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IMF Country Report No. 08/62

Israel: 2007 Article IV Consultation—Staff Report; Staff Supplement; 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 2007 Article IV consultation with Israel, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 10, 2007, with the officials of Israel on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 22, 2008. 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 supplement of February 8, 2008 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 13, 2008 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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ISRAEL

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Israel

Approved by Michael Deppler and Michael Hadjimichael

January 22, 2008

Executive Summary

Economic growth and policies have been strong but vulnerabilities remain. There was agreement between staff and the authorities on the major issues. The key points are as follows:

- Economic growth is projected to remain strong in 2008, although less buoyant than in the recent past. Domestic fundamentals are solid, except that capacity constraints are beginning to bind and risk premia have increased. Slowing demand in partner countries is expected to weigh on activity.
- Interest rates would probably have to rise to keep inflation in the 1–3 percent target range over the medium run. But downside risks to external demand and higher risk premia argue for caution in raising rates.
- The 82 percent of GDP public debt ratio is a key source of economic vulnerability. Given that good times are expected to prevail, the central government deficit should stay at the close-to-balanced position achieved in 2007 to support a rapid decline of the debt ratio. This will require tight execution of the 2008 budget, which tables a ceiling of 1.6 percent of GDP for the central government deficit, and allocating revenue overperformance to deficit reduction.
- The present rules-based approach to fiscal policy has served the country well and should be preserved. An increase in the relatively low expenditure growth ceiling is under consideration. Staff argued for anchoring a revised rule also on a 60 percent of GDP debt objective for 2015. Achieving this objective would require maintaining the close-to-balanced central government position through 2015. The authorities thought that this was a realistic target that was consistent with higher expenditure growth and would be considered.
- Financial sector soundness has been improving and a more diversified and complex system is emerging as a result of ambitious reforms. This will require a commensurate strengthening of prudential policies and practices. Key are more scope to recruit highly qualified staff; rebalancing activities from developing new regulation to on-site supervision; taking a more principles-based approach to regulation; enhancing collaboration between the supervisors, notably with respect to crisis management and resolution; and formal independence for the insurance supervisor.

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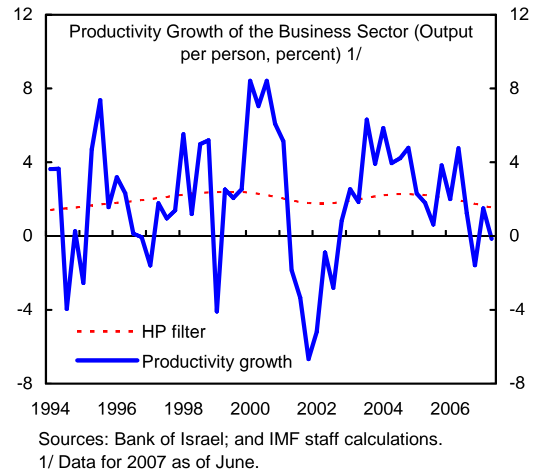
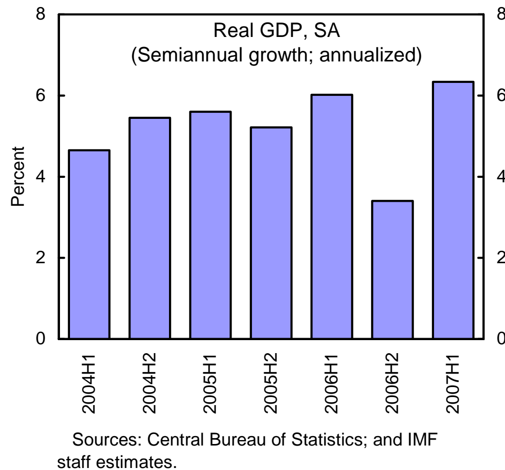
I. REPORT ON THE DISCUSSIONS

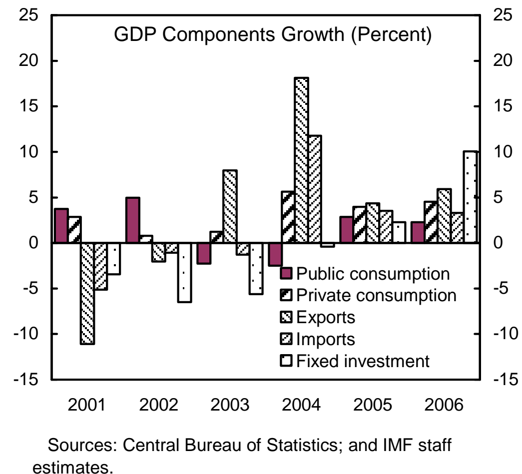
1. **Strong macroeconomic conditions and sound domestic policies have significantly improved Israel's growth performance and prospects but vulnerabilities remain**.[1] Amid global financial market turmoil and heightened uncertainty about growth prospects, the discussions focused on external stability and the exchange rate; financial sector vulnerabilities and policy requirements; and fiscal policy, notably the need to reduce the high public debt.



Sources: Bank of Israel; and IMF staff calculations.
1/ Data for 2007 as of June.



Sources: Central Bureau of Statistics; and IMF staff estimates.



Sources: Central Bureau of Statistics; and IMF staff estimates.

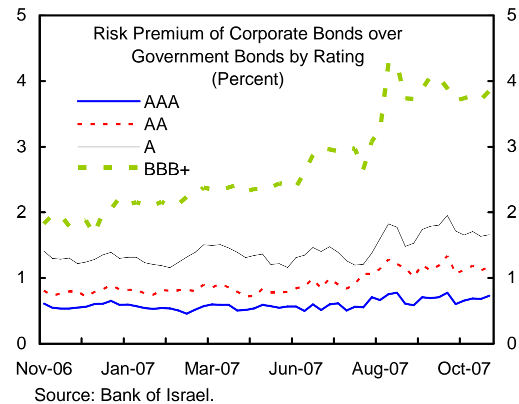
A. Macroeconomic Prospects: Strong but Less Buoyant Activity

2. **The economy is entering the global slowdown with significant momentum**. Notwithstanding the war in the north during 2006, real GDP growth averaged about 5¼ percent during 2006–07 (Table 1, Figure 1). Buoyant world trade propelled exports and investment, fostering strong employment growth—which was also supported by welfare reform—and private consumption.

3. **The global financial turmoil has caused some increase in risk premia but has not prompted significant concerns thus far** (Figure 2–3 Tables 2–4). Stock prices have been

[1] The staff team that met with the authorities comprised Messrs. Decressin (head), Čihák, Epstein (all EUR), Moore and Tower (MCM), and Palmer (MCM Consultant). Israel is a case study for enhanced financial sector analysis.

resilient in the face of recent financial turbulence; CDS spreads on government bonds are up somewhat from unusually-low pre-crisis levels; and corporate bond spreads have widened, reflecting also the bankruptcy of a local nonfinancial firm. Some banks have announced losses on mortgage-related US assets but the effect on profitability and capital has been small. Nor have banks been experiencing funding pressures, as they rely almost exclusively on deposits from the public. The authorities do not expect a fall-out of the financial turmoil on the Israeli banking system that could affect its ability to adequately support the domestic economy, provided losses on AAA-rated prime-mortgage-backed securities (ABS) remain limited.[2]



4. **Looking forward, activity is thus widely expected to remain strong, even if somewhat less buoyant than in the past**. Domestic preconditions for continued output growth remain in place. Specifically, GDP growth is broad based; families' real incomes are rising, including those of the poor; corporate profitability and balance sheets have improved; and the cooperation between employers and trade unions is good. Furthermore, the economy's competitiveness is still solid (¶7). However, capacity constraints are beginning to bind (Figure 4), notably in the market for highly skilled employees; and risk premia on corporate funding have risen. Also, external conditions are becoming less supportive. In particular, decelerating activity in the United States and Europe will weigh on exports and investment, although much hinges on the extent to which the external slowdown spreads beyond foreign real estate sectors; and oil prices are standing some 40 percent above 2007:Q1 levels. Accordingly, the Ministry of Finance (MoF) and Bank of Israel (BoI) foresee 4.2 percent and 4.4 percent real GDP growth, respectively, for 2008. Taking into account the latest developments and prospects, staff projects 3.8 percent real GDP growth, which is around potential, and an output gap that is estimated to be broadly closed.[3]

5. **Risks around the forecasts were seen to be broadly balanced**. MoF staff felt that their forecast was prudent, considering repeated upside surprises to growth in the past. BoI

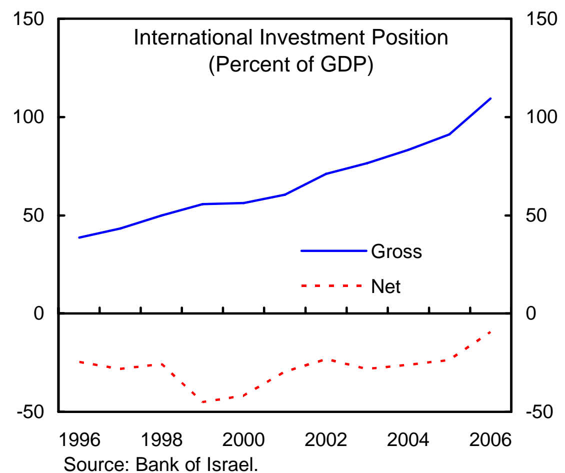
[2] Banks were instructed to disclose their holdings of US mortgage-related assets by September 30, 2007. According to the disclosures by the largest five banks (which account for almost all banking system assets), holdings of structured products, which are being hit by write offs, amounted to 0–12 percent of equity; those of ABS that are not guaranteed by US government-sponsored enterprises amounted to 3-11 percent of equity for four banks and 75 percent of equity for one bank (Hapoalim). All the banks have reported that they have no (or minimal) exposure to sub-prime mortgages in their ABS portfolios. Hapoalim reported that 99 percent of its holdings of ABS are AAA-rated. Mark-to-market losses on these types of assets have to date been modest.

[3] This assumes steady-state productivity growth of 2 percent, with population growth at 1¾ percent.

staff explained that under an alternative scenario, with the United States experiencing a recession, growth would still reach 3.6 percent. The authorities concurred that external risks are tilted to the downside: partner demand might slow more than expected, global financial turmoil might worsen and begin to affect Israel significantly, oil prices could exceed projections further, and rising geopolitical uncertainty could adversely affect output. But domestic risks are to the upside. In particular, despite unemployment rates nearing record lows and wages accelerating gradually, capacity might be less constraining than estimated.

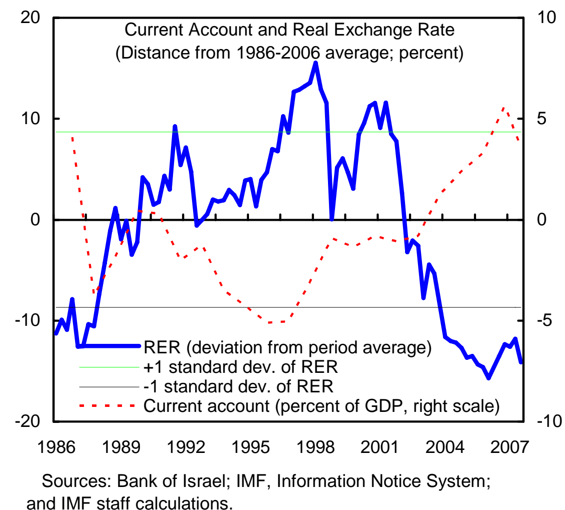
B. External Prospects: More Integration with the World Economy

6. **The economy is integrating rapidly with the rest of the world**. Flows of nonresident investment into Israel—spurred partly by privatization of public enterprises—and resident investment abroad together reached a record 40 percent of GDP in 2006, up from 22 percent of GDP in 2005, partly on account of some exceptionally large transactions. In 2007, gross flows are moderating toward 2006 levels. The increased flows have also pushed gross external debt to about 60 percent of GDP but this does not detract appreciably from robustness. While this raises vulnerability to exchange rate shocks (Figure 5, Table 5), this vulnerability is greatly diminished by the country's net external debt asset position of about 25 percent of GDP. Only the public sector has net external debt liabilities, equivalent to some 3 percent of GDP.



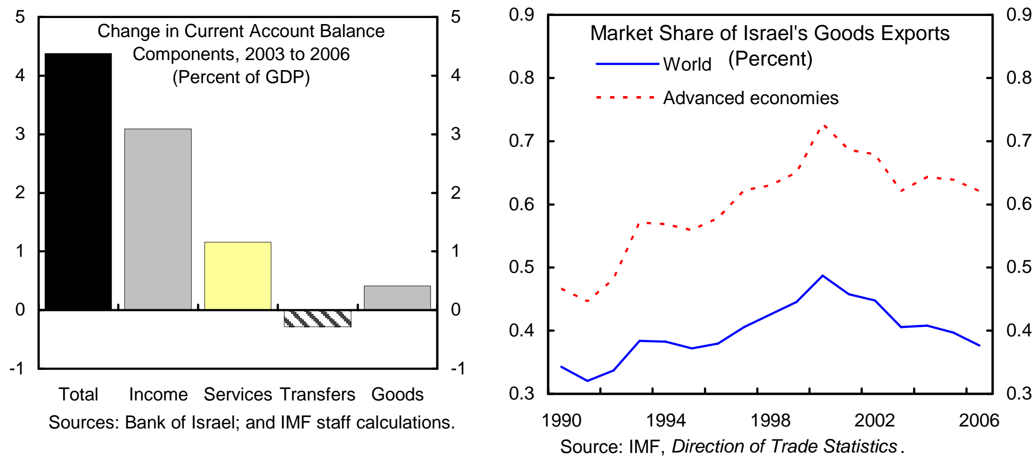
Source: Bank of Israel.

7. **The current account surplus is falling but the exchange rate may still be moderately undervalued**. The current account surplus reached 5½ percent of GDP in 2006, up from 3.3 percent in 2005. While domestic investment has been recovering strongly, public savings have been rebuilt. Concurrently, temporary factors are boosting private savings and the current account, notably the 2005 tax reform on investments abroad, which has fostered record capital outflows. At a constant real effective exchange rate and based on data available through end-November 2007, staff and BoI projections point to a decline in the current account surplus to 2½ percent of GDP by



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

2008. Staff sees the current account stabilizing at 2¼ percent of GDP over the medium run. Multilateral calculations point to an equilibrium current account ("norm") of about 1 percent of GDP for Israel and suggest that the real exchange rate may be undervalued by 5–10 percent, although the "norm" and the underlying current account could be closer together.[4] Consistent with such a view, the balance for goods and services has not moved much during 2004–06 and market shares for goods have moved broadly sideways.



Sources: Bank of Israel; and IMF staff calculations.

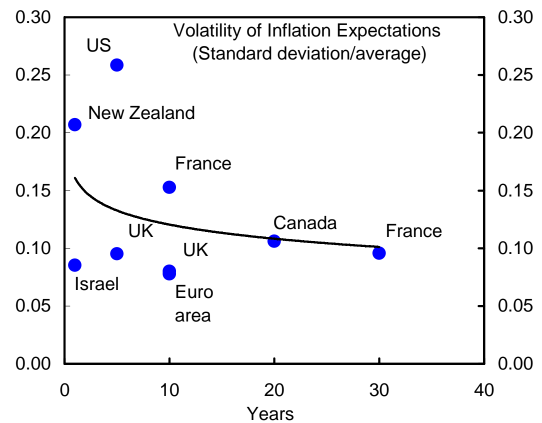
Source: IMF, *Direction of Trade Statistics*.

8. **The authorities had no firm view on the valuation of the exchange rate**. There was agreement that domestic policies are consistent with external stability. However, the authorities considered it difficult to determine the medium-run equilibrium current account balance and exchange rate with much confidence. BoI analysis suggests that the former is higher and the latter more appreciated than over the 1990s. Also, BoI representatives thought that talk about under or overvaluation could prompt calls for renewed intervention in exchange markets (BoI last intervened in 1997), which could complicate monetary policy. The flexible exchange rate regime was viewed to be appropriate for Israel. Also, any undervaluation would allow scope for nominal appreciation, which would help moderate inflationary pressure (¶10).

C. Monetary Policy: Staying on Target Amid Exchange Rate Volatility

9. **Monetary policy has successfully stabilized inflation expectations, even though inflation has frequently been outside the 1–3 percent target range on account of exchange rate changes**. Lately, inflation has been undershooting the 1–3 percent target, largely reflecting sheqel appreciation against the US dollar, but is rising again. By November, prices stood just under 3 percent above the end-2006 level (Figure 6), while the sheqel (NIS) appreciated by about 6.5 percent against the US dollar (US$), which may have

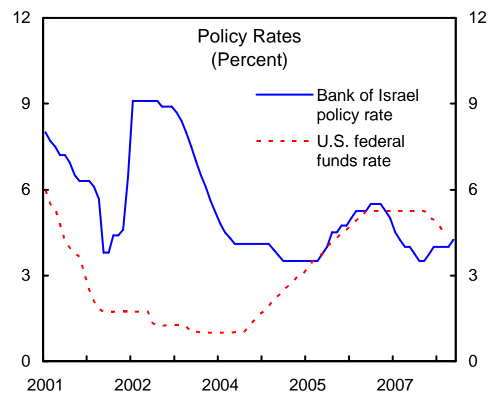
[4] See Selected Issues Paper, Chapter I.



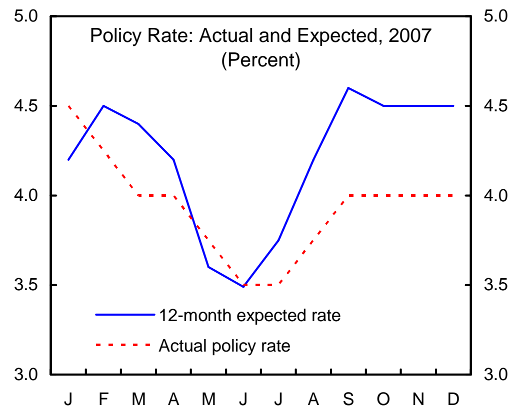
Sources: Bloomberg; and IMF staff calculations.

lowered domestic prices by about 2 percent.[5] As the exchange rate prompted CPI deflation earlier in the year, the BoI responded by cutting interest rates from a peak of 5.5 percent in October 2006, to 3.5 percent by June 2007. The rate cuts to below the U.S. federal funds rate (an unprecedented differential) contributed to weakening the shekel. With inflation reaccelerating, falling unemployment and rising wage pressure, and some evidence of slowing productivity growth, the BoI changed course in August, raising rates in three steps, to 4.25 percent by January 2008.

10. **Further rate hikes will probably be needed for inflation to stay within the 1–3 percent target range, with the amount depending on exchange rate developments**. Monetary policy will have to contend with rising domestic pressures on inflation and a volatile exchange rate. BoI econometric estimates suggest that the domestic component of consumer prices is rising over 4 percent, while the external component is declining, owing to the appreciation of the sheqel against the U.S. dollar. Judging by current developments and with prospects for rising capacity constraints, domestic inflationary pressure is unlikely to moderate in the context of a policy rate that is not firmly within neutral range. Also, global inflation is on the rise. Thus, much will hinge on the development of the NIS/US$ exchange rate. In this regard, there was agreement that, because the current account surplus would probably narrow fundamental pressures for sheqel appreciation would diminish. Furthermore, BoI officials expected capital inflows to moderate more than outflows, as diversification by institutional investors would continue. Market analysts foresee inflation of just over 2 percent over the medium



Sources: IMF, Information Notice System; and IMF staff calculations.



Source: Bank of Israel.

[5] A 10 percent appreciation against the US$ quickly reduces inflation by about 2 percent because housing and some other services are priced in US$, and account for roughly 20 percent of the CPI basket.

run, with the policy rate rising to around 4.5 percent by 2008:Q4. Staff's forecast based on the WEO and other tools is for inflation of around 2 percent in 2008–09, assuming interest rates rise gradually to about 5.0 percent by end-2009. However, the risks around this scenario, particularly on account of the potential for a further appreciation of the exchange rate, remain appreciable (Box 1). More importantly, there was agreement that growing uncertainty about external demand prospects and rising risk premia in capital markets argue for caution in raising rates.

11. **Staff welcomed steps to strengthen the transparency of the monetary policy framework and discussed options for further improvements**. The BoI is moving to publish inflation reports on a quarterly rather than semi-annual frequency to improve communication with markets. In addition, model-based fan charts of inflation and interest projections have been added to the report. Staff welcomed these steps, but suggested clarifying the role of the fan chart forecasts, which are not considered official BoI forecasts, in the BoI's decision making; the relationship between these forecasts and those for other macroeconomic variables (notably the exchange rate); and the monetary policy horizon. BoI officials were open-minded, but also had concerns about publishing a formal, full-fledged inflation forecast. They thought that the volatility of the exchange rate and its high (although weakening) pass through to domestic prices would limit the informational content of such a forecast. Nonetheless, they stood ready to alter their communications, notably when restructuring the BoI following the adoption of the draft BoI law.[6]

[6] In December 2007, the MoF and BoI formally agreed on a new wage agreement that should pave the way for passage of the new BoI law. For details on the law, see IMF Country Report No. 06/120, para. 23.

Box 1. Monetary Policy—Baseline Forecast and Risk Assessments

The **central scenario** assumes a small positive output gap that is expected to close by mid-2008. Under this scenario, and at an exchange rate of about 3.9 shekel/$, the policy rate would be expected to rise in order to maintain headline inflation within the 1–3 percent band over the next two years.

Baseline Forecast on December 17, 2007

	2008Q1	2008Q4	2009
Policy rate	4.3	4.8	5.1
Inflation	2.6	1.0	2.0
Sheqel per U.S. dollar	3.83	3.82	3.9
Output gap	0.3	-0.6	-0.3

The baseline forecast is subject to a number of risks, the policy implications of which are illustrated below (IMF Country Report 06/121, Chapter III provides detailed explanation and properties of the model used to derive these assessments).

- Unexpected slack, resulting in **negative output gap**, would alleviate the need to increase the policy rate in the near term, while keeping headline inflation within the targeting band.

Negative Output Gap
(Deviation from baseline)

	2008Q1	2008Q4	2009
Policy rate	-0.9	-0.9	-0.1
Inflation	0.0	-0.1	-0.1
Sheqel (percent change)	-0.5	-1.8	-1.8
Output gap	-2.0	-0.5	0.0

- Continued **sheqel appreciation** (against USD), coupled with compression in Israel’s risk premium, would also alleviate the need for higher policy rate in the near term.

Lower Risk Premium/Sheqel Appreciation
(Deviation from baseline)

	2008Q1	2008Q4	2009
Policy rate	-0.7	-0.4	-0.2
Inflation	-0.3	-0.2	-0.1
Sheqel (percent change)	3.0	1.1	0.8
Output gap	-0.1	0.0	0.0

- A **25 percent increase in oil prices** from current projected levels would require acceleration in the policy rate hikes, relative to baseline.

Higher Oil Prices
(Deviation from baseline)

	2008Q1	2008Q4	2009
Policy rate	0.3	0.5	0.4
Inflation	0.2	0.1	0.1
Sheqel (percent change)	0.7	0.7	1.0
Output gap	0.0	-0.1	-0.2

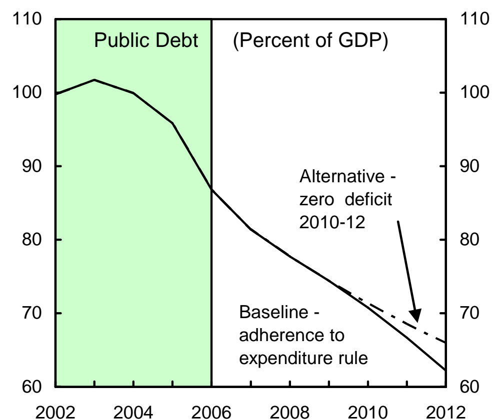
D. Fiscal Policy

12. **The key challenge for fiscal policy is to keep the public debt ratio firmly on a downward path**. Public debt, which exceeded 95 percent of GDP in 2005, is expected to fall to 82 percent of GDP by end-2007, still very high for one of the most vulnerable advanced economies. The 2001–03 downswing—which resulted from a confluence of global and security developments—is a stark reminder of this vulnerability, as the public debt ratio, which had been on a downward trend since the early 1990s, swung upward by 15 percentage points, to 102 percent of GDP. The Debt Sustainability Analysis (DSA) suggests that this vulnerability remains significant (Figure 7, Table 6).

Near-term requirements

13. **Fiscal outturns have been much stronger than budgeted over the past couple of years** (Figure 8, Table 7). This is mainly because higher-than-projected revenue has been allocated to debt reduction, but also because war-related expenditure has been offset through expenditure cuts, contrary to budget plans to accommodate such spending. As a result, the central government deficit has been kept well below the 3 percent of GDP deficit ceiling, falling to 1 percent of GDP in 2006 and approaching balance in 2007.[7]

14. **The authorities are confident that they can stay on the path of debt reduction, notwithstanding growing pressures for more spending**. The central government deficit ceilings are 1.6 percent and 1.0 percent of GDP for 2008 and 2009 respectively. The 2008 budget foresees no more than 1.7 percent real expenditure growth over the 2007 budget. In line with present law, this excludes the last installments of spending on account of the 2006 war and West Bank/Gaza disengagement, which sum to about ½ percent of GDP. At the same time, previously programmed tax cuts for 2008 are estimated to remove about 1 percent of GDP from revenue. However, with the latest data suggesting continued higher-than-expected revenue buoyancy, the mission's interlocutors generally expected a deficit below 1 percent of GDP for 2008, assuming economic activity did not disappoint. The mission argued that in the current period of good times a widening of the government deficit should be avoided. Accordingly, revenue overperformance should serve deficit and debt reduction, a message with which the authorities agreed.

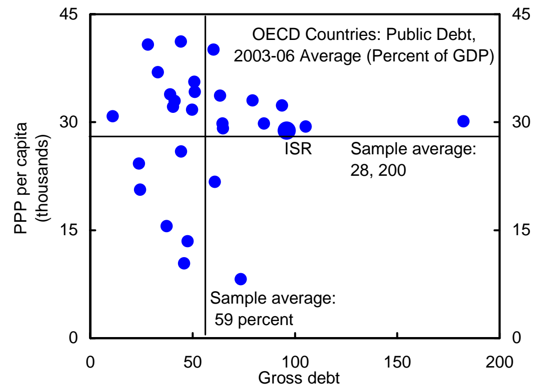


[7] The general government deficit is projected to fall to 1 percent in 2007.

Medium- and long-term challenges

15. **The current fiscal rule—specifically, the ceiling on real expenditure growth of 1.7 percent—is considered unsustainable, and a search for a new rule is underway**. The current real expenditure growth ceiling entails a continuous slimming of the public sector, given the economy's potential growth rate of 3¾ percent of GDP. There are complaints about compressed welfare spending—nondefense spending is already lower than in many advanced economies—and rising inequality/poverty, but there are also pressures for more tax cuts.

16. **The authorities are considering changes for 2009 and beyond, in the context of a revised rules-based approach to fiscal policy**. Staff advised anchoring a revised fiscal rule on the objective of lowering the public debt to 60 percent of GDP by 2015.[8] This objective also featured prominently among plans under discussion in various quarters, including at the National Economic Council, an advisory body to the Prime Minister. Achieving this objective would require maintaining a broadly balanced central government budget, implying general government budget deficits of about 1 percent of GDP through 2015 (Table 8). This objective would be consistent with more expenditure growth, with how much being dependent on future tax relief plans. The authorities considered the 60 percent/2015 objective realistic and would consider it. They stressed that a higher than 1 percent of GDP central government deficit—which is the ceiling planned for 2009—was currently not under consideration for the medium-run, and that they would want to continue overperforming against deficit ceilings. Various expenditure growth rate ceilings would be discussed, bearing in mind that further tax relief was desirable. Staff underscored that debt reduction needed to be given precedence over tax cuts, considering also that, unlike the debt, present tax rates are not out of line with those in most OECD countries. Instead, efforts should focus on simplification of what is an overly complex tax system, including by reducing tax exemptions (Figure 9).



Sources: IMF, World Economic Outlook; and IMF staff calculations.

[8] See Selected Issues Paper, Chapter IV.

Fiscal Projections for the Central Government, 2006−12 1/

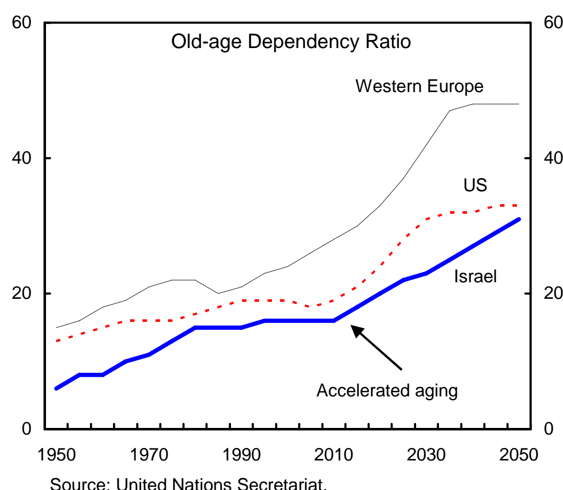
(Percent of GDP)

	2006	2007	2008	2009	2010	2011	2012
Baseline (exp g = 1.7%)							
Revenue	35.2	36.1	35.8	35.4	35.1	35.1	35.1
Expenditure	36.2	36.1	36.2	35.5	34.8	34.1	33.4
CG Balance 2/	-1.0	0.0	-0.4	0.0	0.4	1.1	1.7
GG Balance	-1.8	-0.8	-1.3	-0.9	-0.5	0.2	0.9
Public Debt	**86.8**	**81.4**	**77.7**	**74.4**	**70.8**	**66.7**	**62.2**
Alternative (zero CG def 2010-12)							
Revenue	35.2	36.1	35.8	35.4	35.1	35.1	35.1
Expenditure	36.2	36.1	36.2	35.5	35.1	35.1	35.1
CG Balance	-1.0	0.0	-0.4	0.0	0.0	0.0	0.0
GG Balance	-1.8	-0.8	-1.3	-0.9	-1.1	-1.0	-1.0
Public Debt	**86.8**	**81.4**	**77.7**	**74.4**	**73.9**	**71.1**	**68.6**

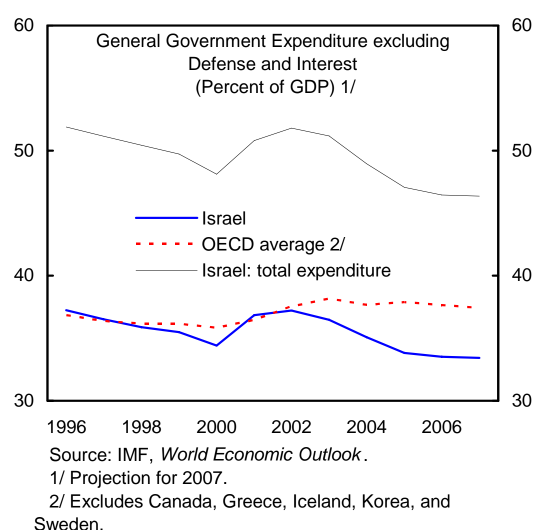
Source: IMF staff estimates and projections.

1/ Staff baseline projections (excludes credit).

2/ Baseline scenario assumes 1.7 percent growth in real expenditure, excluding war-related spending in 2007–08.



Source: United Nations Secretariat.



Source: IMF, *World Economic Outlook*.
1/ Projection for 2007.
2/ Excludes Canada, Greece, Iceland, Korea, and Sweden.

17. **Staff reiterated the need for more fiscal transparency and better governance**. To work well, rules need supporting fiscal institutions. For Israel, this means:[9]

- *Better budgetary preparation and transparency*. Budget documentation needs to include a multiyear scenario analysis of conjunctural and other risks for public finance objectives. Such an analysis could help communicate the vulnerability of the economy on account of the high public debt ratio.

[9] For details, see IMF Country Report No. 07/25, Chapter I.

- *Stronger fiscal governance*, including an institutional set-up to help monitor independently the implementation of any new fiscal rule. Symptoms of creative accounting to meet the current expenditure rule are beginning to emerge, although they do not reach disconcerting proportions. Moreover, recent experience suggests that deviations from rules might be necessary for a variety of good reasons that are difficult to fully specify in advance. An independent and nonpartisan fiscal surveillance mechanism could help address these concerns.

- *Improved long-term fiscal planning*, including analytical work to better understand long-run challenges. The growth rate of the labor force, for example, may well decelerate from around 2½ percent per annum during 2000–05 to around 1½ percent during 2010–15. Some projections suggest that by 2050, only about 2–3 people in the workforce will support each retiree, down from more than 4 people today. These developments have fiscal implications that deserve discussion.

18. **The authorities agreed on the usefulness of risk analysis and better long-term planning**. BoI has already begun to publish a risk analysis after the submission of the budget to the Knesset, and to some extent performs the functions of a fiscal watchdog. The government also considered various macroeconomic scenarios when preparing the budget, although these had not been fleshed out in detail or published.

E. Managing the Transformation of the Financial System

19. **Financial sector reforms are spurring rapid change**. Under the July 2005 reforms, banks have been forced to divest themselves of mutual and provident fund management, to foster a less bank-centric financial system. Also, the abolition not too long ago of the obligation for institutional investors to hold fixed rate government bonds still reverberates. The same holds for the end of the differential tax treatment of holdings of foreign and domestic assets. New financial instruments have been introduced, including sale and repurchase agreements. Further significant measures are planned, including increasing the mobility of savings between different financial products and providers, the extension of (plain vanilla) securitization, and the introduction of money market funds. A new interministerial committee on capital markets has been established under the leadership of the Ministry of Finance to plan the next stages of development of the markets.

Post-reform Changes in Control of Savings and Mutual Funds, 2003–06 1/

(Percent)

	Five Largest Banking Groups	Five Largest Insurance Groups	Other Financial Institutions	
	Total	Total	Total	*Of which:* Foreigners
Total long-term savings				
December, 2003	52	21	27	0
December, 2004	50	28	22	0
December, 2005	45	29	26	0
December, 2006	19	47	35	7
Mutual funds				
December, 2004	84	2	13	0
December, 2005	77	3	21	0
December, 2006	1	41	58	33

Source: Bank of Israel Annual Report, 2006.

1/ Resulting from pension fund reform and the adoption of the Bachar Committee proposals; estimates in percent of total assets.

Changes in Credit to the Business Sector, 2001–06

(Percent)

	2001	2006 1/
Distribution of credit to the business sector 2/		
Bank credit	77	57
Nonbank credit	23	43
Of which: institutional investors	7	20
Annual change in credit to the business sector 3/		
Total credit to the business sector	...	5.6
Of which: tradeable bonds	...	26.7
By source:		
Bank credit	...	0.2
Nonbank credit	...	17.7
Of which		
From institutional investors	...	30.6
From nonresidents	...	7.7

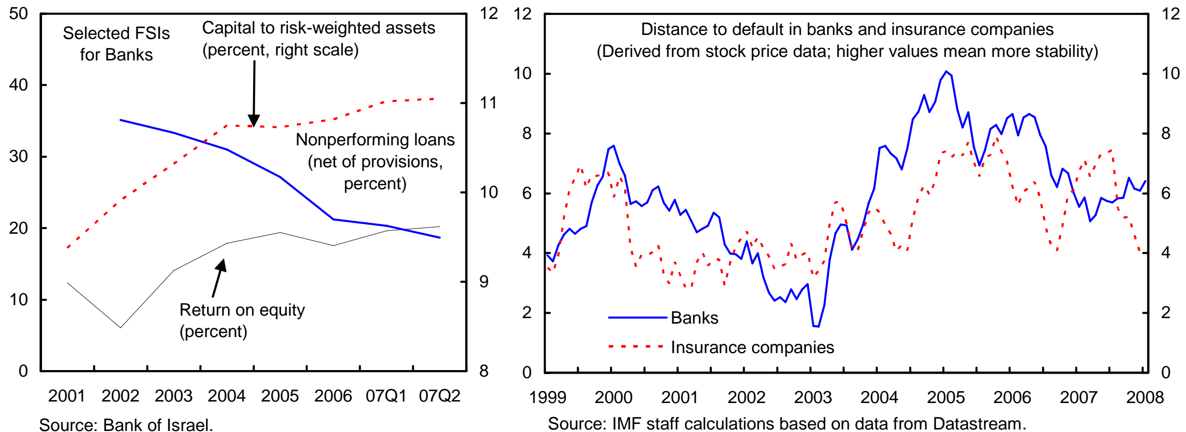
Source: Bank of Israel Annual Report, 2006.

1/ Data for 2006 as of September.
2/ In percent of GDP
3/ Simple average for 2001–06

20. **The shared view was that these changes entail increased risk in the short run but should make the economy more resilient in the long run**. As a result of the reforms capital markets have flourished, the role of banks in funding the business sector has declined in relative terms, and that of institutional investors has increased. This is changing the nature of financial risks:

- *Banks need to find new activities to substitute for old ones, while increasing their still comparatively low regulatory capital ratios and this is likely to lead them into riskier activities*. Some, for example, are entering emerging markets. Accounting indicators, such as nonperforming loans and capital adequacy ratios, suggest a continuous improvement in banking sector soundness since 2002. Market indicators paint a somewhat different picture, suggesting that bank soundness, after a substantial

improvement between 2003 and 2005, may have been retreating in 2006 and 2007. This may reflect reform-related drops in franchise values as well as uncertainties over the long run impact of global credit conditions.[10] However, stress tests based on publicly available data suggest improving system robustness, with credit risk as the main source of risk (Box 2).[11]



Source: Bank of Israel.

Source: IMF staff calculations based on data from Datastream.

- *Managed funds are rapidly increasing their holdings of assets with higher risk and this requires a commensurate improvement in risk management capacities, even if the risks are ultimately largely borne by households*. During 2002–06, the public's holdings of shares and corporate bonds rose from 14 to 32 percent of all assets, mainly at the expense of cash, deposits and government bonds. Concurrently, the end of discriminatory taxation of investments abroad triggered sizable capital outflows.

- *Insurers' business profiles are more diversified as a result of the recent reforms but this is coming with new risks*. The types of permissible activities have been relaxed. Most significantly, insurance companies have acquired the largest share of the fund management businesses which banks have been required to sell. As a result, insurance firms and their affiliates are assuming new or enhanced risks, including credit risk, with which they have less experience.

- *The changes in markets are temporarily stretching the resources of the authorities both on the regulatory and the supervisory front.*

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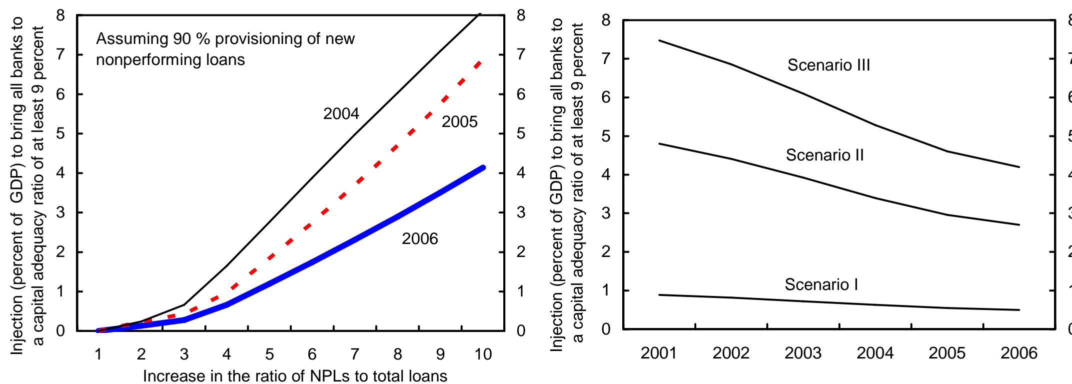
[10] Stock market indicators for insurance companies have weakened recently as a result of the latest market turbulence, although not in a major way.

[11] See also Selected Issues paper, Chapter II.

Box 2. Banking Sector Stress Tests

- Staff performed stress tests of the banking sector to assess banks' resilience to potential shocks to credit risk, interest rate, exchange rate, liquidity, and equity price risk; and to macroeconomic scenarios involving combinations of these shocks.
- The main result of the tests is that resilience of the banking system has improved. This reflects a combination of increasing buffers (improving capitalization and profitability) with generally decreasing exposures.
- The tests confirm credit risk as the main source of risk. Banks' exposures to direct interest rate risk are limited, as most of banks' loan books are in floating rates, and the duration of banks' trading portfolios is relatively short. Banks also have low direct exchange rate risk, reflecting their relatively low foreign exchange positions, and their exposures to equity risk are moderate. Banks are liquid at present, which was reflected in positive results of tests of the impact of sudden withdrawals.
- The staff's tests were based on publicly available data. The staff encouraged the authorities to start carrying out regular stress tests using supervisory data.

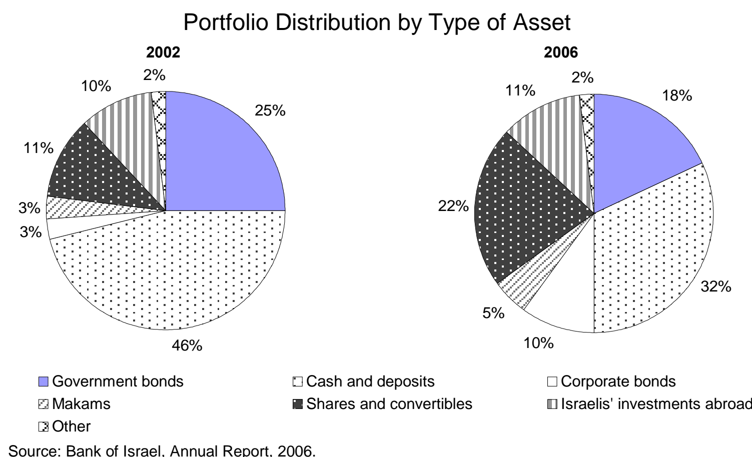


Sources: Staff calculations based on data from annual reports; BankScope; and Datastream.

Notes: Scenario I was parametrized using the last major recession in Israel (2001-02) as a reference point; Scenario II is a more stresssful version of Scenario I; and Scenario III assumes shocks to GDP, exchange rate, and interest rate equal to average of those in a world-wide sample of 17 recent financial crises (see the accompanying Selected Issues Paper).

21. **There was widespread agreement on the need to develop and implement regulation to keep pace with changing risks and new international standards**. The mission welcomed the progress being made with implementation of Basel II for banks, more risk-based approaches to supervision of banks, and improvements in disclosure and

enforcement of standards.[12] Regulators have recently agreed on a Memorandum of Understanding to improve exchanges of information and practical cooperation on initiatives of common interest.



Source: Bank of Israel, Annual Report, 2006.

Share of Institutional Investors' Asset Portfolios Invested Abroad, in Shares, and Tradeable Private and Government Bonds, 2004–06

(Percent)

	Investments Abroad 1/		Shares 2/		Private Bonds 2/		Government Bonds 2/		Other Assets 3/	
	2004	2006	2004	2006	2004	2006	2004	2006	2004	2006
All institutional investors	4.5	9.6	10.3	12.7	17.0	18.7	52.6	42.7	22.0	16.3
Provident and severance pay funds	3.0	8.9	16.6	18.6	17.5	27.6	41.3	29.2	21.6	15.7
Pension funds 4/	0.6	5.8	7.8	9.2	10.0	18.2	71.3	53.4	10.4	13.3
Mutual funds	13.0	17.9	11.3	14.2	3.9	13.6	27.8	29.9	44.0	24.4
Insurance plans 5/	5.6	9.5	7.7	10.6	10.3	11.7	53.1	43.5	23.4	21.4

Source: Bank of Israel Annual Report, 2006.

1/ Including investments in Israeli securities traded abroad, foreign securities, deposits abroad and mutual funds. Does not include investments in ETFs traded in Tel Aviv that track indexes abroad.

2/ Tradeable and non-tradeable assets.

3/ Makams, indexed and unindexed deposits, loans, mutual fund units, property rights, futures, mortgage portfolios and other assets.

4/ Including the Central Pension Provident Fund.

5/ Investment assets for life-insurance schemes.

22. **The Ministry of Finance is reforming insurance regulation extensively in response to the development of insurance companies' business**. The inadequacy of existing solvency requirements has been recognized and proposals made to strengthen the regime in the near future. Efforts are being made to improve the quality of the risk management and controls of insurance companies. Risk-based supervision is being developed.

23. **Regulators are seeking to improve the financial strength of banks and insurance companies further to prepare for a possible economic downturn and coming regulatory**

[12] Progress has also been made on AML/CFT. A ROSC summarizing the findings of a Moneyval assessment will be prepared during 2008. As a related matter, the authorities remain committed to ensuring a continuing clearing function for West Bank/Gaza banks; however, there are concerns about the vulnerability for potential misuse of the Israeli financial system that are in the process of being addressed.

change. The Bank of Israel has asked banks to increase capital ratios further in advance of the implementation of Basel II, the impact of which on bank capital adequacy remains unclear. Insurance companies are being asked to restrict the payment of dividends to no more than 50 percent of income pending finalization of the new solvency requirements.

24. **The mission welcomed the improvements made to date but pointed to the challenges ahead**.[13] Discussions covered five issues:

- Of critical importance is the ability of regulators to build the expertise necessary to support the more complex regulatory system now being put in place. This requires greater recruitment flexibility and competitive pay scales, in line with the practice in many advanced countries. The authorities explained that they had hired industry experts on a consultant basis but agreed that this was not optimal.

- There is a risk that the rapid pace of regulatory change will prove inconsistent with high-quality implementation. Additionally, all regulatory initiatives carry costs to consumers, firms, and regulators themselves. This calls for submitting major new initiatives to cost-benefit analysis. The authorities agreed but expressed concern about the resource implications. Staff explained that some rebalancing from the very rules-based approach to a more principles-based approach by the authorities could be helpful in alleviating resource constraints and also came with other advantages.

- As increased competition brings more risk, there is a need for a strong capacity to manage and resolve financial stress if and when it emerges. In this regard, the mission welcomed the recent Memorandum of Understanding among the supervisors, which includes provisions on crisis management. However, staff argued for further work, such as exercises that test responses to crisis scenarios, to identify remaining gaps.

- In line with good international practice, the insurance supervisor needs independence to set solvency standards; enforce managerial changes in companies and resolve failing institutions, as necessary; and powers to perform groupwide supervision. The authorities agreed, but they thought that the legal process to achieve this was complex and lengthy. Accordingly, they wanted to await a clearer vision of how to adapt the structure of supervision to markets before proceeding on this front.

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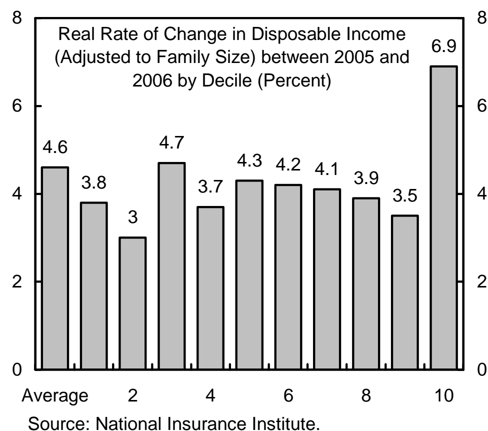
[13] See Selected Issues Paper, Chapter III.

F. Social Policy

25. **Social policy remains a priority for the government, given concerns about inequality**. The government set two key medium-run social targets: (i) raising the employment rate at ages 25-64 by about 3 percentage points to 71.7 percent by 2010; and (ii) increasing the income of the poorest fifth of the population by 10 percent more than per capita GDP. Key measures during 2007 included the adoption of (presently on a pilot basis) an Earned Income Tax Credit and the phased introduction of a compulsory employer-provided pension pillar, which was welcomed by both employer and worker representatives.



II. Staff Appraisal

26. **The economy is performing exceptionally well but still high public indebtedness calls for the continuation of the strong economic policies**. While sound policies have been central to the strong performance, so has unprecedented global growth. Moreover, with the public debt today not much lower than before the latest recession and the country still highly vulnerable to economic shocks, debt reduction remains the key macroeconomic policy challenge. Welcome improvements to the financial sector framework also need to be carried forward to enhance the economy's robustness.

27. **Economic activity is likely to remain strong, even if less buoyant than in recent years, and domestic inflationary pressure elevated**. Domestic preconditions for continued output growth remain in place, while external conditions are becoming less supportive. Given continued solid growth and growing capacity constraints, inflationary pressures would probably mount. Higher interest rates are thus probably needed for inflation to stay on target over the medium run but external downside risks and heightened risk premia argue for caution in raising rates.

28. **Monetary policy has successfully stabilized inflation expectations, but policy and communication challenges remain**. These stem largely from the high pass-through of the NIS/US$ exchange rate to domestic prices. The publication of inflation reports on a quarterly rather than semi-annual basis and the release of model-based inflation and interest rate forecasts are welcome. But greater clarity is needed about the role of these forecasts in BoI's decision making, the relationship between these forecasts and those for other macroeconomic variables, and about the policy horizon. In addition, swift adoption of the draft BoI law is particularly important because it would strengthen the economy's institutional foundation.

29. **The recent positive fiscal performance needs to be carried forward into 2008 to cement its many benefits, including those related to improved international credibility**. The central government budget needs to be kept close to balance, given that good times are expected to prevail and the economy's vulnerability to shocks on account of the high debt ratio needs to be lowered. It is thus appropriate that the budgeted 1.6 percent of GDP central government deficit is a ceiling and not a target. Maintaining a sound fiscal policy stance demands strict compliance with the 1.7 percent expenditure growth ceiling, tight budget execution, and the allocation of any revenue overperformance to debt reduction.

30. **The government's intention to stick with a rules-based approach to fiscal policy, solidly anchored in longer-run objectives, is welcome**. The main objective of a new rule should be to achieve a 60 percent debt-to-GDP ratio by 2015. This ratio is considered an upper limit in many less exposed advanced economies and it can be achieved without an appreciable tightening in fiscal policy. Furthermore, debt reduction should be given precedence over tax cuts, although there is scope to simplify the relatively complex tax system, including through cutting tax exemptions.

31. **Enhanced fiscal transparency and governance are essential to improve the quality of policy making**. Budget documentation needs to include a multiyear scenario analysis of risks for public finance objectives, and a long-term fiscal sustainability analysis, which can help the public appreciate the importance of rapid debt reduction. The governance of the fiscal framework should be further strengthened by instituting independent, nonpartisan fiscal evaluation.

32. **The ambitious reforms of recent years are fostering the development of a more diversified financial system but they also raise new risks**. With the economic expansion, financial soundness indicators have been improving, and risks of major losses in financial institutions appear low, although regulatory capital and solvency levels remain lower than in many advanced economies. In the meantime, the reforms have unleashed dramatic changes that have increased the complexity of the financial system. This raises the importance of high-quality prudential policies and practices, close collaboration among regulators, and ensuring that reporting standards for financial institutions do not deviate unnecessarily from international norms.

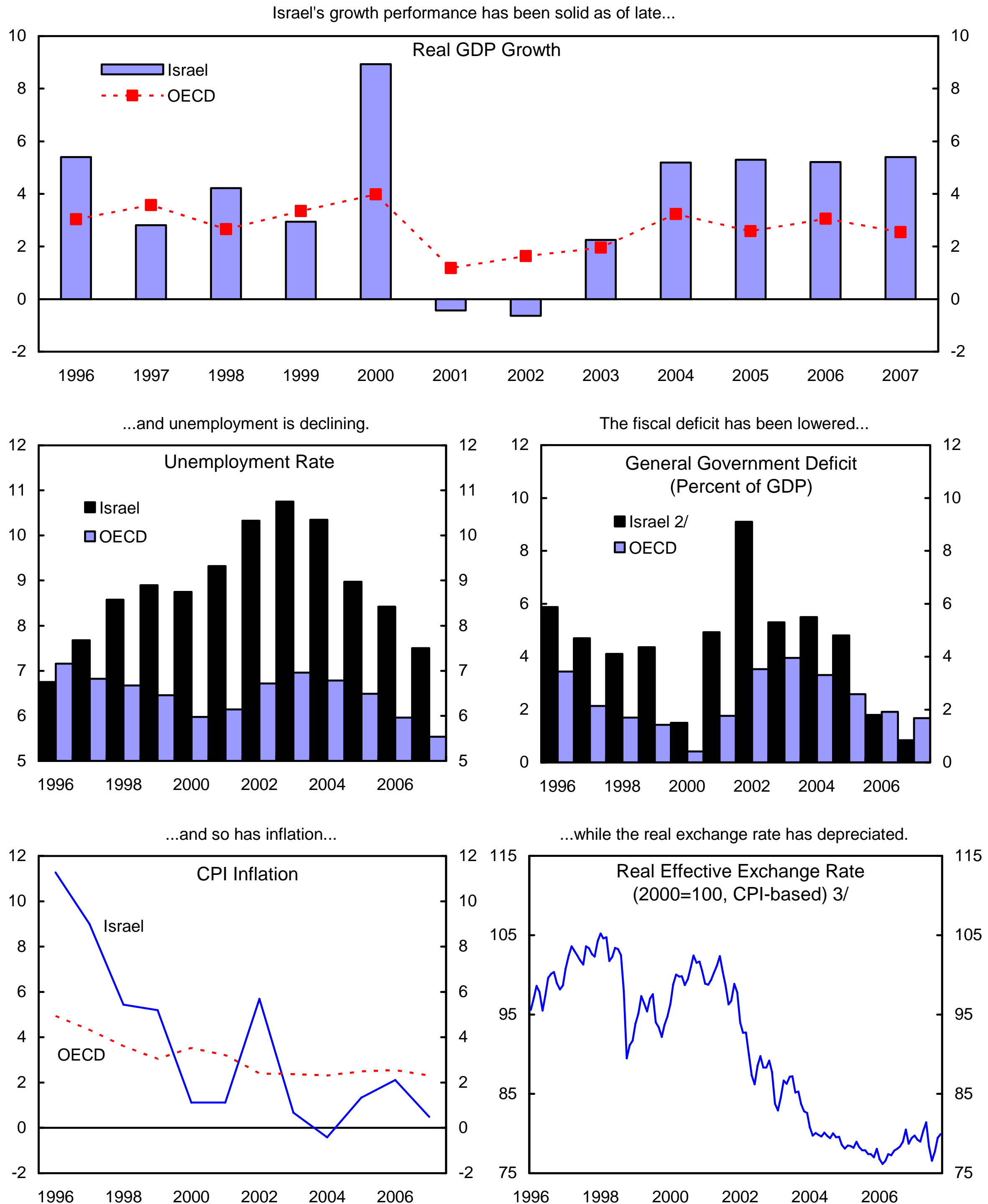
33. **While much work to adapt the prudential framework and financial infrastructure is ongoing, the challenges ahead are still major, and regulators' resources are not commensurate**. In particular, the regulators are moving to increase capital and solvency levels, and are at an early stage of introducing risk-based supervision approaches. However, regulators need to be able to build the expertise necessary to support a more complex regulatory system, which in turn requires greater recruitment flexibility and competitive pay scales. Also, the authorities need to ensure consistency between the pace of regulatory change and high-quality implementation, and achieve the right balance between principles-based and rules-based approaches to supervision. They need to strengthen their

capacity to manage and resolve financial stress. Finally, the insurance supervisor needs to be granted formal independence and broader powers, in line with international standards.

34. Israel has subscribed to the Special Data Dissemination Standards and its macroeconomic statistical system is generally adequate for Fund surveillance.

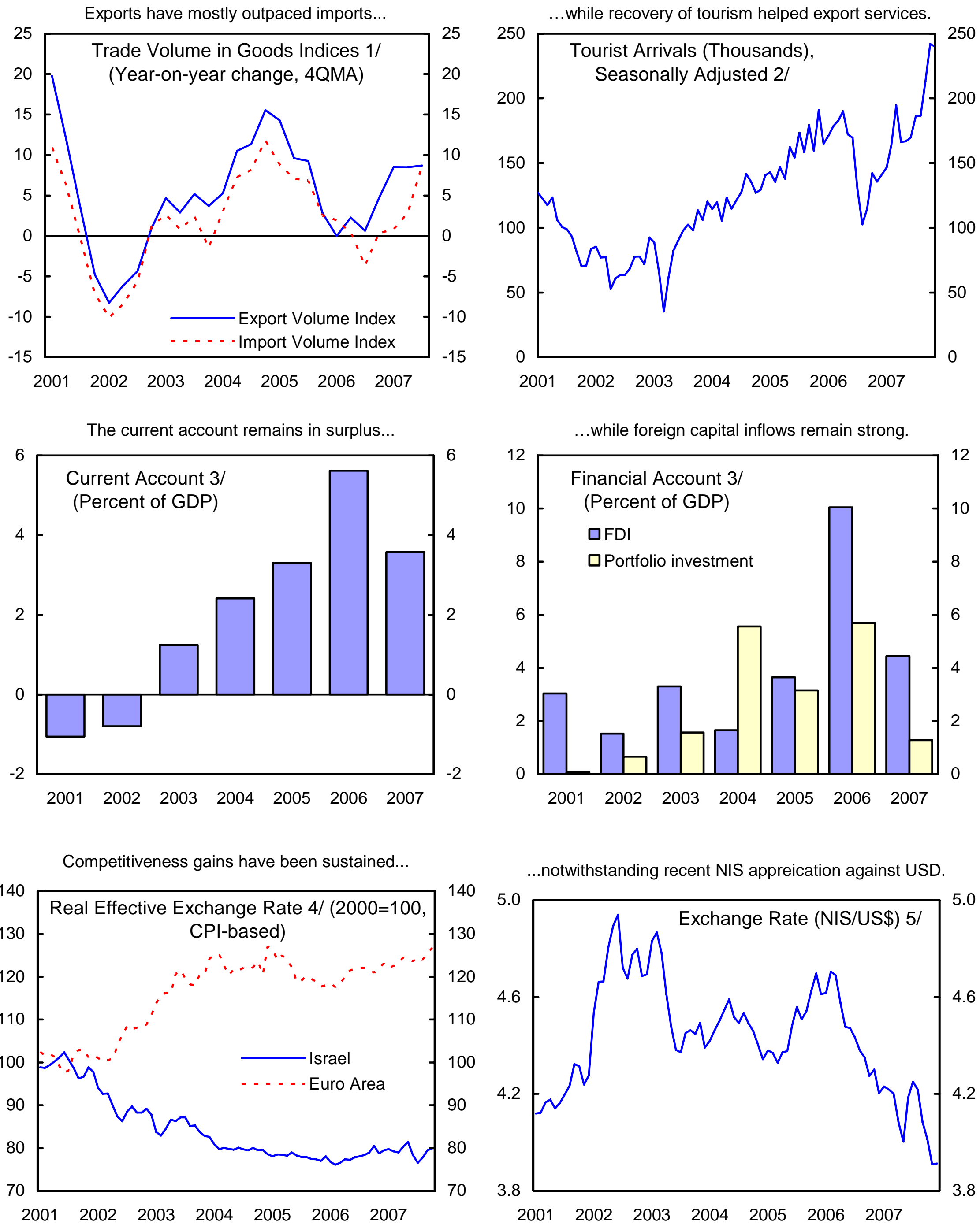
35. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Israel: The Long View, 1996−2007 1/
(Percent, unless otherwise indicated)



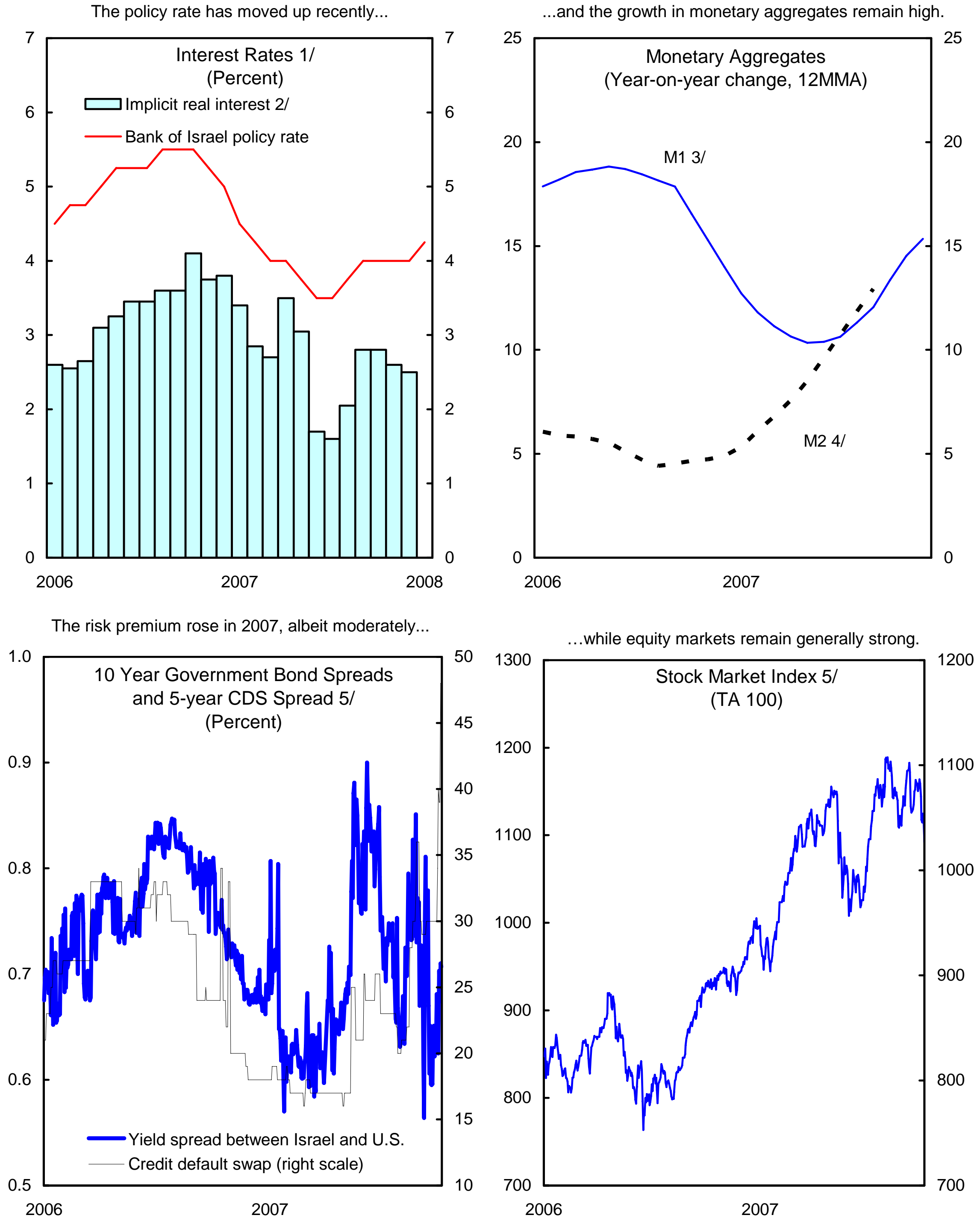
Sources: IMF, *World Economic Outlook;* and IMF, *Information Notice System.*
1/ Projections for 2007.
2/ From 1999 onward, international definition, accrual basis.
3/ Data for 2007 as of October.

Figure 2. Israel: External Indicators, 2001–07



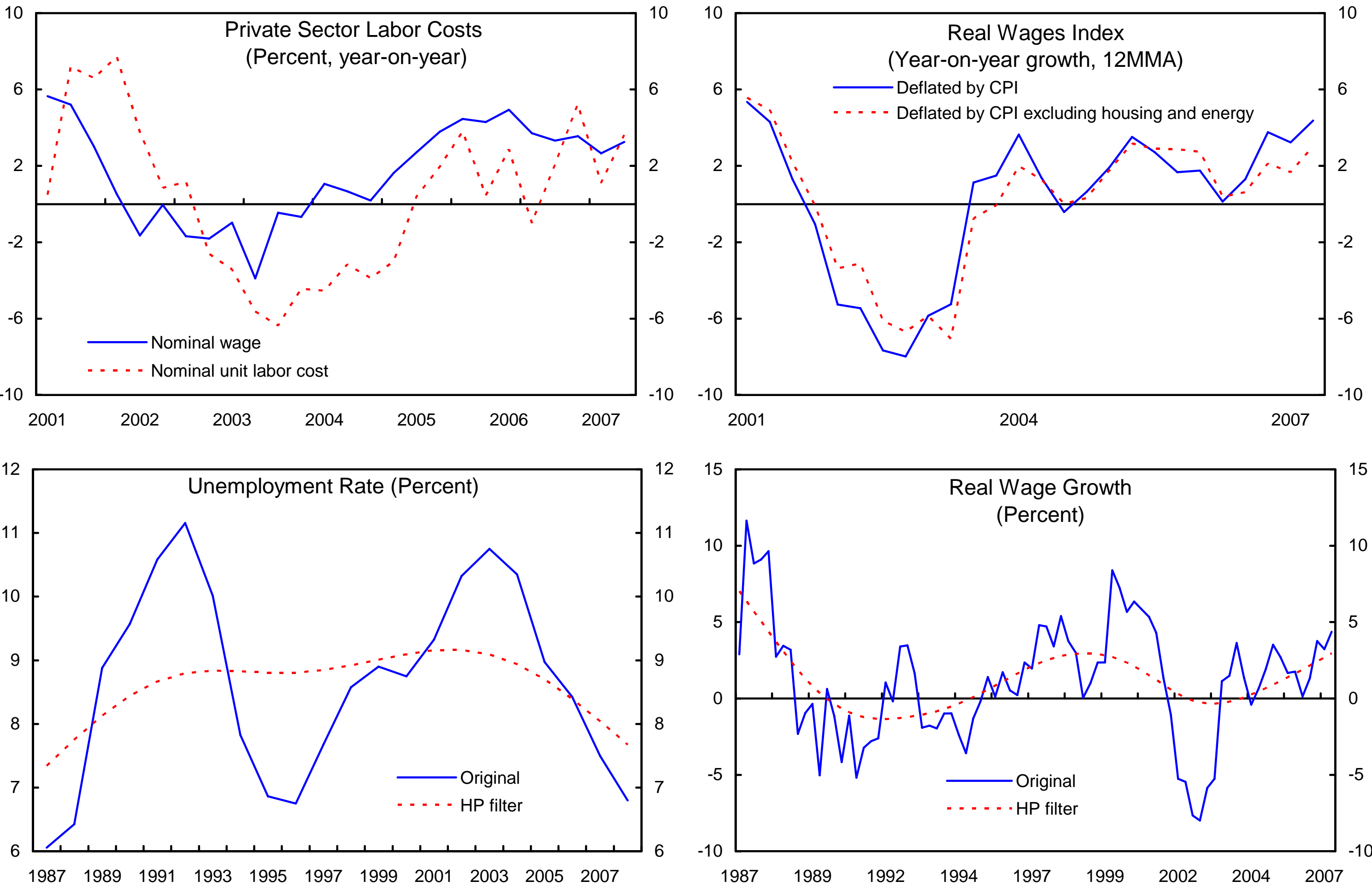
Sources: Central Bureau of Statistics; Bank of Israel; and IMF staff projections.
1/ Inclusive of goods and services; data for 2007 as of September.
2/ Data for 2007 as of November.
3/ Projection for 2007.
4/ A decrease represents depreciation. Data for 2007 as of October.
5/ Data for 2007 as of December.

Figure 3. Israel: Selected Monetary and Financial Indicators, 2006–07



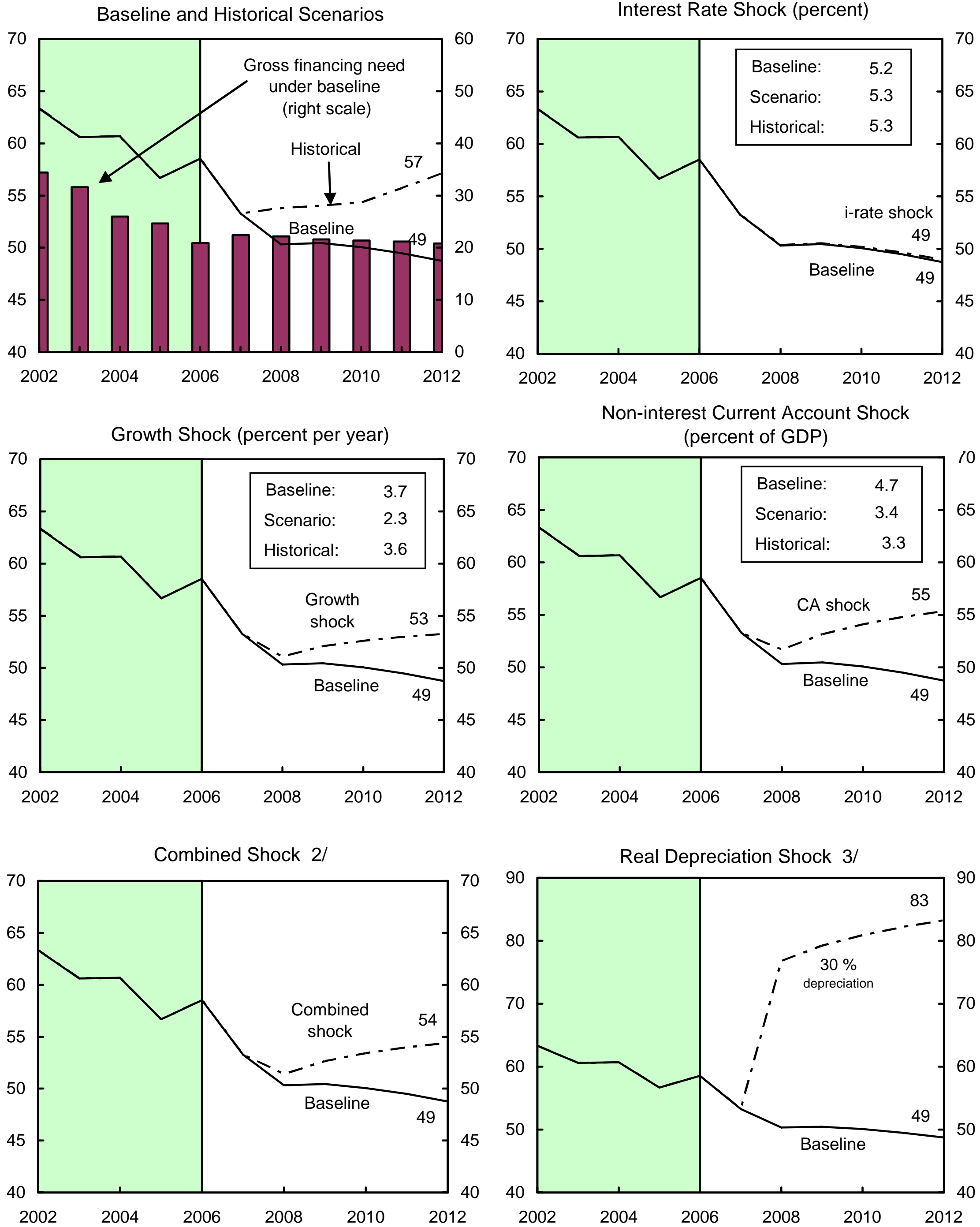
Sources: Bank of Israel; IMF, *International Financial Statistics;* and Bloomberg.
1/ Data for 2008 as of January.
2/ Defined as the Bank of Israel policy rate minus inflation expectations. Data for 2007 as of December.
3/ Data for 2007 as of December.
4/ Data for 2007 as of October.
5/ Data for 2008 as of January 3.

Figure 4. Israel: Labor Market, 1987–2008



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

Figure 5. Israel: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)

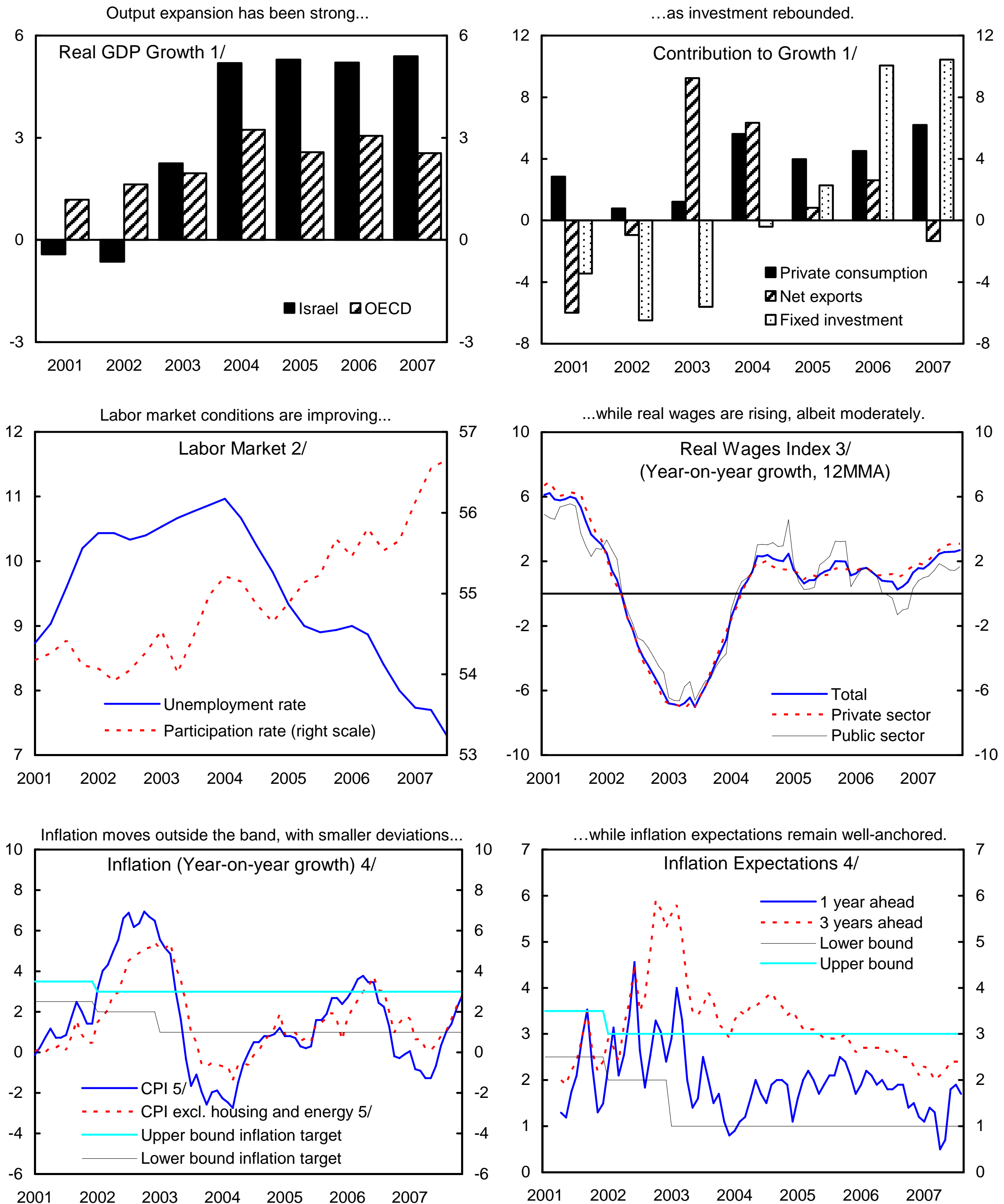


Sources: International Monetary Fund, country desk data, and IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2008.

Figure 6. Israel: Recent Economic Indicators, 2001−07

(Percent, unless otherwise indicated)



Sources: Central Bureau of Statistics; Bank of Israel; IMF, *World Economic Outlook;* and IMF staff calculations.
1/ Projection for 2007.
2/ Seasonally adjusted; data for 2007 as of September.
3/ Data for 2007 as of September.
4/ Data for 2007 as of November.
5/ Percentage change from the corresponding period one year earlier.