumulative allocation	106.36	100.0
Holdings	13.04	12.26

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

V. **Financial Arrangements**: None

VI. **Projected Payments to Fund**:

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/Interest	2.82	2.83	2.84	2.83	2.83
Total	2.82	2.83	2.84	2.83	2.83

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

VIII. **Safeguards Assessments**: Not applicable

[1] For purposes of Fund relations, the West Bank and Gaza are under Israeli authority within the terms of Article XXXI, Section 2(g) of the Articles of Agreement. However, the mission focused on the Israeli economy and did not meet with representatives of the Palestinian Authority.

IX. **Exchange Rate Arrangement**:

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

X. **Article IV consultation**:

The last Article IV consultation was concluded on April 18, 2005. Israel is on the standard 12-month consultation cycle.

XI. **ROSCs:**

- Financial System Stability Assessment was conducted in 2000, issued in August 2001.
- Fiscal Transparency ROSC was conducted in 2003, issued in March 2004.
- AML/CFT ROSC was conducted in 2003, issued in June 2005.
- Data Module ROSC conducted in 2005, expected issuance in March 2006.

XII. **Technical Assistance**:

For purposes of Fund relations, the West Bank and Gaza are under Israeli authority within the terms of Article XXXI, Section 2(g) of the Articles of Agreement.

The IMF has provided technical assistance to the Palestinian Authority (PA) in the WBG, with a focus on assisting the PA in establishing economic and financial institutions, and in monitoring and reporting on fiscal developments and institution building. In particular, technical assistance has been provided in the areas of tax and customs administration, and expenditure management (Fiscal Affairs Department); in the areas of bank supervision and restructuring, payments systems, and central bank organization (Monetary and Financial Systems Department (MFD)); financial sector legislation (MFD together with Legal Department); and in the areas of national accounts and monetary statistics (Statistics Department).

XIII. **Resident Representative**:

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

ISRAEL: STATISTICAL ISSUES

Israel is a subscriber to the Special Data Dissemination Standard. The periodicity, timeliness, and coverage of economic data are generally adequate for surveillance. The methodology underlying the reported overall annual fiscal balance is not in conformity with internationally accepted practice as interest costs exclude the inflation component of such payments. The authorities are gradually moving toward the methodology that is standard in other countries. Data submitted for the 2004 *Government Finance Statistics Yearbook* now present cash and accrual data for revenue and expense, following the *GFSM 2001* format. However, no data on transactions and stocks of financial assets and liabilities were submitted. Within-year monthly reports on central government operations cover only the main aggregates of budgetary accounts, without a breakdown by composition.

ISRAEL: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF FEBRUARY 10, 2006

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	1/2006	2/06/06	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]					
Reserve/Base Money	11/2005	12/15/05	M	M	M
Broad Money	11/2005	12/15/05	M	M	M
Central Bank Balance Sheet	11/2005	12/15/05	M	M	M
Consolidated Balance Sheet of the Banking System	10/2005	01/04/06	M	M	M
Interest Rates[2]	12/31/05	1/4/06	D and M	D and M	D and M
Consumer Price Index	Dec 2005	1/17/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]					
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government					
Stocks of Central Government and Central Government-Guaranteed Debt[5]					
External Current Account Balance	Q2 2005	9/14/05	Q	Q	Q
Exports and Imports of Goods and Services	Q2 2005	9/14/05	Q	Q	Q
GDP/GNP	Q3 2005	11/16/05	Q	Q	Q
Gross External Debt	Q2 2005	9/16/05	Q	Q	Q

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

Statement by the IMF Staff Representative
March 22, 2006

1. This statement contains information on recent economic developments in Israel that has become available since the circulation of the staff report for the Article IV consultation. The information does not alter the thrust of the staff appraisal.

2. The Central Bureau of Statistics (CBS) released the 2005 national accounts on March 15th. Real GDP grew by 5.2 percent, the same as the estimate provided in the staff report. However, the composition of growth changed somewhat, as seen in the table below:

Real Growth Rates	**2005**	
	Estimate	**Actual**
GDP	5.2	5.2
Private consumption	4.0	3.9
Public consumption	2.7	2.0
Fixed capital formation	1.0	2.4
Imports of G&S	4.4	4.0
Exports of G&S	7.0	5.6

3. The Bank of Israel (BoI) kept its policy rate unchanged at 4.75 percent for the month of March. The BoI in its press statement said that while "interest rates in both the United States and Europe are likely to rise in March, the Bank of Israel does not believe that an increase in the interest-rate gap with the United States is needed at the present juncture to keep inflation within the target range." The BoI views the interest rate gap as "an important determinant of the likely behavior of the exchange rate and consequent inflationary pressures, but does not believe that there is a unique level of the gap that is needed to maintain inflation within the target range set by the government." Nonetheless, the BoI noted that expectations of increased interest rates around the world and the continued narrowing of Israel's output gap "increase the probability that interest rates in Israel will rise somewhat during the remainder of the year."

4. The latest reading of the consumer price index (CPI) showed that inflationary pressures are increasing somewhat, with the February CPI registering a monthly rise of 0.6 percent (3.1 percent yoy), with about half of the increase attributed to energy related items. The February figure followed three consecutive monthly declines in the CPI of 0.3 percent, 0.2 percent, and 0.1 percent in November 2005−January 2006, respectively. The staff's view is that additional data points are needed in order to establish the extent to which the latest reading reflects a sustained increase in inflationary pressures. Based on currently available information, the staff's baseline forecast points to a moderate overshooting of the inflation target band—on a year-over-year basis—during the first half of 2006, before inflation returns to within the band in the third quarter of this year.

5. The unemployment rate fell 0.1 percent in the last quarter of 2005, reaching 8.8 percent. According to the CBS, and based on preliminary trend data, the unemployment rate declined to 8.7 percent in the month of January. This is consistent with the staff's projection for the 2006 average unemployment rate of 8.5 percent.

6. The CBS also released the 2005 balance of payments data, with the current account registering a surplus of US$2.4 billion (1.9 percent of GDP), up from US$1.8 billion (1.5 percent of GDP) in 2004.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/33
FOR IMMEDIATE RELEASE
March 23, 2006

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

IMF Executive Board Concludes 2005 Article IV Consultation with Israel

On March 22, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Israel.[1]

Background

Following a strong performance in 2004, the economic expansion accelerated in 2005, supported by a relatively favorable global economic environment, an improvement in the security situation, and prudent policies. Real GDP grew at an estimated 5.2 percent in 2005. Inflation is slightly higher than a year ago, but remains in check. The unemployment rate continues to fall, but remains high. The exchange rate has been broadly stable over the past year, balanced by robust economic activity on the one hand and relatively low interest rates on the other.

The macroeconomic policies and structural reforms of recent years have opened up the economy, increased its competitiveness, and attracted foreign investment. Looking ahead, a key challenge is to sustain the ongoing fiscal retrenchment and thereby reduce the large stock of public debt relative to GDP.

Greater confidence in the macroeconomic outlook has been helped by the authorities' fiscal consolidation efforts, which are critical to putting public debt—about 100 percent of GDP—on a firm downward path. The government is establishing a credible commitment to maintain future deficits below 3 percent of GDP and to limit government expenditure growth, in real terms, to no more than 1 percent a year.

Given the renewed emphasis on fiscal consolidation, and inflation within the Bank of Israel's target range of 1–3 percent, monetary policy has been appropriately accommodative,

[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.

notwithstanding recent increases in the policy rate. A proposed new Bank of Israel Law, currently under consideration, should strengthen the independence of the central bank and help facilitate its primary objective of price stability.

The authorities have continued to implement structural reform policies aimed at boosting competition and efficiency. These included privatization in key sectors and a major reform of the capital market, which has gone well to date. A rapidly changing financial system, however, requires greater scrutiny, and the authorities are committed to refining their supervisory and regulatory activities accordingly.

Executive Board Assessment

Executive Directors welcomed the continued improvement in the Israeli economy: export performance and economic growth are strong, the unemployment rate is falling, inflation expectations remain in check, and the exchange rate is broadly stable. A favorable external economic environment and an improved security situation have been important factors, but sound policies have remained instrumental to this outcome. Notably, fiscal consolidation and an appropriately accommodative monetary policy have underpinned the strong economic performance. Directors noted that, while the macroeconomic outlook is positive, there is further scope to enhance growth and reduce vulnerabilities, especially to external shocks. They stressed the need for the policy agenda to remain focused on strengthening the fiscal position, reducing the high level of public debt, and ensuring financial sector stability in a context of relatively high credit risk and rapid capital market development.

Directors welcomed the improved fiscal performance, and noted that limiting the growth of real public expenditures to one percent a year is a strategy that has served Israel well and should be continued. Directors encouraged the authorities to seize the opportunity provided by strong growth and a favorable fiscal outturn in 2005 to reduce the deficit to well below the 3 percent of GDP ceiling and thereby achieve a meaningful decline in the large stock of outstanding public debt. Such a fiscal consolidation would underpin lower real interest rates and lead to greater private investment, lower future taxes, and stronger medium-term growth.

Directors welcomed the authorities' intention to make the implementation of the multi-year tax reduction plan approved in 2005 conditional on a continuation of the downward-moving debt-to-GDP ratio. Most Directors emphasized the importance of accelerating debt reduction by abstaining from further unplanned tax cuts. Accordingly, automatic stabilizers ought to be allowed to operate fully should revenues over-perform. To sustain the fiscal consolidation efforts, Directors also urged the authorities to adopt a multi-year budgetary framework and a detailed spending plan to enhance credibility and to help ensure that future budgets better reflect long-term priorities. A few Directors also called for a review of the fiscal rules to ensure that additional consolidation is achieved in good years.

Directors commended the Bank of Israel for its success in maintaining low inflation. With inflation expected to revert by the end of the year to the middle of the Bank of Israel target range, they felt the current policy rate is appropriate. Directors cautioned, nonetheless, that the Bank of Israel needs to closely monitor the pass-through from oil prices and exchange rate movements, and that rates may need to rise over time as the output gap closes and demand pressures mount.

Directors observed that Israel's strategy of inflation targeting—and the associated floating exchange rate regime—have served the country well, but noted that there is scope for further enhancing the analytical framework used to formulate policy and communicate it to the public. In particular, Directors welcomed the increased emphasis on the development of new macroeconomic models at the Bank of Israel as a central element of a forward-looking approach to monetary policy. Directors urged the passage of an updated Bank of Israel law to help reinforce central bank independence, enhance transparency and accountability, and aid in achieving price stability.

Directors noted that while the banking system has strengthened—as reflected in the improvement in key indicators—the level of problem loans remains high and the rapid development of the capital market has introduced new challenges to the supervisory and regulatory agencies. While welcoming the measures already taken to reduce the banks' exposure to credit risk and to increase banks' provisioning, Directors stressed that continued supervisory vigilance of the systemically important financial institutions will be essential to maintain financial stability. The need to pay close attention to the division of supervisory responsibilities to prevent regulatory arbitrage was also emphasized.

Directors saw scope for the supervisory authorities to enhance their oversight by cooperating and coordinating with their foreign counterparts, especially in the area of anti-money laundering. To that end, Directors encouraged the authorities to undertake a review of their practices given the revised Financial Action Task Force (FATF) recommendations.

Directors took note of the progress made in structural reforms, including measures to enhance public sector efficiency. Directors also welcomed the efforts to alleviate poverty, such as the work of the advisory group headed by the director general of the ministry of finance. They emphasized, however, that any measures should be accommodated within the current fiscal envelope and that they should be well-targeted to ensure adequate incentives to work and consistency with growth-promoting policies. Directors also stressed that cuts in some welfare benefits have contributed to social hardship, and that it is therefore important to ensure that there is a safety net to protect children, the elderly, and the disabled.

Directors observed that Israel meets the Special Data Dissemination Standards and its macroeconomic statistical system is generally adequate for Fund surveillance.

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 for the 2005 Article IV Consultation with the Israel is also available.

Table 1. Israel: Selected Economic and Financial Indicators, 2000−06

	2001	2002	2003	2004	2005 5/	2006p 6/ 7/
	(Percent change unless otherwise indicated)					
National account indicators (constant prices)						
Private consumption	2.9	1.0	0.9	5.0	3.9	4.0
Public consumption	3.6	5.0	-2.3	-2.4	2.0	2.0
Fixed capital formation	-2.6	-6.2	-4.5	-0.2	2.4	5.8
Imports of goods and services	-4.9	-1.7	-1.7	11.8	4.0	5.3
Exports of goods and services	-11.5	-2.4	7.5	17.4	5.6	7.1
Real GDP	-0.3	-1.2	1.7	4.4	5.2	4.2
Labor market indicators						
Unemployment rate (in percent)	9.3	10.3	10.8	10.3	9.1	8.5
Real wages 2/	-2.6	-6.0	-3.0	2.5	0.8	...
Prices						
CPI (end period)	1.4	6.5	-1.9	1.2	2.4	2.0
CPI (period average)	1.1	5.7	0.7	-0.4	1.3	2.4
Core CPI (excluding housing, fruit and vegetables, end period)	0.2	6.3	-0.6	2.1	1.8	1.2
Interest rates (average, in percent) BOI policy rate 3/	6.8	6.8	7.5	4.2	3.7	4.8
Money and credit (period average)						
Private sector credit 4/	13.1	7.2	-5.5	3.9	10.7	...
Narrow money (M1) 4/	14.2	15.6	0.5	18.0	21.3	...
Broad money (M3) 2/	15.5	6.1	2.2	4.6	8.7	...
Public finance (percent of GDP)						
Central government revenue	37.1	39.2	37.1	37.0	37.3	36.8
Central government expenditure	41.5	43.0	42.7	40.8	39.2	39.8
Central government balance	-4.4	-3.8	-5.6	-3.8	-1.9	-3.0
General government balance	-3.9	-4.2	-6.5	-5.1	-2.7	-3.5
General government debt	95.8	104.5	106.4	105.4	102.0	100.4
Balance of payments						
Trade balance (percent of GDP)	-2.7	-3.5	-2.0	-2.5	-3.2	-2.9
Current account (percent of GDP)	-1.4	-1.2	0.7	1.6	1.9	0.9
Foreign direct investment (percent of GDP)	3.2	1.7	3.5	1.5	4.9	3.3
Exchange rate and terms of trade indices						
NEER (period average) 4/	0.7	-13.5	-7.0	-5.0	-1.3	...
REER (period average) 4/	-0.2	-10.0	-7.9	-7.1	-0.8	...
Terms of trade (2000=100; index level) 8/	99.2	99.3	97.8	95.9	92.7	...

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

1/ CAI World Fact Book. Includes Israeli settlers in the West Bank, Gaza Strip and Israeli-occupied Golan Heights
2/ As of October 2005.
3/ For 2006, reflects the latest policy rate (4.75 percent) set by the BoI in February 2006.
4/ As of November 2005.
5/ National accounts and balance of payments indicators reflect the latest CBS estimates.
6/ Public finance figures based on proposed 2006 budget.
7/ Fund staff projections.
8/ As of September 2005 .

Statement by Jeroen Kremers, Executive Director for Israel
and Nir Klein, Senior Advisor to Executive Director
March 22, 2006

General remarks

On behalf of the Israeli authorities we thank the staff for an insightful set of papers, which provide a fair and balanced description of the consultation discussions and economic developments in Israel.

Following three years of a deep recession, in 2001-03, economic growth has since picked up, and the Israeli economy now shows a strong and consistent recovery. A relatively benign global economic environment and improvement in the security situation, together with a continued policy mix of fiscal tightening alongside accommodative monetary policy in 2005, provided favorable conditions for business sector activity. Fiscal policy was geared towards further consolidation with a lower tax burden and a substantial reduction in the relative size of the public sector. These policy measures together with considerable progress in implementing structural reforms, including much privatization, enabled the government to reduce its budget deficit and to renew progress in reducing the size of the public debt as a percentage of GDP. Monetary policy remained expansionary, yet in keeping with the authorities' determination to meet inflation targets. In this respect, recent inflationary pressures brought about a policy of interest rate increases. In light of recent policies, and in view of recent macroeconomic outcomes, the authorities have succeeded in enhancing credibility and boosting confidence of market players.

The authorities are committed to pursuing prudent policies to support strong and sustainable economic growth alongside price and financial stability. In view of the challenges ahead, the authorities are determined to make every effort to reduce economic vulnerability by promoting development that increases the economy's competitiveness and flexibility. As output is still below its potential, the authorities concurred with the staff's projection that strong economic growth will continue in the medium term, albeit at a slightly slower pace.

GDP

Following GDP growth of 4.4 percent in 2004, economic activity further picked up in 2005, recording a remarkable growth of 5.2 percent. Economic expansion continued to reflect the rapid expansion of the business sector, while the public sector continued to decline (as a percentage of GDP). The robust growth was led by a confluence of external and internal favorable conditions, particularly the continued global growth and the improvement in the security situation, and was supported by prudent fiscal policy and an accommodative monetary stance. These policies helped restore market participants' confidence and raise domestic demand. In 2005, private consumption increased by 3.9 percent and together with export growth, particularly in the high-tech sector, continued to be a major force of economic expansion. Investment in fixed capital grew by 2.4 percent after several years of continuous decline.

The external position continued to be positive. While export growth remained relatively strong at 5.6 percent—albeit slower than the remarkable increase in the previous year—imports recorded a more moderate growth of 4 percent. As a result, the 2005 current account balance ended with a surplus, for the third consecutive year after a decade of continuous deficits. The capital and financial accounts demonstrated great vigor in 2005. Notwithstanding the record-high level of foreign direct and portfolio investments, net capital exports increased in 2005 to 4.5 billion US dollars, a reflection of the removal of several restrictions on institutional investors' investments abroad as well as the reduction of the tax rate differential on investments in Israel and abroad.

The fact that output level was still below its potential enabled a relatively quick response in supply with only a mild commensurate price increase. Higher oil prices continued to have an adverse effect on the supply side, though this was limited as the share of industry with heavy oil consumption in total production is relatively low. As part of the supply-side response, the labor market absorbed 93,000 new employees in 2005—a 3.9 percent increase—mainly in the trade and services sectors. The unemployment rate declined from 9.7 percent at the end of 2004 to 8.8 percent in the last quarter of 2005, while the labor participation rate increased.

Fiscal issues

In 2005, the authorities continued with ongoing efforts to downsize the public sector and further enhance the fiscal position. To promote transparency and credibility, fiscal policy was placed within a medium-term framework—for the years 2005-2010—anchored in 2004 legislation, and stipulating a budget deficit ceiling of 3 percent of GDP and real growth in public expenditure of no more than 1 percent a year. The budget deficit ceiling for 2005 was temporarily increased by 0.4 percent of GDP to allow for one-time spending related to the disengagement, but the contingency was unnecessary, as the 2005 budget balance recorded the lowest deficit in the past five years, amounting to only 1.9 percent of GDP compared to 3.9 percent in the previous year. This significant improvement in the fiscal balance can mainly be attributed to lower-than-budgeted government spending while revenues were broadly in line with earlier projections, despite the tax cuts that were introduced in the middle of the year. This is the third consecutive year that such underspending has taken place.

The low budget deficit and considerable revenues from privatization, together with rapid economic growth led to a sharp reduction in 2005 in the general government debt ratio––contracting by 3.8 percent of GDP to 102 percent of GDP—following a moderate decline in the previous year. The high level of public debt underlines the need for further reduction. The authorities reiterate their commitment to continue with a firm fiscal retrenchment, noting that the budget deficit rule of not exceeding 3 percent of GDP should be regarded as a ceiling and not a target. The proposed 2006 budget, which was approved by the government, adheres to the budget deficit and expenditure's real growth restrictions, with the aim of continuing to reduce the debt to GDP ratio.

Given currently high tax rates, the authorities intend to continue with implementing an agreed multi-year tax reduction plan. However, the implementation of tax reform is conditional on a continuation of the downward-moving debt-to-GDP ratio, meaning that it could be postponed in the event of a sharp or unforeseen decline in revenues.

Monetary issues

The staff views the current monetary stance as accommodative and appropriate. In 2005, Israel continued to benefit from favorable external macroeconomic conditions, such as the relatively low foreign interest rates, a decline in emerging markets' risk premium and a surge in capital inflows. These conditions, which supported foreign currency market stability despite the narrowing interest rate differentials, enabled the Bank of Israel (BoI) to reduce the policy rate to its historically lowest level—of 3.5 percent—and maintain this low rate for a consecutive eight months (February-September). Starting in October 2005, given the rise in global interest rates and the NIS depreciation against the US dollar, together with the rapid economic growth, the BoI gradually raised its interest rate cumulatively by 1.25 percentage points to 4.75 percent.

During 2005, the CPI rose by 2.4 percent, slightly more than during the previous year, yet still within the target range of price stability (1-3 percent). The increased inflationary pressures can be mainly attributed to the global increase in energy prices, the rapid growth in economic activity, which led to further contraction in the excess capacity of production, and to the depreciation of the NIS against the US dollar, particularly in the second half of the year as interest rate differentials narrowed. The CPI excluding housing, fruit and vegetables—a usual measure for core CPI[1]—rose during 2005 by 1.8 percent, 0.3 percentage points less than during the previous year. Continued price adjustments alongside the continued narrowing of Israel's excess production capacity are also expected to exert upward pressure on prices in 2006. The BoI also noted that several factors, such as changes in foreign interest rates and the interest rate gap between the US and Israel, the geo-political uncertainty, possible reversal in capital flows to emerging markets, exchange rate developments, and the rapid economic growth, continue to pose upside inflation risks. The Bank of Israel will continue to closely monitor economic developments, with the intention of achieving the government's price-stability target.

Within the framework of inflation targeting, the authorities use several forward-looking market indicators to formulate monetary policy. Efforts are being made to further improve existing macroeconomic statistical models in order to better understand the macroeconomic structure as well as the monetary policy transmission mechanism. In this regard, the authorities appreciate the recent cooperation between the BoI and the Fund's staff, which has helped to enhance their analytical capacity.

Financial and banking sector

In 2005, significant progress was made in reducing the dominance of the banks in the financial markets as legislation forcing the divestiture of the banks' holdings in mutual and provident funds was enacted and implemented. Within three months after the legislation, a significant part of the banks' mutual and provident funds had been sold to domestic insurance companies or foreign investors. Despite these welcome developments, the new market

[1] Housing prices are highly sensitive to exchange rate movements as most rental contracts are denominated in US dollars.

configuration, which reflects a significant change in the financial and banking systems, demonstrates vulnerabilities that need to be reduced. In this regard, the authorities acknowledge the staff's recommendations as described in the selected issues paper (Chapter IV, paragraphs 37-43).

The authorities express considerable satisfaction at their succeeding in raising the banking system's capital ratio from 9.5 percent in 2000 to 11.5 percent in 2005 (during and despite the recent economic recession), although they are aware that the system has relatively low capital levels compared to its international peers. The banks' recent higher earnings, which reflected favorable macroeconomic conditions, as well as one-time revenues from their divesture of mutual and provident funds, clearly provide an opportunity to further improve these rates.[2] The authorities have taken several measures to reduce the risks of problem loans, including pursuing extensive series of on-site inspections and further enhancing the banks' internal procedures for detecting, classifying and provisioning of problem loans. The authorities are quite confident that despite the considerable level of problem loans, there are no immediate risks to financial stability. In this regard, a recent stress testing performed on the problem loan portfolio showed endurance of the banking system despite heavy losses under extreme scenarios.

AML/CFT

In 2005, the AML/CFT regime was further strengthened as the "Prohibition of Financing Terrorism" was enacted and the Banking Supervision Directive was modified appropriately. The main modifications include the implementation of guidelines for customer identification to combat the financing of terrorism and for treating the risks embedded in check deposits. In addition, the criteria of countries bearing high risk have been elaborated and a list of countries that require heightened scrutiny of money transfers has been furnished. Action is also being taken to encompass credit card companies in the Directive on combating the financing of terrorism. The authorities share the staff's view that more needs to be done to ensure appropriate compliance with legal and regulatory requirements for AML/CFT, particularly in the foreign offices of Israeli banks. Therefore, the Banking Supervision department recently undertook some measures to strengthen those foreign offices' compliance with legal and regulatory requirements of the host country as well as with internal procedures and regulations of a banking group.

Structural reforms and poverty reduction

The authorities are continuing with their reform agenda to boost competition and efficiency in the markets. In the banking sector, following the privatization of Israel Discount Bank, the third largest bank in Israel, the authorities completed in 2005 the privatization of one of the country's two largest banks and the last publicly-owned bank, Bank Leumi, to international institutional investors. In addition, an agreement was signed between the

[2] The divesture of mutual and provident funds, although eliminating a potential source of income, may lead to higher revenues in the future, as banks are now allowed to widen their fee base by offering advisory and brokerage services in pension funds, an area in which banks were previously forbidden to operate.

Ministry of Finance and Hahistadrut (the Israeli labor union) to separate the three seaports with an intention to privatize them in the future. The split of the Ports Authority into three separate companies is expected to enhance competition, raise productivity and significantly reduce labor costs. Furthermore, the authorities took measures to improve transportation infrastructure standards by transforming the public works department, Maatz, a unit of the Transportation Ministry, into a state-owned company. Ongoing efforts are also being made to privatize the Israel Military Industries (Taas) and the Oil Refineries company (Bazan).

Following extensive cuts in welfare payments in recent years, which led to a significant rise in measured poverty,[3] there seems to be a consensus among political parties on the need for implementing—after the elections—policies targeted at reducing poverty, particularly among working, low-income families. In this regard, the government will consider adopting various policy measures that provide incentives for low wage individuals to participate in the labor market, and thus to allow their families to rely on a productive income source. Such considered measures include the "Earned Income Tax Credit" (EITC) plan, a subsidy to low wage working families.

[3] Poverty in Israel is based on a relative measure and not on an absolute one.