INTERNATIONAL MONETARY FUND

IMF Country Report No. 22/81

ISRAEL

2022 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

March 2022

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 2022 Article IV consultation with Israel, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis following discussions that ended on February 7, 2022, with the officials of Israel on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 3, 2022.
- An **Informational Annex** prepared by the IMF staff.
- Supplementary Information.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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PRESS RELEASE

PR21/82

IMF Executive Board Concludes 2022 Article IV Consultation with Israel

FOR IMMEDIATE RELEASE

Washington, DC – March 21, 2022: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Israel.

Israel's economy has weathered the pandemic exceptionally well. The Bank of Israel's (BOI) monetary and prudential measures provided liquidity, kept credit flowing, and prevented undue tightening of financial conditions. Fiscal measures supported households, businesses, and the public health system. Israel's world-leading vaccination campaign boosted confidence and helped mitigate the impact of the pandemic in the face of new, virulent variants. Banks' solid capital, liquidity, and asset quality also allowed them to support the economy.

After a mild downturn in 2020, real GDP exceeded its pre-pandemic level reaching growth of 8.2 percent in 2021. Consumption and the high-tech sector led the recovery. The 2021 fiscal deficit—4.3 percent of GDP—was significantly smaller than expected due to buoyant tax revenues, and public debt declined to 69 percent of GDP. The current account reached a surplus of 4.6 percent of GDP, driven by exports of high-tech services. Unemployment declined to near pre-pandemic levels, and job vacancies are high across all sectors. Thus far, the war in Ukraine has had a limited impact on Israel's economy given its low direct exposure to Ukraine and Russia. Nonetheless, the economic outlook is subject to significant uncertainty.

Executive Board Assessment[2]

The economic recovery is projected to solidify in 2022 and over the medium term. Growth will be supported by strong private consumption, investment, and net exports. With temporary factors winding down, inflation is projected to ease and stay within the BOI's target band over the medium term. The external position is assessed as moderately stronger than the level implied by medium-term

[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.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

fundamentals and desirable policies. The policy mix should remain agile in the face of high growth and still significant uncertainty.

The planned 2022 fiscal stance is appropriate, and the medium-term fiscal path aims to put debt on a downward path. In 2022, pandemic support should target the most affected sectors and vulnerable population groups. Refocusing medium-term policy on reducing public debt and rebuilding pre-pandemic buffers is also appropriate. However, the authorities' planned expenditure restraint may be challenging to implement given Israel's already low civil spending, and a review of public spending efficiency would therefore be useful. There is scope to increase tax revenues by broadening the tax base and making the tax system more progressive. This would also support a needed increase in growth-enhancing spending.

The fiscal framework should be strengthened. A review of the framework should assess the appropriateness of the fiscal rules, the necessary size of fiscal buffers, the ability to face exceptional events, and the potential usefulness of establishing an independent fiscal council.

Inflation pressures have risen, calling for commencing data-driven monetary policy tightening. Inflation has exceeded the BOI's target range despite appreciation of the shekel, which continues to restrain price growth. Signs of underlying inflationary pressures are strong, and inflation expectations have increased quickly in line with CPI. The conditions are in place for the BoI to start raising the policy rate gradually. Foreign exchange purchases should taper off, allowing the shekel's value to be determined by market forces, without precluding future purchases should appreciation pressures threaten to move inflation or inflation expectations below the target band.

Emerging risks in the financial system need to be addressed. Housing risks stress the need to advance structural measures to ease housing supply. Further tightening of macroprudential measures could help stem banks' exposures to housing market risks and prevent potentially unsustainable borrowing. While Israel's financial regulatory architecture has served the economy well, the establishment of a committee to review it is welcome in view of the push for greater competition and financial innovation.

Well-targeted structural reforms could foster productivity, labor reallocation, and inclusiveness. Active labor market policies should seek to expand vocational training and improve its quality. A greater adaptation of the different education streams will be needed to help align student qualifications with labor market needs. Continued efforts to reduce trade barriers and red tape would promote efficient resource allocation, investment, and innovation. Accelerating digital and physical Infrastructure would improve job accessibility.

Further efforts are needed meet the authorities' climate objectives. Options could include larger increases in carbon prices and providing greater regulatory and fiscal support for Israel's innovative green technologies.

Israel: Selected Economic Indicators, 2017–2027

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
					Projections						
Real Economy (percent change)											
Real GDP	4.4	4.0	3.8	-2.2	8.1	5.0	3.6	3.5	3.5	3.5	3.5
Domestic demand	4.1	4.5	3.6	-4.3	9.2	5.8	4.3	4.2	4.1	4.1	4.1
Private consumption	3.6	3.5	3.9	-9.2	11.7	6.6	4.8	4.8	4.6	4.6	4.5
Public consumption	3.4	4.3	2.7	2.5	2.9	6.1	3.3	3.3	3.3	3.3	3.3
Gross capital formation	6.3	7.0	3.8	1.0	9.9	4.0	3.9	3.5	3.6	3.7	3.8
Gross fixed investment	3.8	7.2	3.1	-4.0	10.5	5.7	2.7	3.5	3.5	3.6	0.0
Foreign demand (contribution to growth)	0.3	-0.5	0.2	2.3	-1.0	-0.7	-0.7	-0.7	-0.6	-0.6	-0.6
Potential GDP	3.7	3.6	3.5	1.7	5.1	4.0	3.9	3.6	3.7	3.5	3.5
Output gap (percent of potential)	0.3	0.6	0.9	-3.0	-0.2	0.7	0.4	0.2	0.1	0.0	0.0
Unemployment rate (percent)	4.2	4.0	3.8	4.3	5.0	3.9	3.8	3.7	3.7	3.7	3.7
Overall CPI (percent change, average)	0.2	0.8	0.8	-0.6	1.5	2.7	2.1	2.0	1.9	1.9	1.9
Overall CPI (percent change, end of period)	0.4	0.8	0.6	-0.7	2.8	2.4	2.0	1.9	1.8	1.9	1.9
Core CPI (percent change, average)	0.4	0.9	0.6	-0.3	1.2	1.6	2.5	2.3	2.1	2.0	2.0
Saving and investment balance											
Gross national saving (percent of GDP)	24.7	24.7	24.7	27.6	27.3	27.0	26.7	26.3	26.0	25.7	25.4
Foreign saving (percent of GDP)	-3.6	-2.8	-3.4	-5.4	-4.6	-4.5	-4.2	-3.9	-3.7	-3.4	-3.1
Gross capital formation (percent of GDP)	21.1	21.9	21.3	22.1	22.7	22.5	22.4	22.4	22.3	22.3	22.3
Public Finance (percent of GDP)											
Central government											
Revenues and grants	26.3	25.2	24.5	22.7	26.6	24.4	24.2	24.1	24.1	24.1	24.1
Total expenditure	28.2	28.1	28.2	34.1	31.0	28.0	27.5	27.2	27.0	26.9	26.9
Overall balance	-1.9	-2.9	-3.7	-11.4	-4.4	-3.6	-3.2	-3.1	-2.9	-2.9	-2.9
Structural balance 1/	-2.9	-3.1	-3.9	-10.4	-4.4	-3.8	-3.3	-3.2	-2.9	-2.9	-2.9
Interest payments	2.3	2.2	2.1	2.1	2.1	2.2	2.3	2.3	2.3	2.3	2.3
General Government											
Overall balance	-1.1	-3.6	-3.9	-10.8	-4.3	-3.4	-3.1	-3.1	-3.0	-3.0	-3.0
Structural balance 1/	-2.4	-3.9	-4.3	-9.5	-4.2	-3.7	-3.3	-3.2	-3.1	-3.0	-3.0
Debt	60.2	60.4	59.5	71.7	69.0	67.1	66.4	65.8	65.2	64.7	64.2
Of which: Foreign currency external debt	7.9	8.7	7.9	11.7	10.7	10.6	10.5	10.4	10.3	10.2	10.1
Balance of Payments (percent of GDP)											
Current account balance	3.6	2.8	3.4	5.4	4.6	4.5	4.2	3.9	3.7	3.4	3.1
Goods and services balance	1.9	0.8	2.0	4.6	3.8	3.3	3.0	2.7	2.5	2.2	1.9
Exports of goods and services 2/	29.4	30.0	29.5	28.0	29.7	31.1	30.8	30.5	30.3	30.0	29.7
Real growth rate (percent)	5.3	5.1	3.9	-1.9	13.6	7.3	2.9	2.9	2.9	2.9	2.8
Export prices growth (percent)	2.9	2.1	0.3	-0.7	10.6	8.7	2.1	1.7	1.7	1.3	1.2
Imports of goods and services 2/	27.5	29.2	27.3	23.4	25.3	27.2	27.1	27.1	27.1	27.1	27.1
o/w Oil imports (billions of U.S. dollars)	7.5	9.7	9.2	5.5	10.0	12.5	11.9	11.5	11.5	11.6	11.8
Real growth rate (percent)	4.4	6.8	3.4	-9.5	18.7	9.9	5.0	5.0	4.8	4.7	4.5
Import prices growth (percent)	2.8	4.4	-3.4	-3.7	10.4	9.8	0.8	0.6	0.8	0.5	0.5
Foreign reserves (eop, US$ billions)	113.0	115.3	126.0	173.3	213.0	243.9	256.6	270.0	284.0	297.6	312.9
Exchange Rate											
NIS per U.S. dollar (period average)	3.60	3.59	3.56	3.44	3.23	3.12	3.12	3.12	3.13	3.15	3.17
Nominal effective exchange rate (2010=100)	118.7	118.3	123.2	128.8	134.6	138.8	139.7	139.9	140.4	140.9	141.1
Real effective exchange rate (2010=100)	108.2	106.0	108.9	111.3	114.0	115.6	116.2	116.4	116.7	116.9	117.1
Terms of trade (2010 = 100)	104.6	95.3	98.7	99.5	92.8	92.7	94.0	95.1	95.8	96.3	96.7

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

1/ Percent of potential GDP.

2/ National Accounts data.

INTERNATIONAL MONETARY FUND

ISRAEL

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

March 3, 2022

KEY ISSUES

The Israeli economy has weathered the COVID-19 crisis exceptionally well, but risks are high. With substantial fiscal and monetary support, real GDP growth reached 8.1 percent in 2021, driven by consumption and high-tech exports. The rapid vaccination campaign boosted confidence. The outlook is positive but still subject to high uncertainty.

The policy mix should begin refocusing on longer-term challenges, while remaining alert to short-term risks.

- **Fiscal space needs to be reoriented toward productivity-enhancing spending**. The fiscal deficit has narrowed faster than anticipated, placing debt on a downward path. Additional fiscal space would nonetheless be needed elsewhere in the budget for labor market policies, infrastructure spending, and supporting the authorities' climate goals. There is scope to raise personal and corporate income tax revenues. A review to identify inefficient spending could also be useful.
- **The conditions are in place for the BoI to start raising the policy rate gradually.** The recent discontinuation of liquidity programs is appropriate in view of the emergence of broad-based inflation pressures. With the output gap closing rapidly, monetary policy needs to become less accommodative. Foreign exchange intervention should also taper off, allowing the shekel to be determined by market forces.
- **The financial system has supported the recovery, but risks have emerged.** A conservative supervisory approach has kept the financial system sound. Nonetheless, rapid mortgage growth has contributed to a surge in housing prices. It is critical to advance structural measures to ease housing supply. Tightening of the debt-service-to-income cap could help prevent potentially unsustainable borrowing.
- **Concerted efforts are needed to keep growth inclusive.** The large number of vacancies across sectors indicates the presence of skill gaps and mismatches. Strengthening ALMPs, improving marketable skills of Haredi and Arab students, increasing digital penetration, and investing in future human capital would help address these challenges. Further progress in product market reforms, infrastructure building, and advancing the authorities' climate agenda would also help support more resilient and inclusive growth.

Approved By
Philip Gerson (EUR) and Stephan Danninger (SPR)

Virtual discussions were held during January 18–February 7, 2022. Mission members included Iva Petrova (head), Enrique Flores, Karina Garcia, and Shakill Hassan (all EUR). Shay Tsur (OED) joined the discussions. Indra Mahadewa, Kelly Gao, and Gloria Li supported the mission. The mission met with Bank of Israel Governor Yaron, senior representatives of the Ministry of Finance and the Prime Minister's Office, other senior officials, and private sector representatives.

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ANNEXES