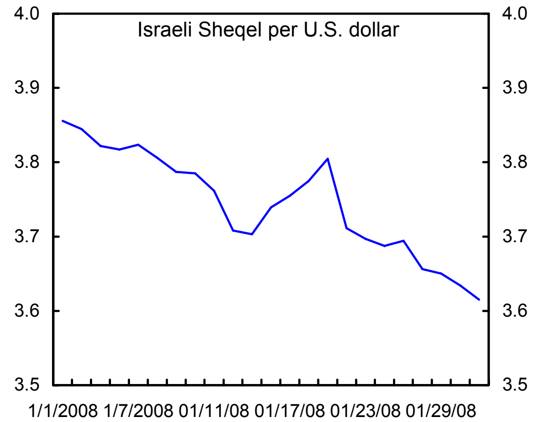
3. **The sheqel has been appreciating since the issuance of the staff report, moving from a rate of 3.8 to close to 3.6 sheqel/US dollar**. As a result, the sheqel is about 5 percent more appreciated than in staff's central scenario for 2008Q1 (Box 2), which should diminish inflationary pressure. In the meantime, markets foresee policy rate hikes of just under 0.5 percent by end-2008, while inflation expectations are around 2.5 percent. In the staff's view, the policy rate would probably have to be above the current 4.25 percent level once growth in trading partner countries reaccelerates, with a view to keeping inflation in the 1–3 percent target range. However, the latest appreciation of the sheqel, external downside risks to activity, and heightened risk premia argue for caution in raising rates over the near term.



Source: Bloomberg.

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IMF Executive Board Concludes 2007 Article IV Consultation with Israel

On February 13, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Israel.[1]

Background

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. Buoyant world trade propelled exports and investment, fostering strong employment growth—which was also supported by welfare reform—and private consumption.

Inflation undershot the 1–3 percent target in 2006 and in the first half of 2007, largely reflecting sheqel appreciation against the U.S. dollar, but rose in the second half of the year. In December 2007, prices stood 3.4 percent above the end-2006 level. The Bank of Israel (BoI) responded to the earlier declining price pressure by cutting the policy rate from a peak of 5.5 percent in October 2006 to 3.5 percent by June 2007. With inflation reaccelerating and unemployment falling and the output gap closing, the BoI changed course in August 2007, raising rates in three steps, to 4.25 percent by January 2008.

Fiscal outturns have been much stronger than budgeted over the past couple of years because of higher-than-projected tax revenue and public expenditure restraint. 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 reaching balance in 2007. Nonetheless, public debt remains high

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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at just over 80 percent of GDP. For 2008–09, the central government deficit ceilings are 1.6 percent and 1.0 percent of GDP, respectively.

Indicators for the financial soundness of corporations and households have generally been improving but the global financial turmoil has caused some increase in risk premia. There have been losses on mortgage-related US assets but the effect on bank profitability and capital has been small thus far. Nor have banks been experiencing funding pressures. Concurrently, credit default swap (CDS) spreads on government bonds are up from unusually-low pre-crisis levels; and spreads between the returns on corporate and government bonds have widened, testifying to a general increase in risk premia.

Looking ahead, slowing demand from Israel's export partner countries is projected to reduce output growth in 2008 to around 3½ percent, with broadly balanced risks. The ongoing shift from external to domestic sources of economic growth would further reduce the external current account surplus.

Executive Board Assessment

Executive Directors welcomed the Israeli economy's exceptional performance, which reflects both sound policy implementation and strong global growth. Directors observed that, while public debt has declined in recent years, its still elevated level leaves the economy vulnerable to shocks, and debt reduction remains a priority. They considered that further improvements to the financial sector framework would enhance the economy's resilience. Looking forward, Directors agreed that, with the domestic preconditions for buoyant activity in place, economic growth is likely to remain strong, although external conditions are becoming less supportive.

Directors observed that, given continued solid growth and growing capacity constraints, domestic inflationary pressure would probably mount, although the recent appreciation of the sheqel has lowered external inflationary pressure. They considered that, while interest rates may have to be at a higher level once external demand reaccelerates, external downside risks to activity and heightened risk premia argue for caution in raising rates over the near term.

Directors praised monetary policy for successfully stabilizing inflation expectations. They welcomed improvements in the transparency of policymaking, and encouraged the authorities to consider steps towards providing greater clarity on the role of macroeconomic forecasts in decision-making and on the monetary policy horizon. Directors recommended swift adoption of the draft Bank of Israel law, as it would strengthen the economy's institutional foundation. They agreed that the flexible exchange rate regime is serving Israel well.

Directors welcomed the strong fiscal policy performance that brought central government accounts into balance in 2007. They viewed that, with activity projected to remain strong, the budget should be kept close to balance, to further reduce the public debt ratio and the economy's vulnerability to shocks. Accordingly, for 2008, Directors supported compliance with

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the 1.7 percent expenditure growth ceiling, tight budget execution, and the allocation of revenue overperformance to debt reduction.

Looking forward to 2009 and beyond, Directors generally welcomed the government's intention to stick with a rules-based approach to fiscal policy. A reformed rule that aims at reaching a 60 percent debt-to-GDP ratio by 2015 would be consistent with a debt level that is considered an upper limit in many less exposed advanced economies, and could also accommodate an increase in welfare spending. Directors agreed that debt reduction should be given precedence over tax cuts, and saw scope to simplify the relatively complex tax system, including through cutting tax exemptions.

Directors recommended enhanced fiscal transparency and governance to sustain the improved quality of policy making. Budget documentation could usefully include a multiyear scenario analysis of risks for public finance objectives, and a long-term fiscal sustainability analysis, which could help the public appreciate the importance of rapid debt reduction. Consideration could also be given to strengthening the governance of the fiscal framework by instituting independent, nonpartisan fiscal evaluation.

Directors concurred that the ambitious reforms of recent years, which foster the development of a more diversified financial system, may also raise new risks. They welcomed the improvement in financial soundness indicators, as well as ongoing work to adapt the prudential framework and financial infrastructure, while noting that major challenges still lie ahead. Directors noted the importance of giving regulators more scope to build the expertise necessary to support the increasingly complex regulatory system. Achieving consistency between the pace of regulatory change and high-quality implementation, and the right balance between principles-based and rules-based approaches to supervision will also be important. Directors underscored the value of strengthening the capacity of regulators to manage and resolve financial stress. They also viewed that the insurance supervisory authority should be granted independence in those areas where it is currently subject to constraints on its powers, in line with international standards.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2007 Article IV Consultation with Israel is also available.

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