staff estimates and projections.

1/ IMF staff estimates and projections.

2/ Operational concept, excludes the inflation component of interest payments on domestic government debt.

3/ As of November 2002.

Statement by Jeroen Kremers, Executive Director for Israel
March 7, 2003

On behalf of the Israeli authorities I would like to thank staff for the constructive policy dialogue. In the authorities' opinion the staff report is a sound and balanced assessment of developments and prospects of the economy as well as the policy challenges facing Israel in the period ahead.

Background

Since the fall of 2000 Israel's economy has been adversely affected simultaneously by three external developments: (a) the global slowdown ; (b) the global technology spending collapse, and (c) the deterioration in the security situation. The economy is in the deepest recession in 50 years. GDP contracted by 0.9 percent in 2001 and by 1.1 percent in 2002.

The main thrust of the Israeli authorities' economic strategy has been the same for more than ten years: promoting macroeconomic stability and structural reforms as the preferred way to achieve a sustainable output and employment growth and to successfully integrate in the global economy. The falling fiscal revenue, because of recession, required repeated expenditure adjustments to keep the fiscal deficit under control. Inflation has been kept under control by a credible monetary policy, therefore the depreciation of the sheqel and rising oil prices only partially passed into inflation. The external debt, mainly of a long maturity, is almost fully covered by foreign reserves. The internal debt does not pose a threat to solvency given Israeli high potential growth.

The main current problem is growth. However, Israel is well prepared to benefit from a change for better in the global economic climate. The decrease in real wages by 6 percent and devaluation of the sheqel by 20 percent in 2002, contributed to the competitiveness of the Israeli economy traditionally led by exports. Many companies cut costs and further increased efficiencies by restructuring, and some demonstrated a remarkable resilience to difficult domestic circumstances. Moreover, Israel has good fundamentals which should help it to grow. To list some: (a) Israel has the world's highest investment in civilian research and development as percentage of GDP - 4.3 percent. (b) Israel has the world's highest rate of academic graduates as percentage of ages 25-64 – 25 percent; (c) the world's highest ratio of scientists and engineers per 10,000 – 135; (d) according to the World Economic Forum, Israel is number 4 measured by the competitive advantage index; (e) according to Transparency International, Israel is between the twenty least corrupted countries; (f) according to the World Economic Forum, Israel is number 12 on the 'network readiness index', which measures market and regulatory conditions of information technology, network infrastructure and the level of usage, and (g) Israel has a liberal trade policy.

Fiscal policy

In 2002, the government succeeded to contain the fiscal deficit to 3.9 percent of GDP. This was achieved despite the recession which sharply decreased revenue, and additional defense expenditure. The government, true to its commitment, did not cut investment expenditure, including transport infrastructure, seeing in insufficient infrastructure an impediment to growth and to lowering the unemployment rate. The future needs for infrastructure investments in roads, rails, ports, electricity generation, desalination of sea water would require about NIS 90 billion. After many failed trials in the past, the government succeeded to implement broad-based tax reform. For the first time capital gains and interest income are taxed, allowing a lowering of the high taxes on labor income. For the first two months of 2003 the fiscal deficit reached NIS5.4 billion, one third of the planned deficit for the whole of 2003. The new government is fully aware of the challenges facing the Israeli economy. The Ministry of Finance is presently preparing a new comprehensive economic plan which would include a deep cut in expenditure, while continuing to invest in infrastructure. The plan will be unveiled at the end of March.

In the long term, the government intends to continue its commitment to promote economic activity based primarily on the business sector and a reduced government share in the economy through a continued gradual reduction of the budget deficit, government expenditure and government debt as a share of GDP.

Monetary policy and financial sector

Monetary policy has been committed to meeting the inflation targets set by the government. This commitment guided the central bank in the March 2002 hike of interest rates. The decision was based on the entire range of indicators that the central bank usually examines in assessing the need to change rates in order to meet the inflation target. The exchange rate is in no sense an objective in itself, as long as it is within the band; it is one of the indicators of inflationary pressure. The central bank lowered the interest rate by 0.2 percentage point to 8.9 percent in January 2003. The January – February 2003 higher than expected fiscal deficits caused market concerns. If the high deficits were to continue, they might disturb market stability and make the central bank's decision to lower the interest rate rather difficult.

In March 2002 the government drafted an amendment of the central bank law. This amendment, however, turned out to lack clarity as to the central bank's objective, infringed on the bank's operational independence and inappropriately selected the members of its policy-making body. The amendment, which caused aggravating market concerns, was shelved by the former government. The new heads of the Ministry of Finance issued a statement that they too would not pursue the amendment under any circumstances.

The authorities are strictly supervising banks and the banks in Israel are encouraged, through on-site and off-site supervision, to promptly recognize bad loans and to make adequate provisions. In view of a further deterioration of economic conditions, the authorities encourage the banks to strengthen their capital base by refraining from paying dividends and by raising a new capital.

The authorities are committed to make further progress by implementing the FSAP and the ALM/CTF ROSC mission reports' recommendations.