INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/75

ISRAEL

March 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; 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 2017 Article IV consultation with Israel, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 24, 2017 consideration of the staff report that concluded the Article IV consultation with Israel.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 24, 2017, following discussions that ended on February 8, 2017, 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 9, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Israel.

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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 17/101
FOR IMMEDIATE RELEASE
March 28, 2017

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

IMF Executive Board Concludes 2017 Article IV Consultation with Israel

On March 24, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Israel.

Israel is enjoying strong economic growth, estimated at 4 percent in 2016, supported by strong domestic demand—partly due to high vehicle sales ahead of a tax increase—and an export rebound. Unemployment declined to 4.4 percent in Q4 2016 and wage increases have picked up. Nonetheless, inflation remained below the 1–3 percent target range of the Bank of Israel (BOI), reflecting external factors and government measures to reduce the cost of living. The BOI has held the policy rate at 0.1 percent since February 2015 and stated that monetary policy in Israel will remain accommodative for a considerable time. Strong revenues contained the fiscal deficit to 2.1 percent of GDP in 2016 and the public debt ratio declined to 62 percent of GDP.

Housing prices rose at an average pace of 7.5 percent y/y in 2016, even after nearly doubling in real terms since 2007. Housing loans grew at a similar pace, bringing household debt to a still modest 74 percent of disposable income. Residential investment has risen but completions remain below estimated household formation. Some softening in the housing market emerged recently, with mortgage volumes and housing sales slowing and price declines recorded in late 2016, which may reflect a rise in mortgage interest rates driven by earlier macroprudential measures together with changes in real estate taxes. Israel's banking system is sound and the authorities are taking a range of measures to promote efficiency and competition in the banking sector, including the separation of credit card companies from the two largest banks.

Israel's near-term economic outlook is positive. Growth is expected to settle around 3 percent and inflation is likely to rise gradually, although with significant uncertainty around the timing of such a rise. In the longer term, however, the rising share of Haredi (ultra-orthodox Jews) and the

[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.

Israeli-Arabs in the working-age population could slow potential growth and raise poverty given the lower labor force participation and average productivity of these groups.

Executive Board Assessment[2]

Executive Directors commended Israel's sound policies, which have resulted in strong macroeconomic performance. While noting that the near-term outlook remains favorable, Directors also recognized that the country faces important structural challenges from elevated housing prices, high incidence of poverty and inequality, low labor productivity, and low labor force participation in some groups of the population. Against this backdrop, Directors called for continued sound policies that safeguard macroeconomic and financial stability and for deeper structural reforms that help improve potential growth, while reducing poverty and inequality.

Directors noted that the Bank of Israel (BOI) has maintained an appropriately accommodative monetary policy given that inflation remains below target. Most Directors concurred that monetary policy tightening should await clearer evidence of inflation returning toward the target in a lasting manner so as to avoid a premature policy tightening, although a few Directors considered that an earlier tightening might be warranted.

Directors called for reforms that expand housing supply in order to improve affordability—particularly for young and low-income households—and thereby also limit macro-financial risks from this sector. They welcomed recent progress in expediting land planning, and encouraged steps to improve municipal incentives for residential development, increase land privatization and urban renewal, and reduce construction times and costs. Directors considered macroprudential policies to be appropriately tight, and welcomed the BOI's continued vigilance in relation to macro-financial risks.

Directors agreed that the banking system is sound. They welcomed the authorities' plans to promote competition and efficiency in the sector, but underscored the importance of safeguarding financial stability when implementing these reforms. Directors noted that the separation of two credit card companies from banks should be supervised closely. They agreed that steps to facilitate new entry into the banking sector should be complemented with a strengthening of the bank resolution and deposit insurance frameworks. Directors also supported the establishment of the Financial Stability Committee to improve regulatory coordination.

Directors noted that the 2017–18 budget allows for higher fiscal deficits, which could reverse the declining trend in the public debt ratio. Against this backdrop, most Directors agreed that currently favorable macroeconomic conditions provide an opportunity to protect fiscal buffers by

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

reducing the central government deficit to around 2 percent of GDP in coming years, including by saving any revenue over-performance in 2017. A number of Directors considered that the increases in the fiscal deficit and debt ratio could be accommodated without jeopardizing debt sustainability, especially given the need to implement structural reforms and raise essential public investments. More generally, Directors supported additional spending on education, training, and infrastructure, financed by increased central government efficiency, procurement savings, and lower tax benefits. Directors welcomed the improvements in the medium-term fiscal framework, especially the recent strengthening of expenditure commitment controls, and emphasized that political ownership of fiscal targets is key to their effectiveness.

Directors stressed that inclusiveness is central to sustaining strong growth and reducing poverty. They recommended expanding well-performing active labor market programs and promoting job creation for communities with lower participation, including through better transport connections and financing access for business development. To more immediately reduce poverty while reinforcing work incentives, Directors generally favored increasing the Earned Income Tax Credit. They also encouraged product market reforms, especially lowering trade barriers and regulatory burdens, so as to increase competition, boost productivity, and reduce living costs.

Israel: Selected Economic Indicators, 2013–19

	2013	2014	2015	2016	2017	2018	2019
				Prel.	Projections		
Real Economy (percent change)							
Real GDP	4.4	3.2	2.5	4.0	2.9	3.0	3.0
Domestic demand	3.0	4.0	3.8	5.6	2.7	2.9	2.9
Private consumption	3.8	4.3	4.3	6.3	3.0	2.9	2.9
Public consumption	3.5	3.7	3.3	3.6	3.5	3.2	3.0
Gross fixed investment	4.5	0.0	0.1	11.0	-0.8	2.8	2.8
Stock changes (cont. to growth)	-0.9	0.7	0.6	-0.9	0.3	0.0	0.0
Net exports (contribution to growth)	1.4	-0.8	-1.3	-1.9	0.5	0.0	0.0
Potential GDP	3.7	3.6	3.2	3.6	3.0	3.0	3.0
Output gap (percent of potential)	0.7	0.3	-0.4	-0.1	-0.1	0.0	0.0
Unemployment rate (percent)	6.3	5.9	5.3	4.8	4.8	4.8	4.8
Overall CPI (percent change, end of period)	1.8	-0.2	-1.0	-0.2	1.1	1.8	2.0
Overall CPI (percent change, average)	1.5	0.5	-0.6	-0.5	0.7	1.4	1.9
Saving and investment balance							
Gross national saving (percent of GDP)	23.5	24.1	24.3	23.9	23.1	23.0	22.9
Foreign saving (percent of GDP)	-3.5	-4.0	-4.3	-3.6	-3.4	-3.4	-3.3
Gross capital formation (percent of GDP)	20.0	20.1	19.9	20.2	19.7	19.6	19.6
Public Finance (percent of GDP)							
Central government							
Revenues and grants	25.5	25.7	25.8	26.3	25.6	25.7	25.6
Total expenditure	28.8	28.4	27.9	28.4	28.3	28.4	28.4
Overall balance	-3.3	-2.7	-2.1	-2.1	-2.7	-2.7	-2.9
Cyclically adjusted primary balance 1/	-1.1	-0.6	0.1	-0.2	-0.9	-1.0	-1.1
General Government							
Overall balance	-4.2	-3.4	-2.7	-2.5	-3.3	-3.5	-3.7
Debt	67.0	66.0	64.1	62.2	62.6	63.0	63.2
Of which: Foreign currency external debt	14.4	14.9	13.6	13.2	13.3	13.3	13.3
Balance of Payments (percent of GDP)							
Exports of goods and services 2/	33.4	32.2	30.7	30.1	31.0	31.3	31.4
Real growth rate (percent)	3.6	1.4	-4.3	3.9	3.5	4.0	4.0
Imports of goods and services 2/	31.1	30.4	27.7	27.6	28.2	28.5	28.4
Real growth rate (percent)	-0.3	3.8	-0.5	9.7	1.7	3.7	3.9
Goods and services balance	2.4	1.9	2.8	2.0	2.8	2.9	3.0
Oil imports (billions of U.S. dollars)	14.6	12.8	7.4	5.8	7.8	8.0	8.1
Current account balance	3.5	4.0	4.3	3.6	3.4	3.4	3.3
Foreign reserves (eop, US$ billions)	81.8	86.1	90.6	98.4	105.0	109.1	113.9
Exchange Rate							
NIS per U.S. dollar	3.6	3.6	3.9	3.8	...	...	...
Nominal effective exchange rate (2005=100)	104.1	106.4	108.0	111.6	...	...	...
Real effective exchange rate (2005=100)	103.0	104.5	106.6	108.6	...	...	...

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 2017 ARTICLE IV CONSULTATION

March 9, 2017

KEY ISSUES

The Israeli economy is growing strongly and labor market conditions have tightened, yet Israel faces interlinked challenges:

- High and rising housing prices;
- High poverty and inequality; and
- Low labor productivity, and for some groups, low labor force participation.

Macroeconomic policy should continue to support the economy while protecting fiscal buffers. Monetary policy should remain accommodative pending clear signs of a durable rise in inflation. The 2017–18 budget eases fiscal policy despite solid growth prospects and could lead to a reversal of the decline in Israel's public debt ratio. Fiscal adjustment to achieve a 2 percent deficit on average is needed, while supporting education and training reforms with added resources and raising infrastructure spending to enhance potential growth. The recent strengthening of commitment controls should aid medium-term fiscal management, but political ownership of fiscal targets is key.

Supply-side bottlenecks need to be addressed to improve housing affordability and contain macrofinancial risks. Housing prices are very high, posing a vulnerability while disproportionately affecting low-income households. Reforms should improve municipal incentives for development, ensure adequate land privatization and urban renewal, shorten approval times and reduce construction costs. Macroprudential policies are appropriately tight and the Bank of Israel should monitor developments closely.

Financial stability must continue to be safeguarded during the course of reforms to promote efficiency in the sector. Israel's banking system is healthy, but there are concerns about inefficiency and limited competition. The planned separation of credit card companies from two major banks should be closely supervised. Enhancing the resolution framework and establishing deposit insurance would enable a reduction in capital requirements for new bank entrants while protecting financial stability. Completing the process of establishing a Financial Stability Committee would further improve coordination among the regulatory agencies.

Inclusiveness is key to promoting sustained growth in Israel. Productivity can be enhanced by further lowering import barriers, reducing the high regulatory burdens, and reforming network industries. The participation of vulnerable groups should be promoted through active labor market policies and by raising the Earned Income Tax Credit, which would help address poverty more generally.

Approved By
Philip Gerson (EUR) and Bob Traa (SPR)

Discussions were held in Jerusalem and Tel Aviv during January 30–February 8, 2017. The team comprised Mr. Beaumont (head), Mses. Mineshima and Geng, and Mr. Xie (all EUR). Mses. Ftomova and Vega (all EUR) assisted the mission from headquarters. Mr. Yakhin (OED) joined most meetings. The mission met with Finance Minister Kahlon, Bank of Israel Governor Flug, representatives of the Prime Minister's Office, the Finance Committee of the Knesset, other senior officials, academics, trade union, and private sector representatives.

CONTENTS

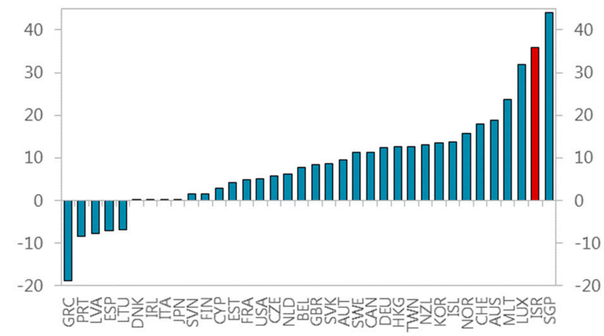
ANNEXES

APPENDICES

CONTEXT

1. Israel has achieved strong growth, especially in employment, despite the global financial crisis. Growth averaged 3.9 percent (2 percent per capita) in the decade to 2015, well above the 1.7 percent (1.1 percent per capita) mean for advanced economies. Employment surged 36 percent in this period, aided by a 5 percentage point rise in labor force participation following sharp welfare cuts adopted after the dot-com bust in the early 2000s. Labor productivity growth is lower than might be expected, averaging 0.8 percent, in part because the large rise in labor participation weighed on average skill levels.

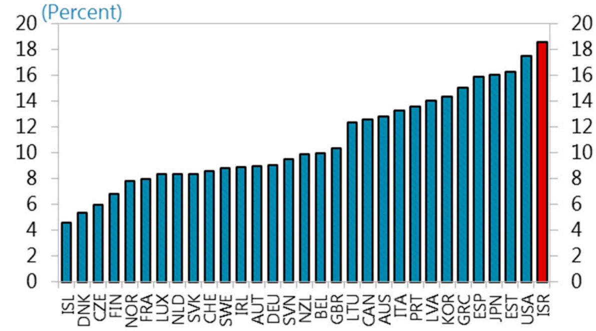
Employment Growth in the Past Decade
(Percent change, 2005-2015)



Sources: IMF WEO database; and IMF staff calculations.

2. Yet differences among Israel's diverse religious and ethnic groups contribute to relatively high poverty.[1] Of the population of 8½ million, some 20 percent are Arab Israelis, 10 percent Haredi (ultra-orthodox Jews), and 65 percent other Jews. Haredi and Arab household incomes are reduced by the low participation of Haredi men and Arab women and by the lower average skills and wages of these groups, such that Israel has high poverty rates for disposable income. The low equivalized incomes of Haredi households partly mirror their high number of children and the focus of Haredi secondary schools for males on religious studies rather than math, science, etc.

Relative Poverty among Advanced Economies 1/
(Percent)



Source: OECD.
1/ Share of people below 50 percent of median equivalized disposable income, in 2014 or latest available.

3. The coalition government faces pressures to lower the high cost of living. The government is currently comprised of six parties with 66 seats in the 120-member Knesset, which has a term of four years, but no Israeli administration has completed a full term since 1988. Since mass protests in 2011 opposing the continued rise in the cost of living, especially the cost of apartments for young families, governments have taken a range of measures aimed at reducing living costs, including cuts in the price of various services and in the VAT rate.

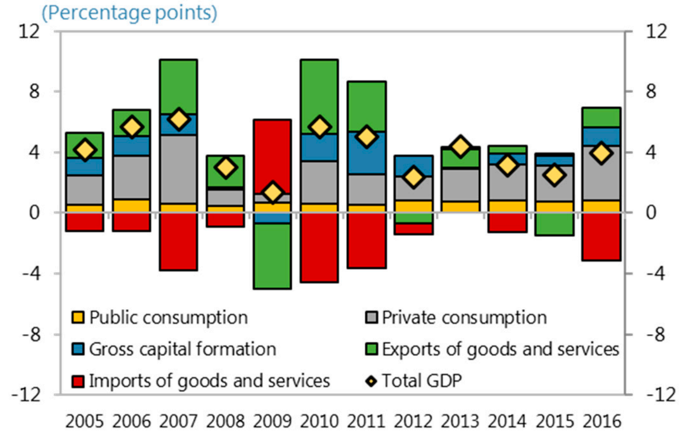
4. Traction of Fund advice is generally good. A number of Fund recommendations have been implemented from the 2012 Financial System Stability Assessment (FSSA), the 2015 Article IV consultation, and 2015 Fund technical assistance on enhancing medium-term fiscal management (Annex I). The Bank of Israel (BOI) is in the process of following up on recommendations from the 2016 technical assistance on banking supervision.

[1] See A. Thegeya "Income Inequality in Israel" in Israel: Selected Issues 2015 (IMF Country Report No. 15/262).

SOLID GROWTH YET CHALLENGES AHEAD

5. **Israel's growth picked up in 2016, supported by strong domestic demand and a rebound in exports.** In 2015, growth was 2½ percent, held back by weak exports, which partly reflected company-specific factors.[2] Real GDP grew by a preliminary 4 percent in 2016 as domestic demand surged and exports rebounded. Demand benefitted from strong labor market conditions and low interest rates. One-off factors also played a role, including Intel's fabrication plant upgrade and a spike in vehicle purchases ahead of a tax hike on highly-polluting models, also seen in higher imports and taxes.

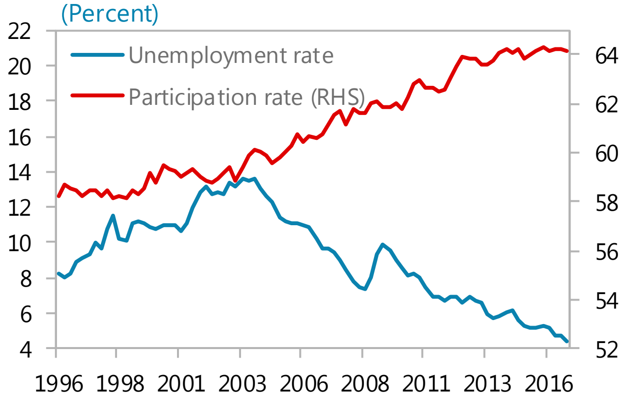
Composition of Real GDP Growth
(Percentage points)



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

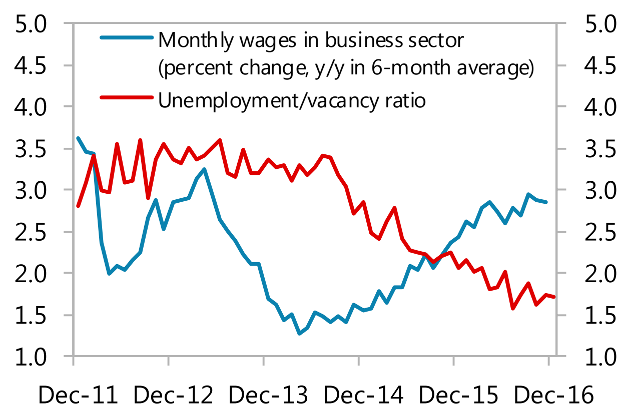
6. **Labor market conditions have continued to improve and wage growth is rising from low levels.** Employment rose by a solid 2.6 percent y/y in 2016, reflecting continued growth in the working age population and a decline in the unemployment rate of 1 percentage point, while the labor force participation rate remained broadly stable. At 4.4 percent in Q4 2016, the unemployment rate is at an historic low while job vacancy rates are high. Owing to this labor market tightening, nominal wage growth in the business sector picked up to almost 3 percent y/y in the second half of 2016, from below 2 percent in 2014, and real wage gains were about 3½ percent as a result of the decline in the headline CPI. Increases in the monthly minimum wage, of 8.6 percent in 2015 and 13.6 percent in January 2016, may have also contributed to stronger aggregate wage growth.

Labor Market 1/
(Percent)



Sources: Haver Analytics; and IMF staff calcluations.
1/ Data cover population aged 15 and above.

Wages and Labor Market Slack



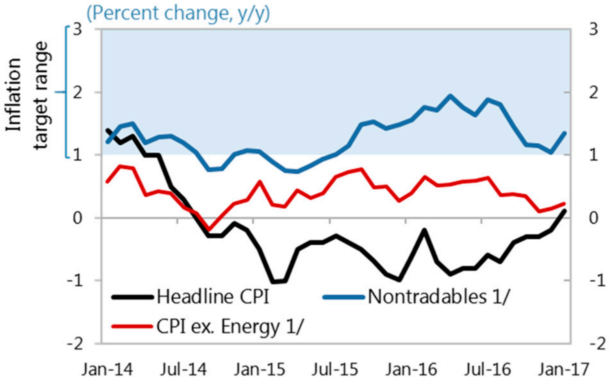
Sources: Haver Analytics; and IMF staff calculations.

---

[2] A few major companies like Teva (pharmaceuticals), Israel Chemicals, and Intel play a large role in Israeli exports. Exports of potash and bromine fell owing to a strike at Israel Chemicals in the first half of 2015. Intel's exports declined due to slowdown in production related to the fabrication plant upgrade.

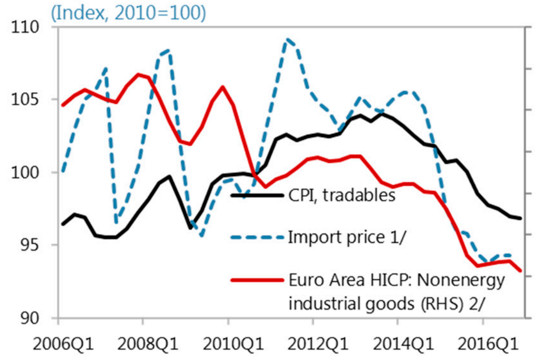
7. Government measures to reduce the cost of living and declines in tradables prices have weighed on inflation. Headline CPI inflation remained modestly negative since the second half of 2014, yet turned slightly positive in January 2017. Contributing factors include declines in energy prices, low trading partner inflation, appreciation of the shekel especially against the euro, and various government measures.[3] Yet, even excluding energy, fruit and vegetables, and the estimated effect of government measures, CPI inflation was low at 0.2 percent in 2016. Narrowing margins, perhaps due to competition from internet purchases, may also be keeping inflation down.

CPI Inflation
(Percent change, y/y)



Sources: Haver Analytics; BoI; and IMF staff calculations.
1/ Excluding fruit & vegetables, and estimated impact of government measures.

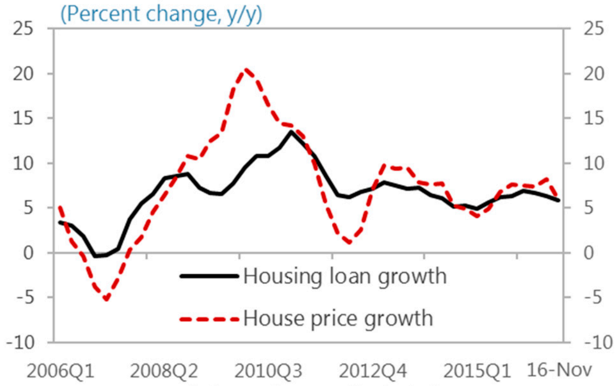
Importing Goods Price Deflation
(Index, 2010=100)



Sources: Haver Analytics; BoI; and IMF staff calculations.
1/ Excluding ships, aircrafts, diamonds, and fuel.
2/ Converted to Shekel

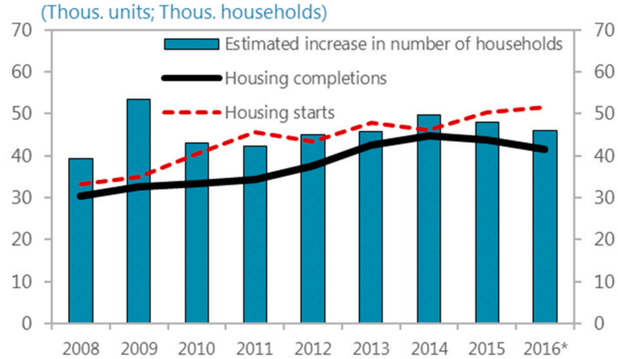
8. Housing prices rose further in 2016, even after nearly doubling in real terms since 2007, yet some softening in market conditions emerged recently. Dwelling prices rose at an average pace of 7½ percent y/y in 2016, with housing loans growing at a similar pace, bringing household debt to a still modest 74 percent of disposable income (Figure 8). Residential investment has risen in response to higher prices, but completions remain below estimated household formation. Nonetheless, mortgage volumes and housing sales slowed during the year and price declines were recorded in late 2016, which may reflect a rise in mortgage interest rates driven by earlier macroprudential measures together with recent tax policy changes on real estate.

House Price and Housing Loans
(Percent change, y/y)



Sources: Haver Analytics; and IMF staff calculations.

Housing Supply and Demand Indicators 1/
(Thous. units; Thous. households)



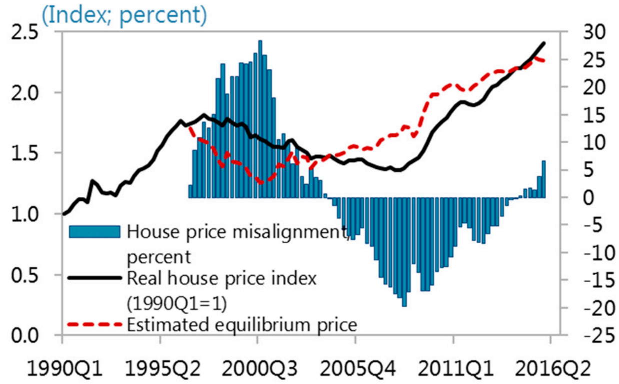
Sources: CBS; and IMF staff calculations.
1/ Annualized based on outturn as of end-2016Q3.

---

[3] Government measures to lower living costs include cuts in VAT, electricity, gas and water prices, public transport costs, public nursery prices, diary food prices, taxes on alcoholic beverages and cigarettes, and the television levy, etc.

9. **Although housing prices are clearly high, the extent to which the housing market may be misaligned is uncertain.** As discussed in section B, Israeli housing prices are very high, especially in Tel Aviv, with implications for poverty and inequality. Nonetheless, a cross-country econometric analysis suggests the uptrend in real housing prices in Israel is mainly driven by growing incomes, the rising number of households relative to housing supply, and low interest rates, with only a modest estimated overvaluation of 9 percent as of Q3 2016. Yet uncertainty around such estimates is wide, as housing market developments are complicated by purchases for investment purposes by high-income households.

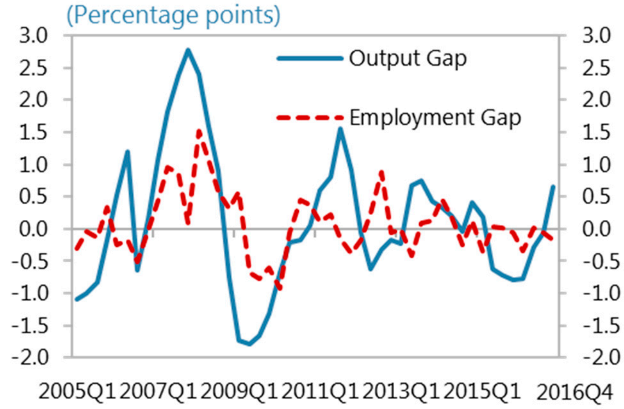
Housing Market Valuation
(Index; percent)



Sources: CBS; Haver; OECD; and IMF staff estimates.

10. **Output growth is expected to settle around 3 percent and inflation is likely to rise gradually.** Domestic demand growth is expected to dip in 2017 given the high base in 2016, but a firming in exports reflecting stronger trading partner activity and ongoing investments in the sector will support overall growth in 2017. With unemployment remaining low, and the output and employment gaps broadly closed, a further rise in wage growth along with a rise in international inflation rates makes a rise in CPI inflation likely, although significant uncertainty remains around the timing of such an increase. An eventual rise in interest rates would help moderate domestic demand growth in the medium term, keeping overall growth near potential, estimated at some 3 percent.

Resource Utilization Indicators
(Percentage points)



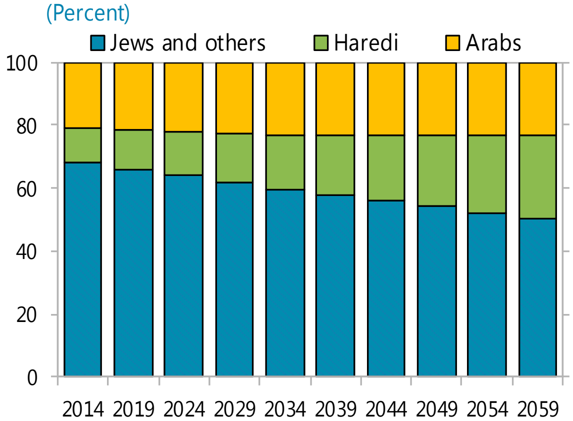
Sources: Haver Analytics; and IMF staff calculations.

Macroeconomic Indicators

(Percent change y/y, unless noted)	2013	2014	2015	2016	2017	2018	2019
Real GDP	4.4	3.2	2.5	4.0	2.9	3.0	3.0
Total domestic demand	3.0	4.0	3.8	5.6	2.7	2.9	2.9
Exports	3.6	1.4	-4.3	3.9	3.5	4.0	4.0
Imports	-0.3	3.8	-0.5	9.7	1.7	3.7	3.9
Trading partner GDP	2.4	2.8	2.8	2.2	2.6	2.8	2.8
Employment	2.6	3.0	2.5	2.7	2.5	2.5	2.5
Unemployment rate (percent)	6.3	5.9	5.3	4.8	4.8	4.8	4.8
CPI (percent change, end of period)	1.8	-0.2	-1.0	-0.2	1.1	1.8	2.0
CPI (percent change, average)	1.5	0.5	-0.6	-0.5	0.7	1.4	1.9
Credit to households	8.4	7.1	8.3	8.2	…	…	…

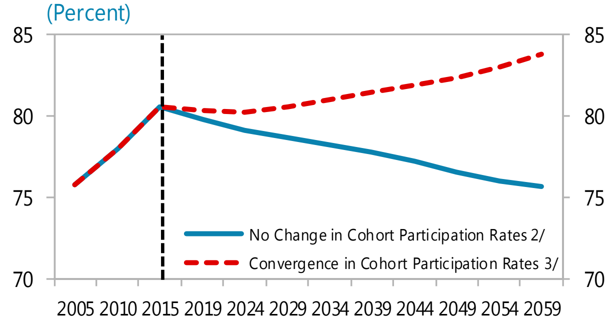
11. In the longer term, however, changes in the composition of the population could significantly lower Israel's growth potential and raise poverty. The share of Haredi in the working age population will rise given their higher fertility, as will the share of the Israeli-Arab population though to a notably smaller extent. To illustrate the broad scale of the economic impact, if the labor participation rate of each group remains unchanged from its 2015 level, the total labor force participation rate is projected to decline by almost 3 percentage points in a decade. The lower average productivity of these groups would further lower potential growth. Moreover, a growing share of the population with low wages, or out of the workforce, would exacerbate the already relatively high levels of poverty and inequality.

Population Composition: Official Projections
(Percent)



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

Labor Force Participation Scenarios 1/
(Percent)



Sources: Central Bureau of Statistics; and IMF staff calculations.
1/ Based on Central Bureau of Statistics population projections.
2/ Participation rates of each cohort remain at 2015 levels.
3/ Participation rates of Haredi men and Arab women rise to level of Haredi women by 2059, participation rates of other cohorts remain at 2015 levels.

12. Risks are wide ranging, with significant downsides requiring strong buffers (Annex II):

- **Domestic/regional**: Regional tensions have in the past hit tourism hard and more adverse developments could damage confidence and investment. Housing prices could weaken in coming years, impacting construction and dragging on domestic demand. Yet financial stability would be cushioned by relatively low household debt and the health of banks.

- **External**: Weak growth in Israel's main trading partners would weigh on Israeli exports and growth. Impacts could exceed historical experience with exports being less diverse than those of most advanced economies and with reduced space for monetary policy to cushion shocks.

- **Potential growth/inequality**: Limited progress on closing the gaps in participation and productivity of the Haredi and Arab populations may undermine stability by slowing growth and raising inequality. Yet, participation gaps have narrowed and this progress may continue.

13. The Israeli authorities shared a similar macroeconomic outlook. They assessed that the high growth in 2016 reflected broad-based strength in domestic demand and exports, underpinned by supportive macroeconomic policy and improvements in the terms of trade which bolstered real disposable income. They also viewed that the labor market was close to full employment and expected GDP to grow at around 3 percent in the coming years. While noting the resilience that the Israeli economy had shown in the face of a range of shocks, they fully recognized the economic and social challenges posed by the evolving composition of the Israeli population.

POLICY DISCUSSIONS

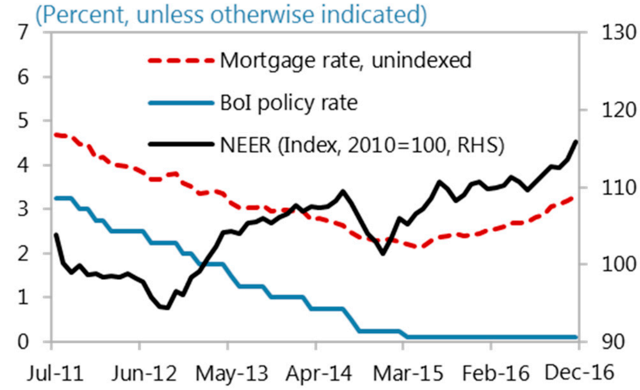
14. Policies should support fiscal and structural reforms to promote sustained and inclusive growth. Macroeconomic policy should provide a supportive environment for undertaking structural reforms while also protecting buffers in the medium term. Supply-side bottlenecks in the housing market need to be addressed in a lasting manner to help moderate inequality over time and also to help contain macrofinancial risks. Inclusiveness is key to sustaining strong growth in Israel, requiring policies to promote the participation and productivity of the Haredi and Israeli-Arab populations while mitigating poverty without undermining work incentives.

A. Monetary and Exchange Rate Policies

15. Monetary conditions are accommodative, although developments with the shekel and retail interest rates imply some tightening. The BOI has held the policy rate at 0.1 percent since February 2015 owing to inflation being below the 1–3 percent target range, and it has stated that monetary policy in Israel will remain accommodative for a considerable time. Yet the shekel appreciated 5 percent in nominal effective terms in 2016, extending the appreciation trend of recent years, while the average mortgage interest rate (unindexed mortgages) has risen 80 basis points since early 2015 to 3.1 percent (see paragraph 26).

Monetary Conditions Indicators

(Percent, unless otherwise indicated)

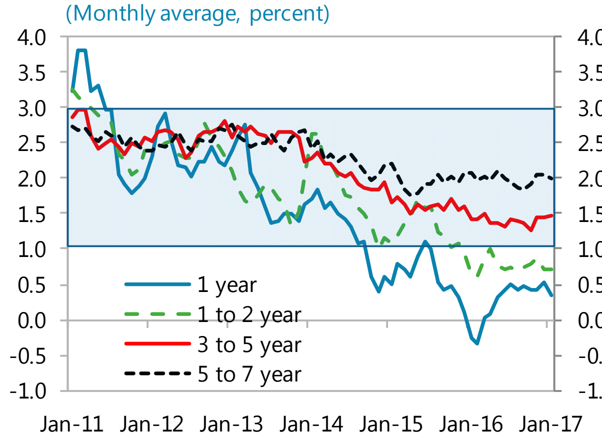


Sources: Bank of Israel; and IMF staff calculations.

16. Monetary policy should remain accommodative pending a durable rise in inflation and inflation expectations. Core CPI inflation remains below the 1–3 percent target range, even after excluding the impact of energy price falls and government measures to lower living costs. A rise in inflation seems likely given domestic and international developments, yet the timing of this increase remains uncertain, especially in relation to the pass-through from rising domestic wage growth and an easing in the drag from low foreign inflation and shekel appreciation. While longer-term inflation expectations remain anchored to the target, there has been a significant decline in short- and medium-term expectations. In these circumstances, there is a need to avoid a premature monetary tightening before inflation is clearly heading back to target.

Inflation Expectations

(Monthly average, percent)

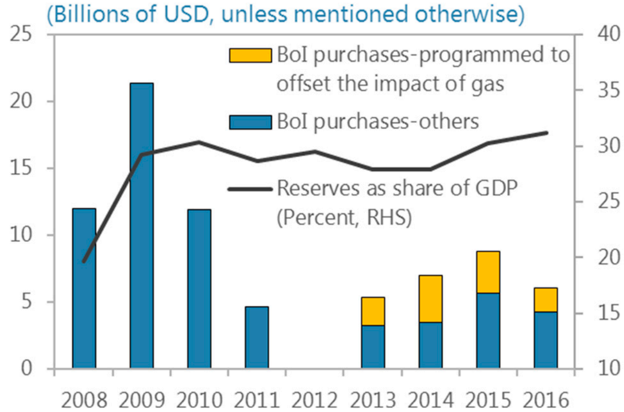


Sources: Bank of Israel; and IMF staff calculations.

17. A significant deviation of the shekel from fundamentals is not evident (Appendix I). Israel's real exchange rate appreciation in recent years has lifted it to about 7 percent above its historical average on a CPI basis, and 17 percent higher on a unit labor cost (ULC) basis. The current account surplus of 3.6 percent of GDP in 2016 is above its norm of balance, but high household saving due to mandatory pension contributions and high official and private transfers, could warrant a higher norm. With estimates of undervaluation ranging from 3 to 9.6 percent on approaches favored by staff, it is not clear that the shekel deviates significantly from its fundamental value. Current account inflows are reflected in a combination of portfolio and other investment outflows led by pension funds, partly offset by net FDI inflows into Israel's vibrant high-tech sector.

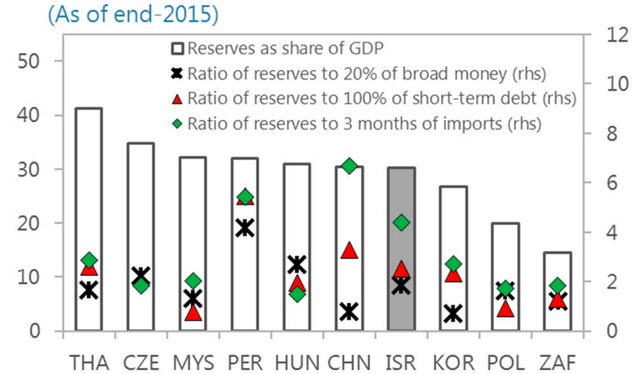
18. FX intervention declined in 2016. The BOI purchased the equivalent of $6 billion in 2016, down from $8.8 billion in 2015. About one-third of 2016 purchases were under the pre-announced program to offset lower imports owing to natural gas production, with the remainder aimed at moderating shekel overvaluation. Such purchases enable the BOI to make monetary conditions more supportive while avoiding stoking the property market through interest rate cuts. At the same time, the amounts purchased have not prevented the significant shekel appreciation in recent years.

Foreign Reserves and FX Intervention
(Billions of USD, unless mentioned otherwise)



Sources: Bank of Israel; and IMF staff calculations.

Indicators of Reserve Adequacy 1/
(As of end-2015)



Sources: IMF WEO database; and IMF staff calculations.
1/ Comparator countries have similar tolerance for external risks based on indicators for economic flexibility, market maturity, and market access.

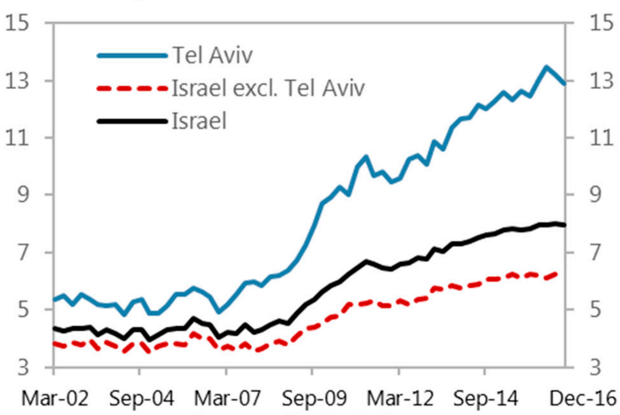
19. Israel's foreign reserves are comfortable. Foreign reserves ($102 billion at end-February 2017) have remained broadly stable as share of GDP since 2009. Although Israel's reserves exceed standard metrics relative to imports, short-term debt, and broad money, they do not appear excessive by international standards, especially considering Israel's geopolitical risk exposure and its limited export diversification.

20. The BOI held broadly similar views on monetary policy yet it considers that the shekel is mildly overvalued. The BOI forecasts inflation to return to within the target range in 2017Q4, and it sees some upside as well as downside uncertainty around this inflation outlook. Nonetheless, it considers that tightening too early would likely be more costly than having to tighten more rapidly at a later stage. However, the BOI's analysis, based on a range of in-house and external analytical tools, concludes that the shekel is mildly overvalued, driven by spillovers from the very accommodative global monetary policy. The resulting decline in competitiveness was reflected in sluggish goods exports, particularly in the European market. According to the BOI's analysis, the estimated range for adequate reserves is $70–$110 billion. Reserves are currently within that range.

B. Housing and Macroprudential Policies

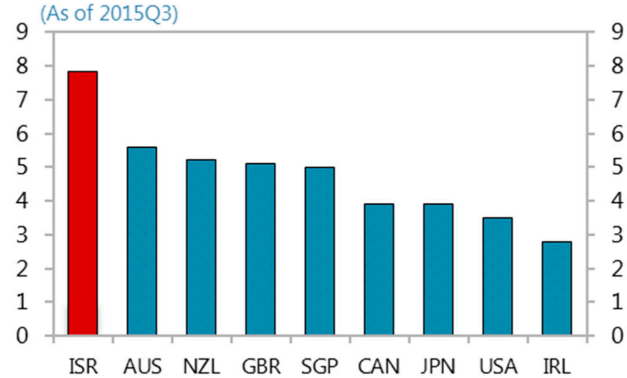
21. Housing affordability has deteriorated substantially. The average cost of a home has risen to more than seven times the average household's annual income, up from a ratio of about five in 2002–07, with affordability significantly worse than in a range of other countries. The situation is especially severe in Tel Aviv, where the price-to-income ratio is almost twice the national average.

Housing Price-to-Income Ratio in Israel



Sources: CBS; and IMF staff calculations.

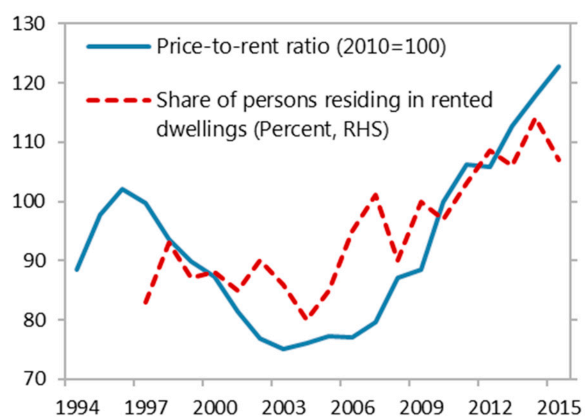
Price-to-Income Ratio
(As of 2015Q3)



Sources: Demographia International Housing Affordability Survey 2015Q3; CBS; and IMF staff calculations.

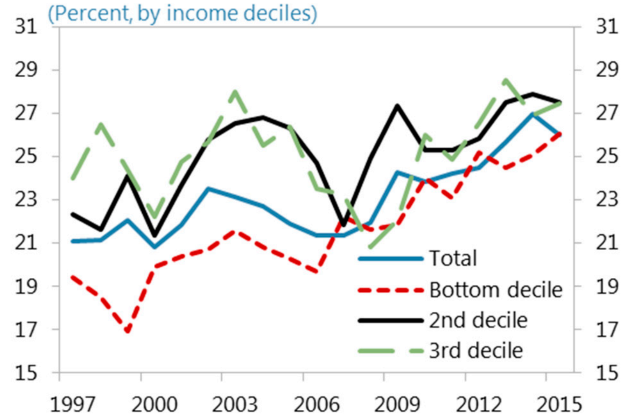
22. Elevated housing costs have disproportionate impacts on young and low-income households (Figure 6). Lower-income families can increasingly no longer afford the down payment, resulting in rising rents in the past decade. Increases in rental expenditure as a share of consumption are largest among low-income households, while high-income households seeking investment returns increasingly own more than one dwelling.

House Price and Share of Renters



Sources: CBS; and IMF staff calculations.

Rent as Share of Total Consumption Expenditure
(Percent, by income deciles)



Sources: CBS; and IMF staff calculations.

23. Recent housing market reforms include useful measures, but some initiatives are costly and may not have lasting benefits:

- **Fiscal measures**: Several tax measures aim to discourage investor demand: (i) higher transaction taxes on second or subsequent homes until end 2020; (ii) the introduction of a recurrent property tax on owners of three or more houses; and (iii) partial exemptions from capital gains tax on sales of residential properties until end 2017, with full exemptions on investing proceeds of sales in the capital markets. These tax changes may dampen price rises in the near term owing to investor sales, but focusing a recurrent property tax on investors could over time raise rental costs for low-income households, and the ceiling on monthly tax payments is regressive. The Buyer's Price program helps households purchase a first house, yet it benefits the relatively few households that win a lottery, provides housing supply mostly in the periphery, and comes at an off-budget fiscal cost peaking at 0.2 percent of GDP in 2017–18 (Annex III).

- **Administrative steps**: The government is also seeking to reduce the exceptionally long time to complete construction from the start of planning, previously estimated to average 13 years. In 2014 the government established the Housing Cabinet to handle all planning stages and to coordinate between the numerous parties involved in the process and it then consolidated the Land Authority and the Planning Administration under the Finance Ministry in 2015. Estimates are that the planning process has been expedited by 2–6 years, but further gains may be possible by simplifying rules and decentralizing the approval of smaller projects.

24. Further reforms are needed to durably expand supply and improve affordability:

- **Addressing municipal disincentives.** Local governments are reluctant to approve residential projects because residential property taxes are well below those on commercial properties even as they require additional infrastructure and public services. The authorities rely on "blanket agreements" with municipalities to overcome these hurdles for major projects. But correcting the incentives would make the supply of housing more responsive to demand on a lasting basis.

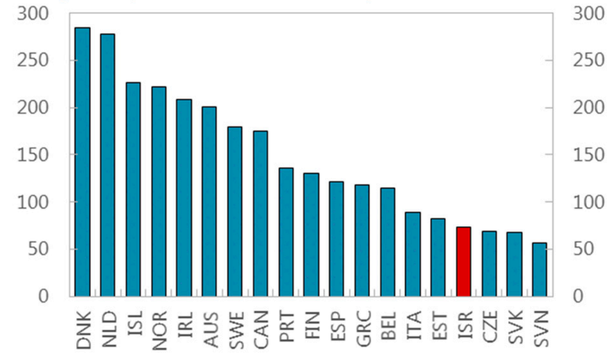
- **Ensuring adequate land supply for housing.** The majority of the land in Israel is state owned. Accelerating land privatization, focusing on areas of high demand, would help mitigate housing price pressures. Recent efforts to reduce impediments to urban renewal are welcome, and this should be expanded dramatically as urban density in Tel Aviv is relatively low. At the same time, improved public transportation would help relieve demand in major centers. In addition, municipalities could charge taxes on undeveloped privately held land to promote its use.

- **Reducing construction times and costs.** The government recently approved six foreign companies to construct residential buildings in Israel to help raise productivity in the sector. This welcome initiative should be expanded over time to allow broader entry of companies, which could also help relieve shortages of skilled labor. Construction costs and the time to build should also be reduced by streamlining building regulations.

25. A more developed rental market would also aid housing affordability. The rental market is primarily small-scale landlords, partly because rental income is taxable for companies but not for individuals. Recent amendments to the laws and regulations for investment in Real Estate Investment Trusts (REIT) are welcome steps to attract professional investment and management into the rental sector, which could in time expand the supply of rental property and moderate rents. Although over a quarter of the population lives in rental dwellings, protection for tenants is among the lowest in OECD countries. Reforms in this area could also aid rental market development.

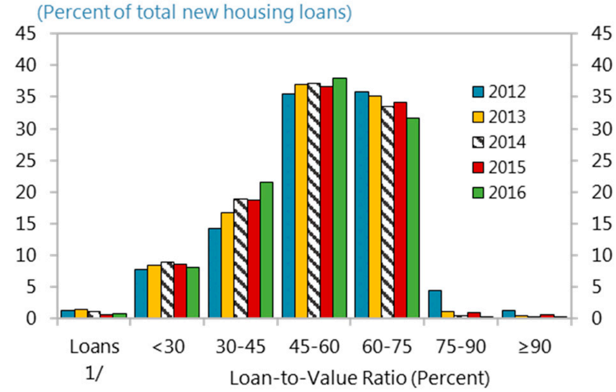
26. Macroprudential policies are appropriately tight, yet the BOI should continue to monitor developments closely. The BOI has proactively implemented a battery of macroprudential measures in the housing area, both quantitative limits and measures affecting banks' cost of funding mortgages (Annex IV). As a result, household debt-to-income ratios remain low in Israel and mortgages with LTVs exceeding 75 percent have been almost eliminated. In particular, the requirement for banks to increase capital by 1 percent of outstanding mortgage lending by January 1, 2017 helps account for the rise in mortgage interest rates during 2016. With a view to avoiding an impediment to housing supply—which would have undermined macrofinancial stability—the BOI allowed banks to raise credit supply to the construction sector by recognizing their transfer of credit risk to secondary insurers abroad. This broad perspective on managing macrofinancial risks is welcome and the BOI should continue to monitor property market and debt developments closely.

Household Debt to Disposable Income Ratio
(Percent, in 2015 or latest available)



Sources: CBS; OECD; and IMF staff calculations.

New Housing Loans by Loan-to-Value Ratios
(Percent of total new housing loans)



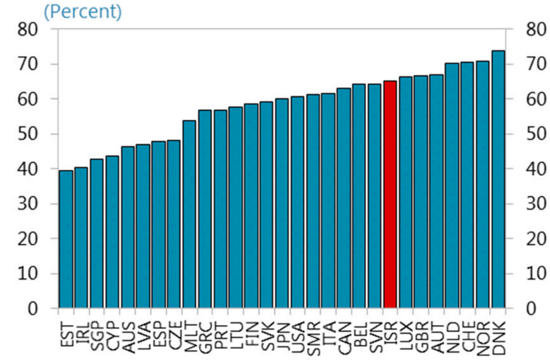
Sources: Bank of Israel; and IMF staff calculations.
1/ Loans not secured by housing.

27. The authorities considered that housing market reforms struck a reasonable balance between measures with near- and longer-term effects and noted that macroprudential policy would remain vigilant. The MOF fully agreed that housing supply is the key issue, noting the progress already made by the administrative reforms of planning. The Housing Cabinet had also been effective in addressing impediments to urban renewal and construction financing, and one of its current priorities is addressing skilled labor shortages. Regarding municipal incentives, political obstacles to changing taxes were insurmountable, so they would need to consider other approaches. Construction sector regulation would be reviewed as part of a broader government initiative. At the same time, the full benefits of these supply-side measures would only be realized in the long term. The Buyer's Price program would provide younger households with affordable housing more quickly and its contribution to supply would become significant in the medium term. As part of the upward pressure on housing prices reflected investor purchases in the context of the current low-yield environment, the MOF considered the combination of tax measures appropriate, noting that some are temporary. Given the high level of housing prices, there are some downside risks in coming years, but recent BOI analysis shows that high risk loans are well controlled. The BOI added that bank capital buffers have increased recently as past measures came into effect, and following their rise, mortgage rates better incorporate the risk associated with mortgage lending, but it would remain vigilant and ready to take actions if needed to protect financial stability.

C. Financial Sector Policies

28. Israel's banking system is sound but there are concerns about competition and efficiency. Indicators for capitalization, loan quality, and profitability point a healthy banking system. The leverage ratio of 6.6 percent exceeds most advanced economies and loan-to-deposit ratios below 100 percent show limited exposure to funding pressures. However, the system is highly concentrated, with five locally-owned banking groups accounting for 95 percent of banking sector assets, and the two largest groups for over 60 percent of assets (Table 6). Moreover, there have been no new entrants in almost half a century and its cost efficiency is low relative to other OECD countries partly due to high human resource expenses.

Non-Interest Expenses to Gross Income, 2015
(Percent)



Source: IMF Financial Soundness Indicators Database.

Table. Banking System Soundness Indicators, 2011–2016
(End-period, in percent)

	2011	2012	2013	2014	2015	2016 Q3
Regulatory capital to risk-weighted assets 1/	14.0	14.9	14.8	14.3	14.0	14.6
Regulatory Tier I capital to risk-weighted assets 1/	8.4	9.2	9.8	9.7	9.9	10.7
NPL to total gross loans	3.4	3.5	2.9	2.2	1.8	1.6
NPL net of loan-loss provisions to capital	12.3	12.3	8.9	4.6	3.4	2.5
Return on average assets (before tax)	1.2	0.8	0.9	0.8	1.0	1.1
Return on average equity (before tax)	12.3	12.1	13.3	11.8	14.4	15.5
Liquid assets as percent of short-term liabilities	…	…	25.7	27.7	26.5	…
Customer deposits as a percent of total (non-interbank) loans	111.3	113.0	113.9	115.8	117.8	117.3

Source: IMF Financial Soundness Indicators Database.
1/ The calculation of capital base follows rules under Basel II.

29. The authorities are therefore taking a range of steps to promote the efficiency of the financial sector:

- **Information and electronic banking**: To help customers compare the costs of bank services, the BOI has introduced a bank "identification card," which is an easy-to-read annual report from banks on a customer's financial assets, liabilities, loan and deposit rates, and various fees. A National Credit Register is in the process of being established, which could broaden access to credit while also reducing the competitive advantage of the major banks. The BOI is establishing policies to facilitate electronic banking, which would ease account mobility between banks.

- **Restructuring**: Following the recommendations of the Strum Committee, the authorities have enacted legislation to separate the credit card companies from the two largest banks while protecting them from their previous owners. The Committee also recommended expanding access to the clearing and settlement infrastructures by regulating these in accordance with the EU Payment Services Directive, along with an increased role for nonbanks in credit provision.

- **Cost cutting**: The BOI has promoted a reduction in bank's operating costs by requesting the banks to provide five-year streamlining programs. These programs are expected to reduce branch numbers by 20 percent and staffing by 10 percent, with the resulting savings to be used to support technological improvements and reduced fees in addition to raising profits. The associated upfront costs are accommodated by some temporary relief in capital requirements.

30. The separation of credit card companies should be closely supervised. Ahead of the adoption of legislation for this separation in December, the BOI has already taken appropriate steps to avoid conflicts of interest between the banks and the credit card companies. Given the importance of these two credit card companies for the payments system, it is appropriate that their regulation remain with the Banking Supervision Department (BSD) of the BOI. The viability of their post-separation business models and the stability of their funding structures are of particular importance. Enacting legislation for securitization is important to facilitate the funding of credit card companies, especially considering that credit card interest rates are relatively low in Israel.

31. Further strengthening the financial stability framework is needed to fully realize the benefits of greater competition. A more contestible banking market increases the need for deposit insurance with appropriate coverage limits, together with enhanced bank resolution tools, to protect stability and contain potential costs. Hence, both of these instruments should be established before significantly reducing the NIS 100 million minimum capital requirement for bank entry. More broadly, in the wake of major decisions on financial sector reform, it is important to safeguard the operational independence of each financial regulator from political pressures, including to ensure potential new entrants are not deterred by uncertainty about future regulatory arrangements.

32. Regulatory arrangements are being enhanced and the establishment a Financial Stability Committee (FSC) should be completed. In 2016, an independent Capital Markets, Insurance, and Savings Authority (CMISA) was established by separating the respective division from the MOF. It is important to operationalize the Solvency II framework for the insurance sector to ensure its resilience to shocks. Following up on technical assistance recommendations, the BSD is in the process of adopting a more risk-focused approach to supervision in order to lower compliance costs while maintaining high standards. Steps include limiting prior approval requirements to high-risk initiatives and increasing engagement with banks' boards and senior management. To facilitate collaboration and coordination among the various financial regulators, the 2012 FSAP Update recommended to establish an FSC. The authorities have agreed that the FSC will be chaired by the Governor of the BOI, and it is now important to enact the respective legislation to enable the sharing of information needed to make the FSC operational.

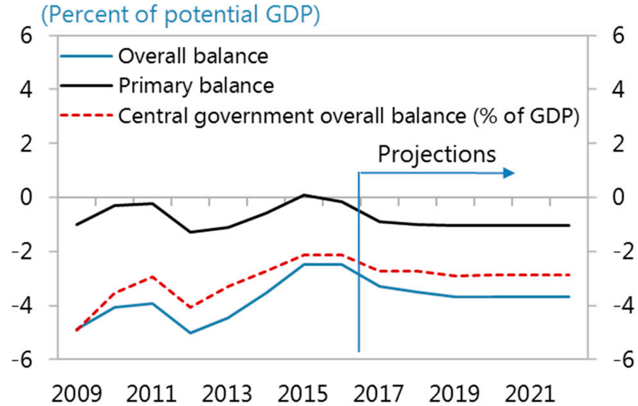
33. The authorities generally shared staff's assessment and would continue working on these issues. They agreed that strong supervision is key to maintaining sound financial sector in Israel, as reflected in the recent creation of an independent CMISA, and they expected the FSC legislation to be tabled at the Knesset by April. The BOI and MOF have established a working group on deposit insurance and bank resolution issues, with a view to ensuring stability is protected while facilitating new bank entry. The regulatory authorities fully supported the need to safeguard their operational independence from political pressures.

D. Fiscal Policy

34. **Strong revenue performance contained the fiscal deficit in 2016 and the debt ratio declined to 62 percent of GDP.** The central government deficit came in at 2.1 percent of GDP in 2016, well below the 2.9 percent target, with revenue over performance of 0.7 percentage points of GDP reflecting higher-than-expected growth and exceptionally high vehicle sales. The cyclically-adjusted general government deficit was unchanged at 2½ percent of GDP in 2016.

35. **A two-year budget adopted for 2017–18 allows for higher fiscal deficits.** The central government deficit targets for both 2017 and 2018 were revised to 2.9 percent of GDP, up from 2½ and 2¼ percent of GDP respectively. The higher deficit target primarily reflects a marked increase in current expenditures of 0.6 percent of GDP, reflecting expanded allowances for the elderly and disabled, education, and healthcare. A small increase in investment, of 0.1 percent of GDP, aims to enhance mass transport, build roads to minority communities, and raise housing supply. The net cost of tax measures is estimated to be around 0.1 percent of GDP from 2018. In practice, staff estimates the deficit will be about 2¾ percent of GDP in 2017–18 given the prudent macroeconomic framework underpinning revenue projections.

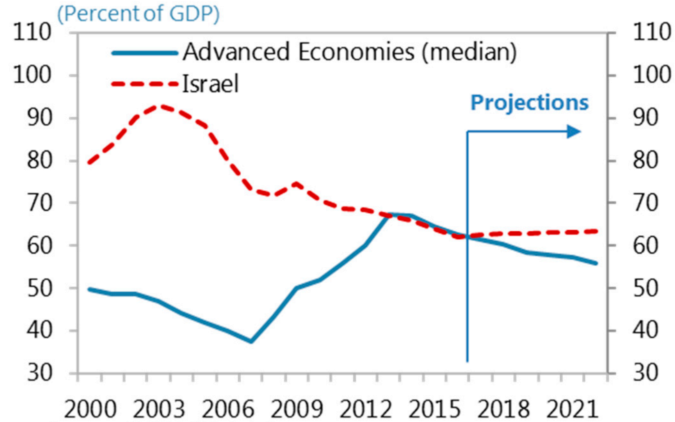
Cyclically-Adjusted General Government Balances
(Percent of potential GDP)



Sources: Israeli Ministry of Finance; and IMF staff projections.

36. **Israel should be protecting its fiscal buffers in this relatively favorable economic environment.** After bringing public debt down to the advanced economy median in recent years, the 2017–18 budget allows a gradual increase in the debt ratio of 1½ percentage points over the next five years, to be significantly above the gradually declining median by 2022. Israel has some fiscal space if it were to be needed, with government debt projected to remain below the 85 percent threshold for advanced economies and gross financing needs at manageable levels of around 10 percent of GDP (Appendix II). However, Israel faces wider uncertainties than most advanced economies, making the government's medium-term debt target of 60 percent of GDP a more robust benchmark for assuring that large scale fiscal support can be deployed if the need arises.

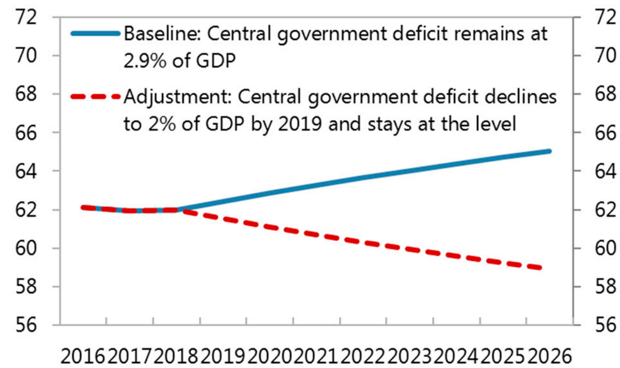
General Government Debt
(Percent of GDP)



Source: IMF WEO database.

37. A fiscal deficit of around 2 percent of GDP over the cycle is therefore appropriate, with temporary flexibility to facilitate structural reforms. Bringing the central government deficit down to 2 percent of GDP would generate a gradual debt decline in normal times.[4] Such a deficit—equivalent to 3 percent of GDP for general government on a GFS basis—would rebuild buffers after a rise in deficits and debt owing to a recession. Nonetheless, if structural reforms with clear benefits for potential growth are adopted, a deficit that is somewhat higher could be appropriate temporarily if needed to accommodate upfront reform costs. The current favorable macroeconomic conditions support undertaking this modest adjustment in the coming years. Indeed, if the deficit is below target in 2017, the authorities should seek to lock in that overperformance by not further cutting taxes or raising spending without offsetting measures.

General Government Debt under Adjustment Scenario 1/
(Percent of GDP)

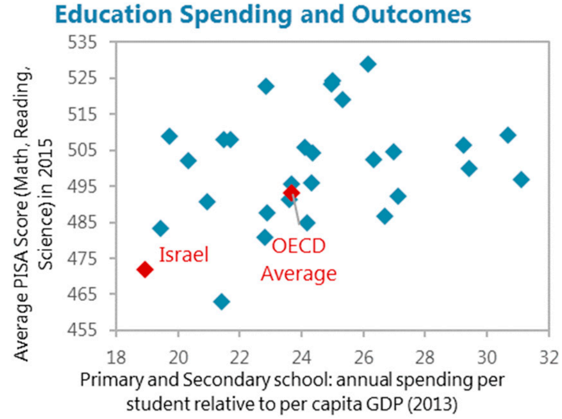


1/ Assuming the general government deficit exceeds the central government deficit by 0.6 percent of GDP in 2017 and 0.8 percent in 2018 thereafter; annual nominal GDP growth of 5 percent; and non-debt financing of 0.5 percent of GDP annually.
Source: IMF staff estimates

38. Although progress is being made on making the structure of fiscal policy more favorable for inclusive growth, needs remain, especially in education and infrastructure. It is welcome that the 2017–18 budget includes a sizable rise in healthcare spending to support reforms that should reduce queues for public services. But there are also other spending priorities, as well:

- **Education and training.** Israel's education outcomes are below OECD average in terms of PISA scores. Reforms of education and training, supported by additional resources, could narrow the wide gaps in achievement across social groups, bolster the skills of those already in work, and help Haredi men and Arab women enter the workforce.

Education Spending and Outcomes



Source: OECD.

- **Transport infrastructure.** Prospects for rapidly rising road congestion threaten productivity and would reinforce demand for property in favorable locations. Timely completion of the public transportation projects underway is needed. The government intends to enhance road and other transport infrastructure through extrabudgetary projects (e.g., public-private partnerships), but these are often subject to extensive delays. Additional budgetary resources would enable a more rapid expansion of efficient public projects while expediting extrabudgetary projects.

[4] This deficit target assumes nominal GDP growth averaging 5 percent and an annual stock-flow adjustment of around ½ percent of GDP. Fiscal targets may in future need to be adjusted for gas-related revenues of around 0.4 to 0.8 percent of GDP, part of which are to be placed in a Sovereign Wealth Fund.

39. Funding these essential public investments in human and physical capital while protecting Israel's fiscal buffers will require a balanced approach. Defense spending is high (6 percent of GDP), making it important during peacetime to adhere to the multi-year defense budget (Annex V) to contain this spending in a durable manner. Other savings can be achieved by raising the efficiency of central government administration and by further improving public procurement procedures.[5] In addition to implementing planned steps to enhance tax administration, revenues can be significantly enhanced in a growth-friendly manner by scaling back tax benefits, which total 5 percent of GDP. The government should assess whether such benefits are well-targeted and used as intended (e.g., those related to capital investments and education funds). It could also replace blanket VAT exemptions on fruit and vegetables with targeted transfers.

Projected Foregone Revenue from Tax Benefits

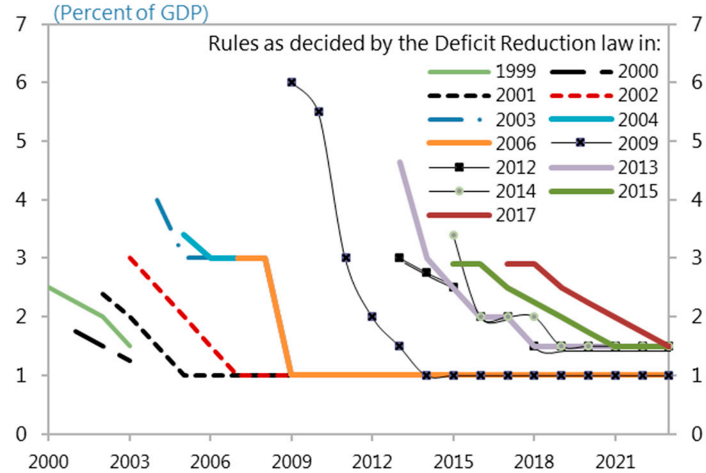
(Percent of GDP)	2017	2018
Direct taxes	4.1	4.0
Pension	1.7	1.7
Law for the encouragement of capital investments	0.5	0.5
Education funds	0.4	0.4
Exemption from betterment tax on apartments	0.4	0.3
Credit to parents for children	0.2	0.2
Exemption for the National Insurance allowances	0.2	0.2
Others	0.7	0.7
Indirect taxes	0.8	0.8
VAT	0.4	0.4
Customs and purchase tax	0.4	0.4
Levies	0.1	0.1
Total	***5.0***	***4.9***

Sources: Israeli Ministry of Finance; WEO; and IMF staff calculations.

40. Important improvements in the medium-term fiscal framework have been made, but greater political commitment will be key to its effectiveness in practice. Following the recommendations from IMF Technical Assistance in 2015, the government has implemented a number of welcome measures to strengthen the medium-term fiscal framework (Annex V). In particular, strengthening commitment controls will improve prospects for containing spending trends, as will the agreement on a multi-year defense budget, combined with enhanced transparency in the implementation of that budget. However, long experience demonstrates that the medium-term budget framework remains susceptible to deviations from the fiscal rules. Including concrete measures to close such deviations in the budget document would enhance the credibility of fiscal rules. The government should also set clear criteria that limit changes in the spending and deficit ceilings to exceptional cases such as natural disasters. To enhance budget transparency, the Land Authority should be converted to a budgetary entity, while U.S. grants and related defense spending of ¾ percent of GDP annually should be reported on budget.

Central Government Deficit Target Adjustments

(Percent of GDP)



Sources: MoF; Brender (2013); IMF (2014); and IMF (2015).

[5] Following recommendations in March 2013, the authorities undertook procurement reforms to streamline and standardize tender procedures, introduce centralized e-procurement, and encourage staff professionalization given the job's growing complexity. However, only 10–15 percent of total public procurement at the central government level is processed in accordance with the program (OECD).

41. The authorities expected better fiscal outturns but had differing views on tax cuts. The MOF highlighted that the deficit had been below target in both 2015 and 2016, with some potential for this pattern to recur. At the same time, if revenues are strong, it considers it important to cut tax rates such as VAT to further reduce the cost of living. In contrast, the BOI did not support tax cuts at this time, as one-off factors make it difficult to assess revenue trends and civilian spending is low. The MOF was cautious about setting out criteria for adjusting fiscal targets, including in relation to potential upfront costs of structural reforms, fearing they could be a slippery slope.

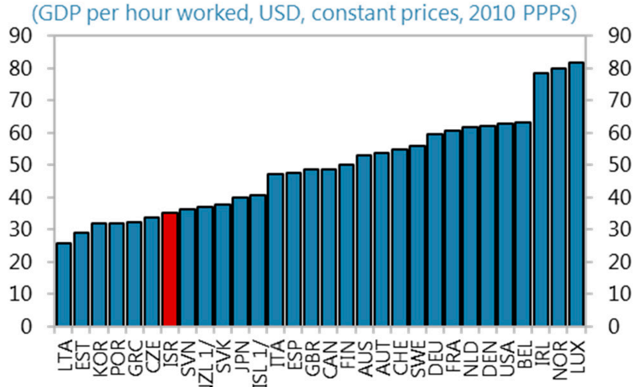
E. Structural Reforms

42. Israel has two main opportunities to improve its longer-term economic outlook:

- **Productivity is relatively low, especially in sectors sheltered from international competition.** Average labor productivity in Israel was 56 percent of U.S. levels in 2015 and 74 percent of EU levels. Labor productivity growth is higher in industries that are more exposed to international competition. The inefficiencies in sheltered sectors reduce productivity and wages for employees and contribute to the high prices in Israel relative to per capita incomes.

Labor Productivity Comparison, 2015

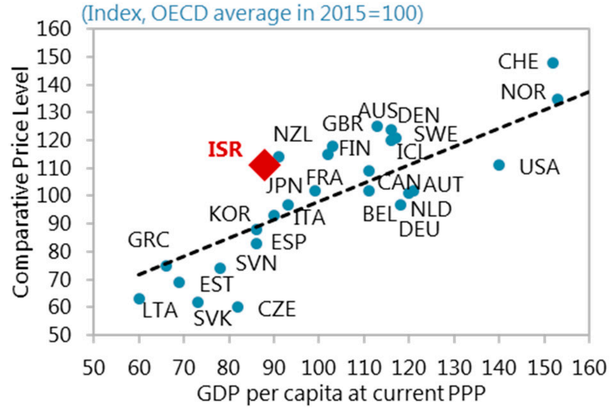
(GDP per hour worked, USD, constant prices, 2010 PPPs)



Sources: OECD; and IMF staff calculations.
1/ 2014 data is used due to data availablity.

Price Level and GDP Per Capita

(Index, OECD average in 2015=100)

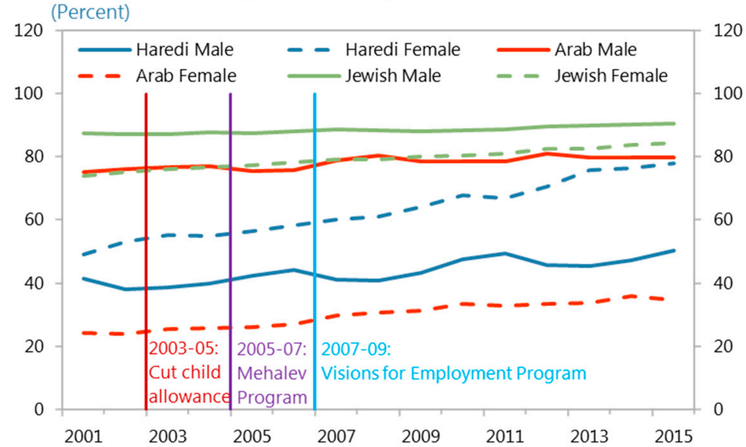


Sources: OECD; and IMF staff calculations.

- **Labor participation of some groups remains very low**. Participation of Haredi females has risen substantially in the past 15 years to approach that of other Jewish females. Haredi male participation has risen in recent years, but remains very low at only 50.5 percent. Participation of Arab women has steadily increased, but at 34.6 percent there is much room to benefit from their inclusion in the labor force.

Labor Force Participation Rate by Cohorts

(Percent)



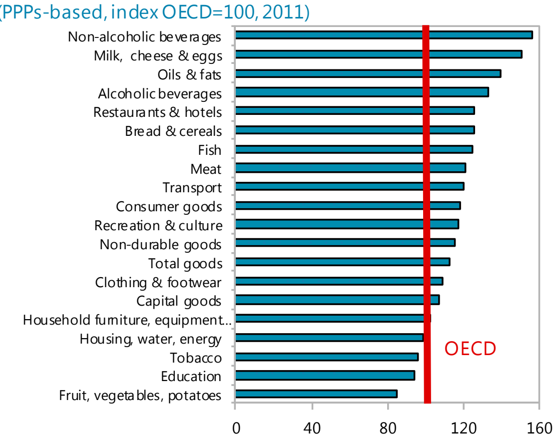
Sources: CBS; and IMF staff calculations.

43. Product market reforms are needed to increase competition, boost productivity, and reduce the cost of living. Israel's product markets are characterized by (i) relatively low trade openness, (ii) complex and burdensome regulation that forms a barrier to entry, and (iii) associated signs of inadequate competition in some sectors. Reforms should therefore prioritize three areas:

- **Lowering barriers to external competition.** Israel recently liberalized imports of dry food products. Trade barriers should be further lowered by expanding the coverage of quota increases and tariff cuts, especially on food, e.g., half of dairy products and eggs face tariffs over 100 percent. Support for agriculture should be shifted to less distortionary targeted subsidies. Import procedures should be simplified, standards aligned with those in other advanced economies, and restrictions that hinder foreign competition in services eased.

Selected Price Levels

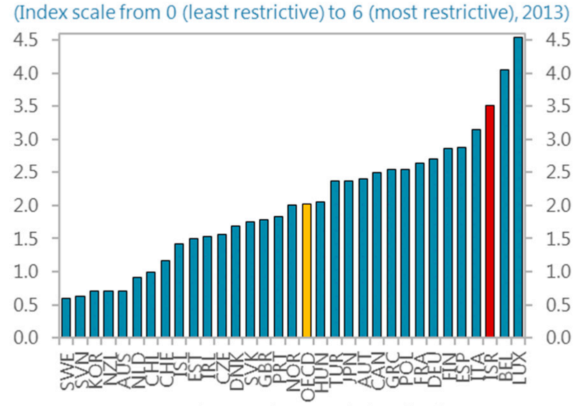
(PPPs-based, index OECD=100, 2011)



Source: OECD 2016 Economic Survey for Israel.

Regulation in Retail Trade

(Index scale from 0 (least restrictive) to 6 (most restrictive), 2013)



Source: OECD, Product Market Regulation database.

- **Reducing regulatory burdens**. Israel's [Doing Business] ranking dropped from 30th in 2008 to 52nd in 2016. Regulation should be reviewed and modernized to achieve public goals in a low-cost manner. Simple and timely administration of regulations, such as a "one-stop shop," is critical for the ease of doing business. Regarding proposals for new regulations, requiring robust regulatory impact assessments is critical.

- **Reforming state enterprises**. The weak efficiency of SOEs, especially in network industries (e.g., electricity, ports, airports, postal services, water management) drags on productivity and costs across the economy. In particular, implementing long-planned reforms in the electricity sector is key to helping Israel make efficient use of its natural gas resources.

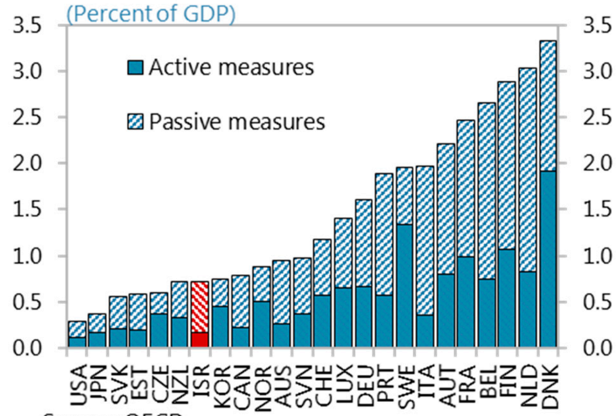
44. Broad efforts are needed to support higher participation and reduce poverty. Earlier welfare cuts, and house price rises in the last decade, are found to have boosted labor supply, yet there were also significant social costs.[6] Going forward, policies should enhance the ability to participate, promote the availability of suitable jobs, and support the incomes of those in work.

---

[6] See Box 5.2 in the BOI Annual Report 2006 for an evaluation of the effect of a cut in child allowances on labor force participation and Box 5.1 in the BOI Annual Report 2005 and Box 5.3 in the BOI Annual Report 2008 for evaluations of the impact of the employment support program. See Chapter 5 in BOI Annual Report 2015 for an assessment of the connection between rising housing prices and the supply of labor.

45. Active labor market policies (ALMP) should be expanded. The Ministry of Labor and Social Affairs has established 46 Career Centers to provide a range of employment services to Israeli-Arabs, Haredi, and Ethiopian Israelis, in their communities. It also funds adult vocational training and is running programs to promote integration in high-tech industry, to boost Haredi employment in the public sector, and encourage SME entrepreneurship. But only 0.2 percent of GDP is spent on such ALMP, limiting its impact. Programs showing good results should receive more funding, working in coordination with employers to ensure their effectiveness.

Public Expenditure on Labor Programs, 2014
(Percent of GDP)

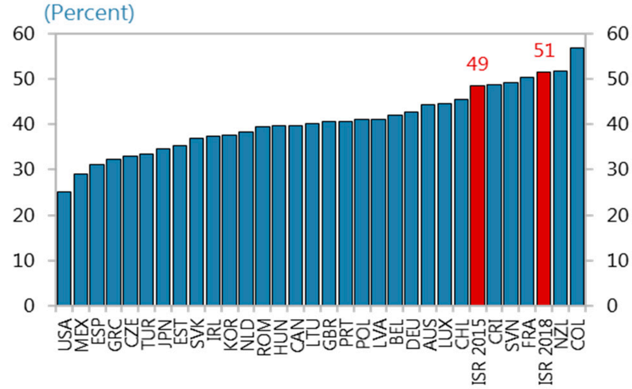


Source: OECD.

46. The environment for small businesses, including infrastructure, is key to the availability of suitable work. More jobs are needed in, or close to, Haredi and Israeli-Arab communities. Investments in connecting their towns to main roads need to be increased, alongside improvements in access to public transport. Other supports for local business development and employment are also needed, including access to financing, which, in the Israeli-Arab communities, may require government assistance to work around the difficulties with using land as collateral.[7]

47. Raising the Earned Income Tax Credit (EITC) is also critical to reducing poverty. The minimum wage has been increased significantly in recent years, to 51 percent of the average wage based on the increase planned for December 2017. Israel's minimum wage would be among the highest by international standards, increasing the risk of adverse employment effects, especially on the low-skilled or young.[8] The EITC averages NIS 3,619 per household in 2015, equivalent to just 7 percent of the minimum wage, with an overall budgetary cost of only 0.1 percent of GDP. In 2015, 414,500 low income workers were eligible for the EITC, mostly with children, of which 70.2 percent used the credit. A substantial expansion of the EITC would provide well-targeted support to low income workers with families, helping to address poverty while reinforcing incentives to work. It would also be desirable to broaden the impact of the EITC, such as by lowering the minimum earnings threshold so that more part-time workers qualify. Payments of the credit should be more frequent and timely, to encourage greater use of it and strengthen its effectiveness in encouraging employment.

Minimum Wages Relative to Mean Wages, 2015
(Percent)



Sources: OECD; Bank of Israel; and IMF staff calculations.

[7] See SME and Entrepreneurship Policy in Israel 2016 (OECD 2016).

[8] See Cross-Country Report on Minimum Wages (IMF Country Report No. 16/151).

48. The authorities are keenly aware of the need for structural reforms to enhance productivity and participation. A cross-government initiative to streamline regulation by 25 percent is being led by the Prime Minister's Office. The MOF supports a progressive reduction in the remaining trade barriers, using targeted subsidies to support agriculture where needed. The authorities had few concerns that the increase in the minimum wage would affect employment in the current macroeconomic conditions, and, if needed, there was sufficient flexibility in the framework for adjusting the minimum wage. The BOI endorsed expansion of ALMP and EITC, together with supporting development of small business in Haredi and Israeli-Arab communities, while the MOF was concerned that a significant expansion of the EITC could undermine work incentives for those households at or near the income levels subject to abatement of the credit.

STAFF APPRAISAL

49. The Israeli economy is well placed for reforms to help sustain strong and inclusive growth. Growth of 4 percent in 2016 benefited from robust domestic demand, only partly due to one-off factors, supported by an export rebound. Labor market conditions have improved with historically low unemployment and rising wages, yet inflation remained low. Growth is expected to settle around 3 percent in coming years with a moderation in domestic demand growth yet some firming in exports. In the longer term, however, demographic trends, especially the rising share of Haredi in the working-age population, could lower Israel's growth potential and raise poverty.

50. Monetary policy should remain accommodative pending a durable rise in inflation and inflation expectations. With inflation below the 1–3 percent target band in recent years, the BOI has maintained appropriately accommodative monetary policy, which has helped keep long-term inflation expectations well anchored. A further rise in wage growth, together with higher foreign inflation and commodity prices, makes an eventual increase in Israeli inflation likely. Nonetheless, there are uncertainties around the timing of an increase in inflation, which, together with weakness in short- to medium-term inflation expectations, calls for avoiding a premature monetary tightening. The shekel has appreciated in recent years despite the accommodative stance of monetary policy and it is not evident that it deviates significantly from fundamentals.

51. Reforms that durably expand housing supply are needed to improve affordability over time and thereby also lower macrofinancial risks. Bringing the relevant authorities under the MOF is already expediting land planning and the Housing Cabinet has helped address financing issues and impediments to urban renewal. Recent tax measures may moderate price increases in the near term but the Buyer's Price Program is costly and boosts supply mostly in the periphery. Correcting municipal incentives in relation to residential development is essential to make the supply of residential property more responsive to demand on a lasting basis. Land privatization should be accelerated and urban renewal expanded, complemented by improved public transportation to relieve demand in major centers. Construction times and costs should be reduced by streamlining building regulations and further opening this market to foreign competition.

52. Financial stability must continue to be safeguarded during the course of reforms to promote efficiency in the sector. Regulatory arrangements continue to be enhanced with the establishment of the independent CMISA and the move to a more risk-focused supervisory approach by the BOI to lower compliance costs while maintaining the high standards. The FSC legislation should be enacted to improve coordination among regulators and the Solvency II framework for the insurance sector should be operationalized. A range of steps have been taken to promote the efficiency of the financial sector, including separation of two credit card companies from banks, which will need to be closely supervised. Steps to lower entry barriers to the bank market should be taken in a context of adequate tools to protect stability and contain potential costs, including in relation to deposit insurance and bank resolution. It is also important to safeguard the operational independence of each financial regulator from political pressures, including to give new entrants greater certainty about future regulatory arrangements.

53. Fiscal policy should further support Israel's growth potential while protecting buffers. Strong growth in 2016 helped lower the fiscal deficit and maintained the downtrend in public debt ratios. Although the 2017–18 budget includes useful steps, such as expanded healthcare resources, allowing deficits of up to 2.9 percent of GDP could result in a gradual rise in public debt. In the current favorable macroeconomic conditions, the central government deficit should be reduced to around 2 percent of GDP in coming years. At the same time, education and transport infrastructure are priority areas for additional spending to help sustain growth. Funding these essential public investments while narrowing the deficit can be achieved by through additional savings from central government administration and improving public procurement and by reducing sizable tax benefits. Important improvements in the medium-term fiscal framework have been made, especially the enhanced commitment controls, but greater political commitment is key to its effectiveness.

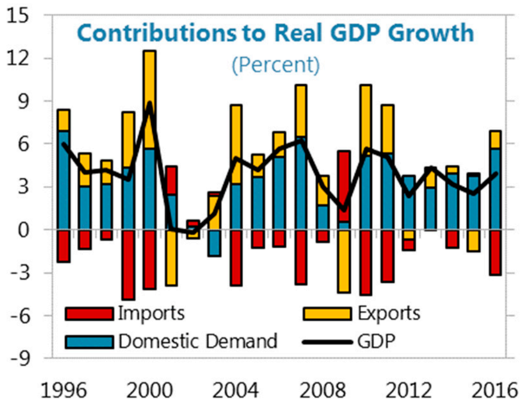
54. Product market reforms are essential to increase competition, boost productivity, and reduce living costs. Regulation should be modernized to achieve public policy goals in a low-cost manner and simple and timely administration of regulations is also critical. Steps to lower tariff and non-tariff barriers to external competition should be broadened. SOE reforms, especially in the electricity sector, would also help reduce costs across the economy.

55. Inclusiveness is central to sustaining strong growth and reducing poverty in Israel. Narrowing the wide gaps in the labor participation and productivity of Haredi and Israeli-Arab populations can improve potential growth prospects significantly and is essential to avoid a rise in poverty as their share in the population increases. Innovative active labor market programs, such as community-based career centers, and a range of integration and vocational training programs are being introduced with promising results. Resources for well-performing programs should be expanded while ensuring effectiveness through close coordination with employers. Job creation in Haredi and Israeli-Arab communities would benefit from improved transport connections including access to public transportation, and support for business development such as access to financing. At the same time, the EITC should be increased substantially while also widening eligibility for this credit, in order to more immediately help reduce poverty while reinforcing incentives to work.

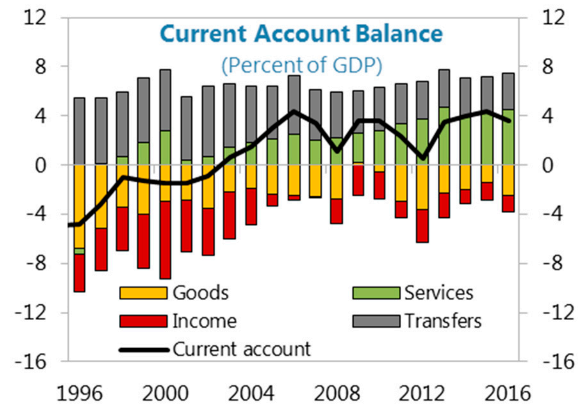
56. It is proposed that the next Article IV consultation with Israel take place on the standard 12-month cycle.

Figure 1. Israel: The Long View

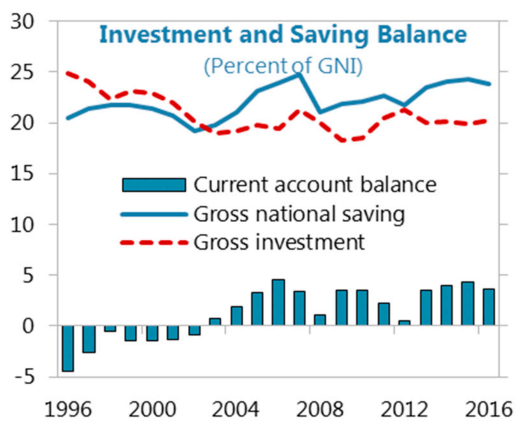
Growth has relied on domestic demand rather than exports since 2012.



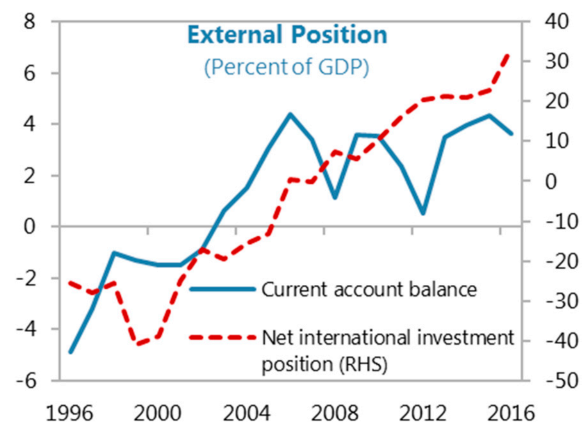
The current account has been in surplus for the past decade…



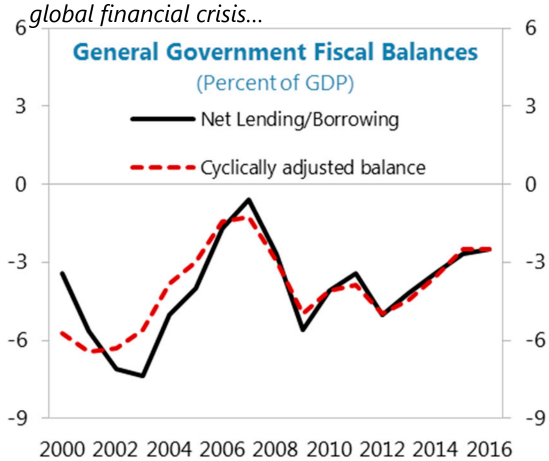
…reflecting a decline in investment rates in the mid-2000s and high saving rates…



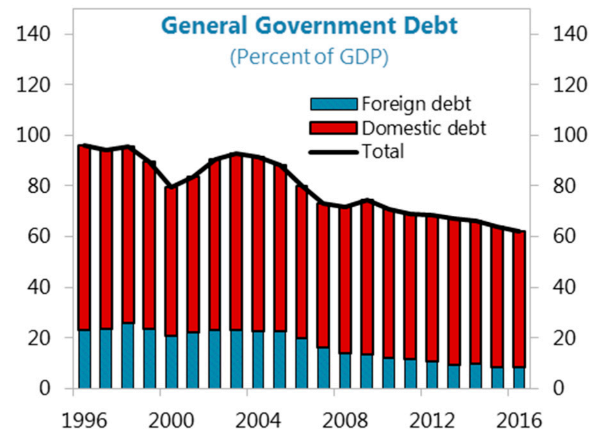
…helping raise the net IIP over time.



Fiscal deficits have been declining since the global financial crisis…



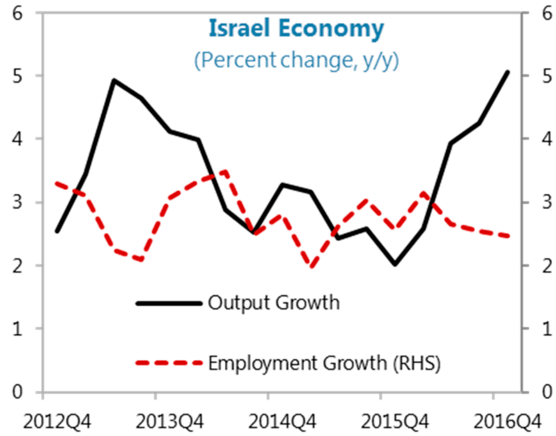
…contributing to a down trend in government debt.



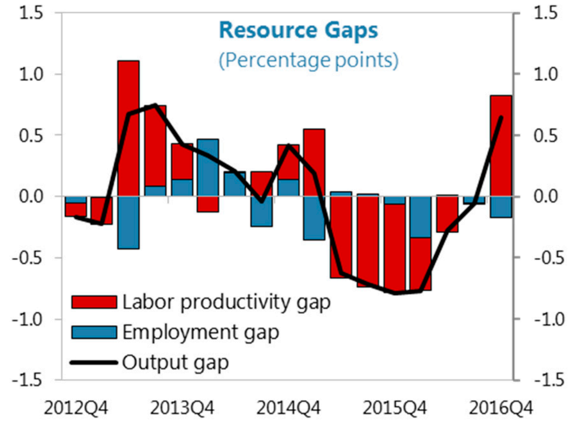
Sources: Bank of Israel; Central Bureau of Statistics; IMF Information Notice System; and IMF staff calculations.

Figure 2. Israel: Recent Economic Developments

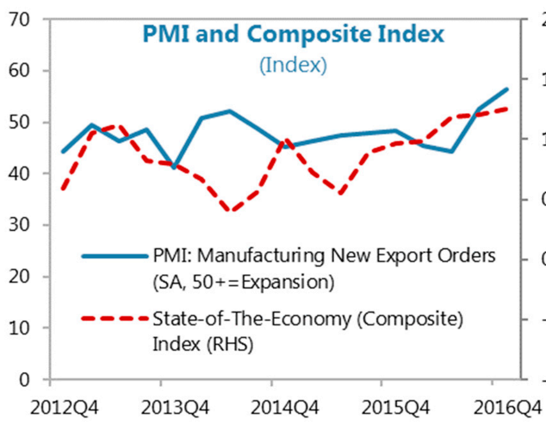
After a period of weakness in 2015, growth has picked up in 2016…



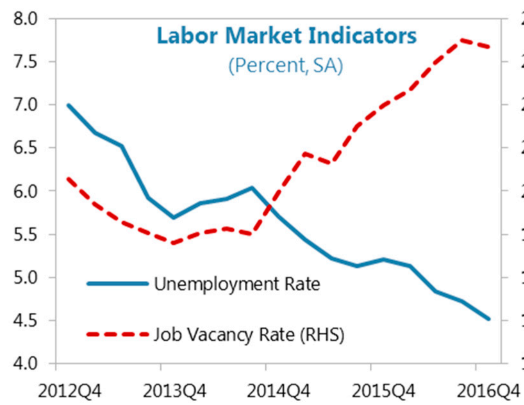
…with employment gaps closing.



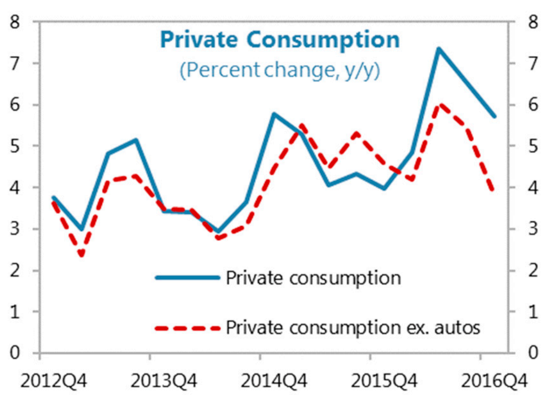
High-frequency data suggest strong growth to continue…



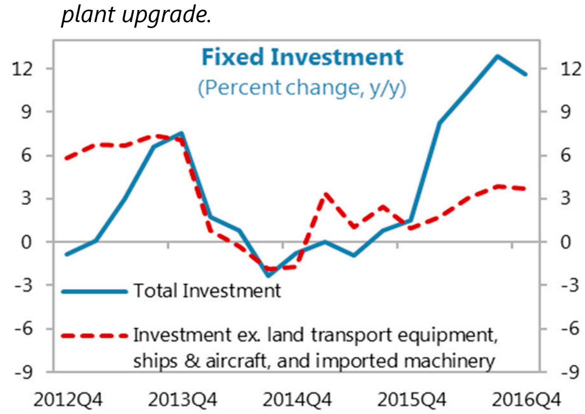
…while unemployment fell to historic lows along with rising vacancy rates…



…contributing to strong consumption, partly boosted by a temporary surge in car purchases in 2016 ahead of tax hikes…



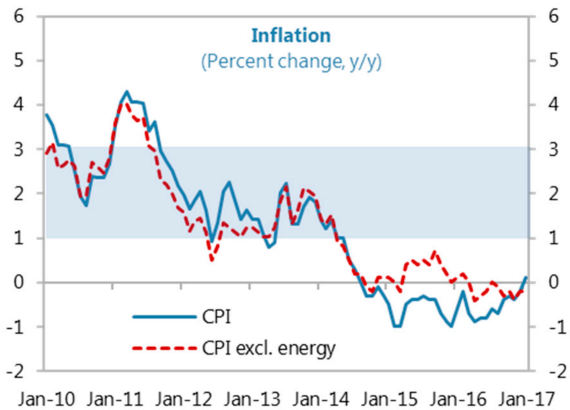
… which also contributed to strong growth in fixed investment together with Intel's fabrication plant upgrade.



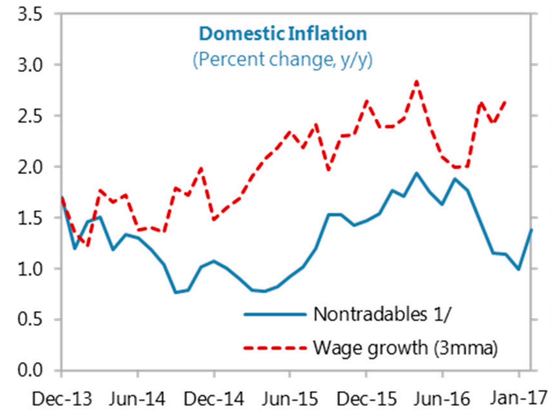
Sources: Bank of Israel; Central Bureau of Statistics; Haver Analytics; IMF World Economic Outlook; and IMF staff calculations.

Figure 3. Israel: Inflation and Monetary Indicators

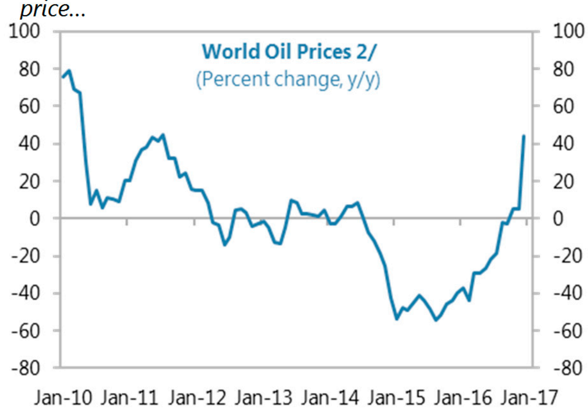
Headline inflation is below the target band.



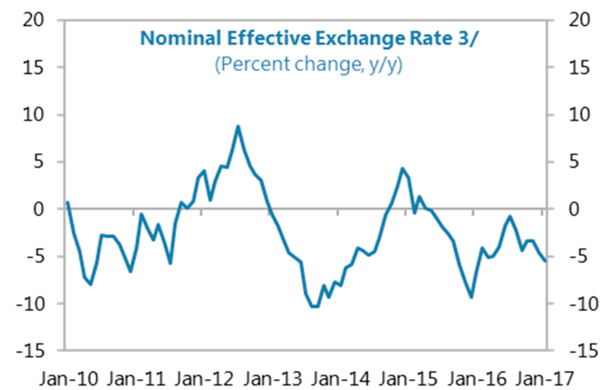
Nominal wage growth has been rising gradually and nontradable is within the band....



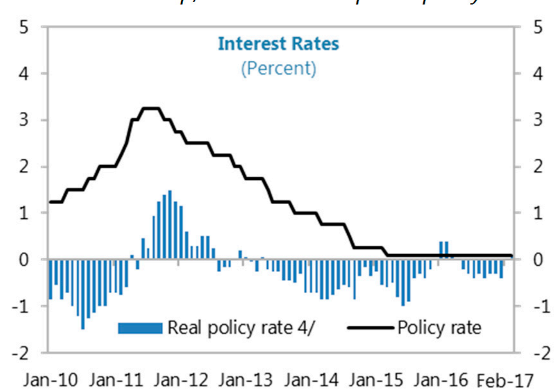
...suggesting that external factors, such as energy price...



...and exchange rates, have played a role.



Against this backdrop, the BOI has kept the policy rate.

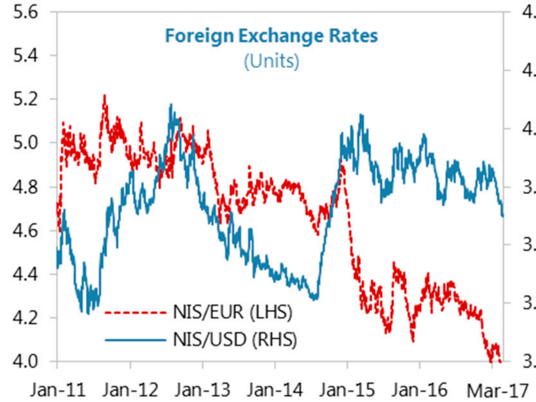


So far, long-term inflation expectations remain well anchored.

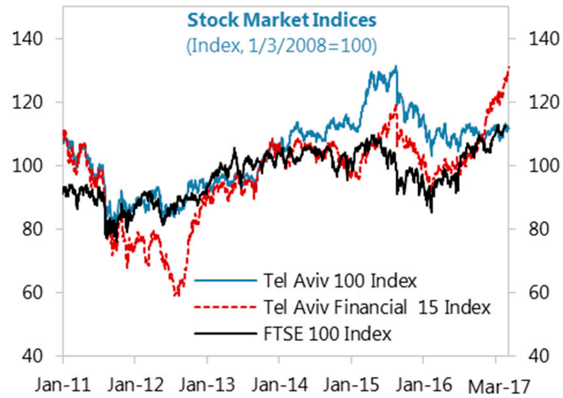
Sources: Haver Analytics; Bank of Israel; IMF WEO database; and IMF staff calculations.
1/ Excluding fruit and vegetables, and estimated impact of government measures.
2/ Crude Oil (petroleum), simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh, US$ per barrel.
3/ A negative change indicates appreciation of the shekel.
4/ Real policy rate is calculated as the difference between nominal policy rate and one-year ahead inflation expectations.

Figure 4. Israel: Selected Financial Indicators

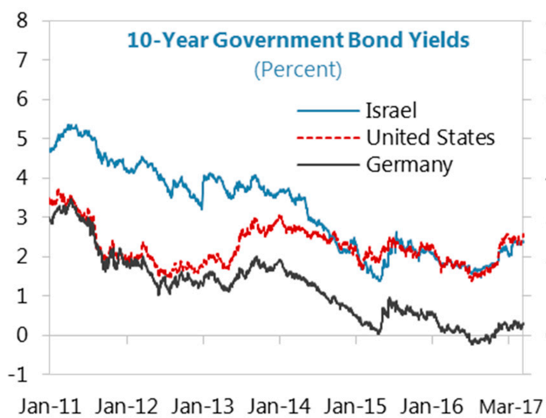
The shekel has appreciated against major currencies.



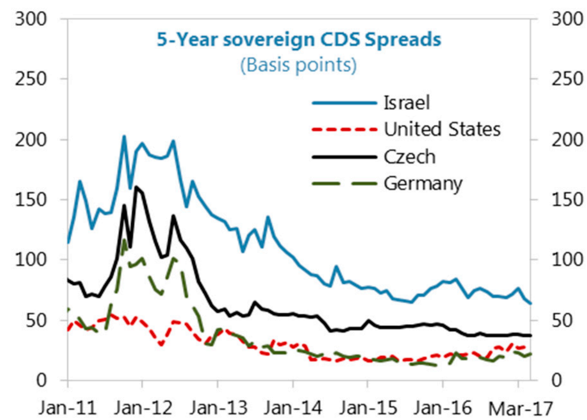
The stock price has been flat aside from the financial sector…



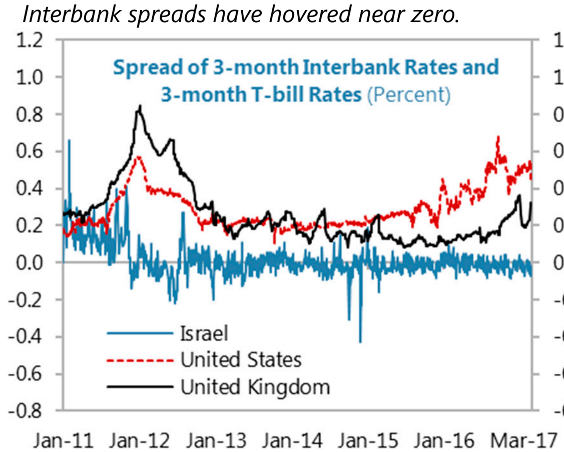
…while sovereign bond yields—despite the recent uptick—have tracked US yields closely…



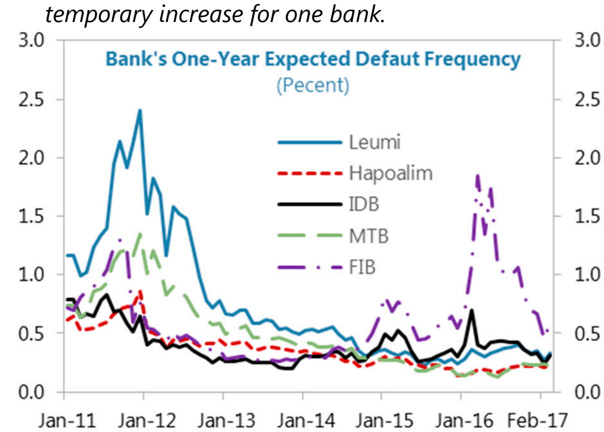
…and sovereign CDS spreads have been stable.



Interbank spreads have hovered near zero.



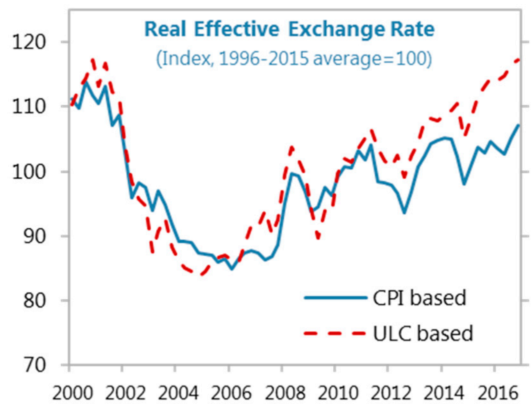
Default probabilities have fallen aside from a temporary increase for one bank.



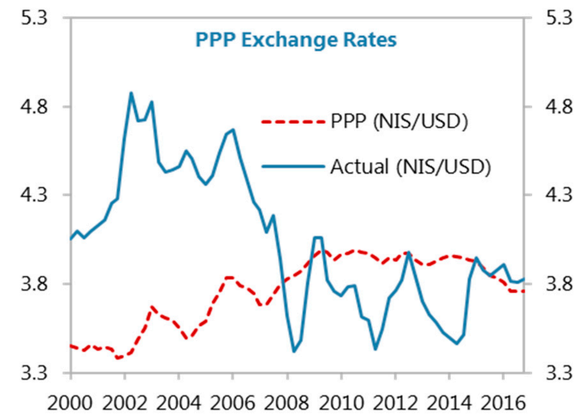
Sources: Bloomberg; Datastream; Haver Analytics; and Moody's Analytics CreditEdge.

Figure 5. Israel: Exchange Rates and BOP

The shekel has appreciated over recent years…

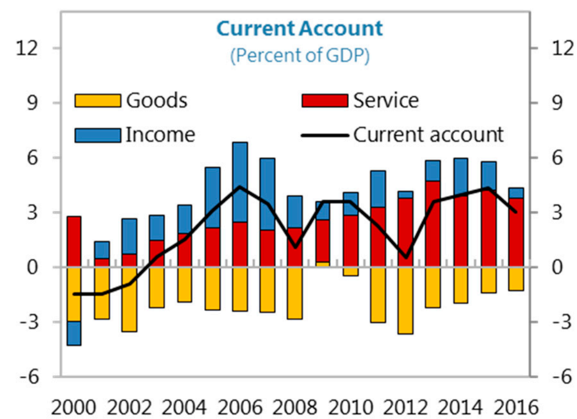


The exchange rate is broadly in line with the PPP.

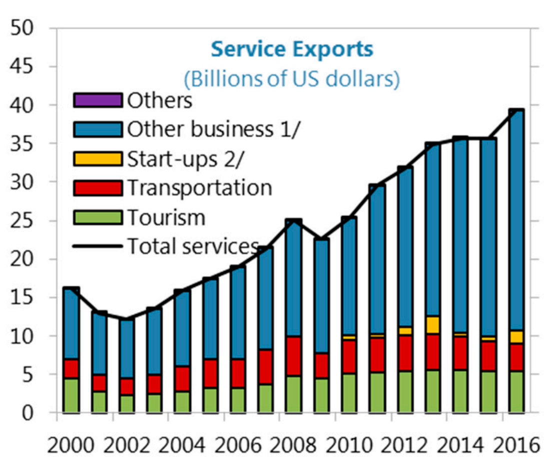


…hurting Israeli goods exports, but services have been robust.

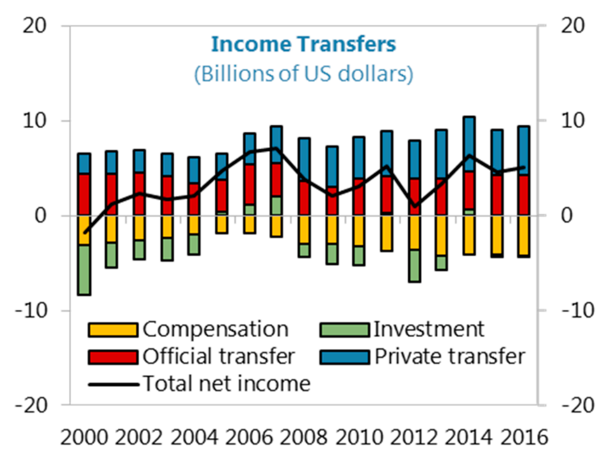
The CA balance remains surplus, led by services.



Service exports are led by other businesses.



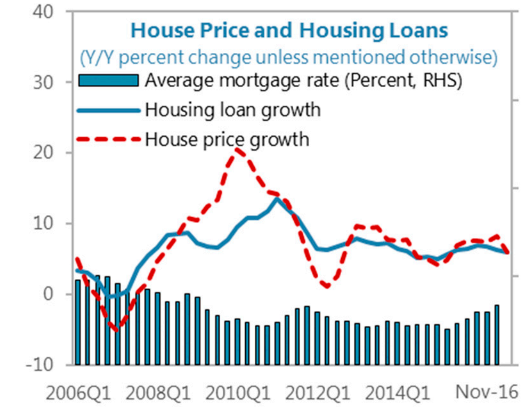
Official and private transvers make substantial contributions to the current account.



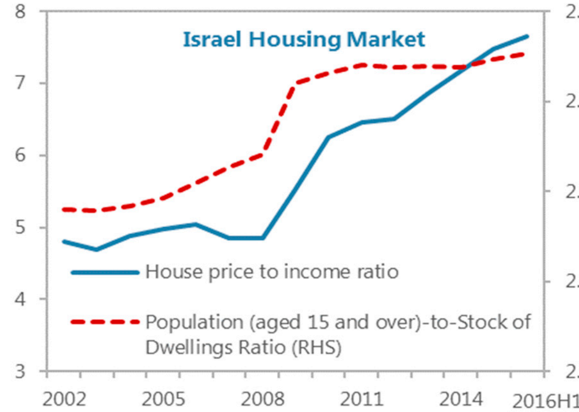
Sources: Bank of Israel; Central Bureau of Statistics; Haver Analytics; OECD; and IMF staff calculations.
1/ Includes medical services, communications, R&D, and IT services.
2/ Start-ups are included from 2010.

Figure 6. Israel: Housing Market Development

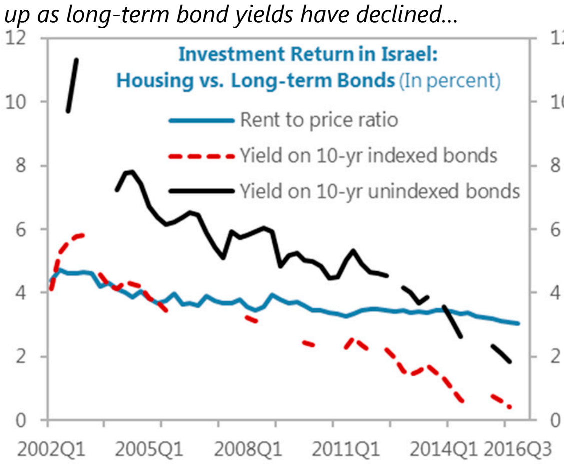
House prices and mortgage credit have been rising at 7-8 percent y/y in recent years, fueled by growing incomes and low interest rates.



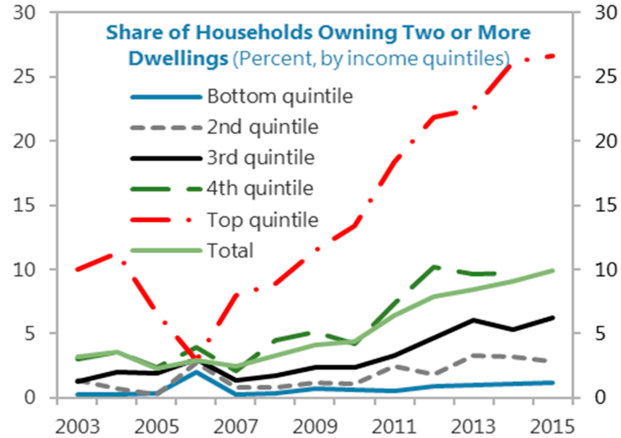
Housing supply has not kept pace with population growth, contributing to prices rising faster than incomes.



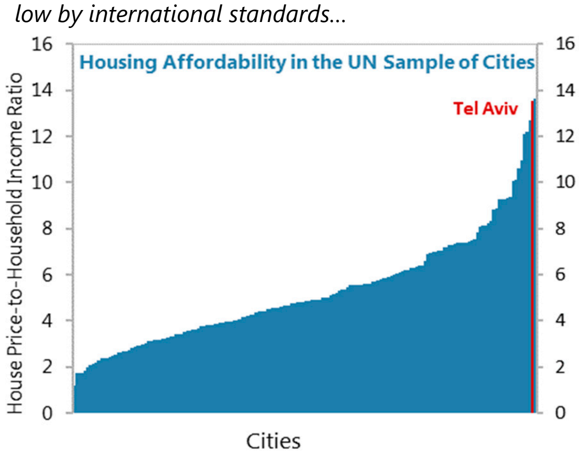
In addition, housing investment returns have held up as long-term bond yields have declined…



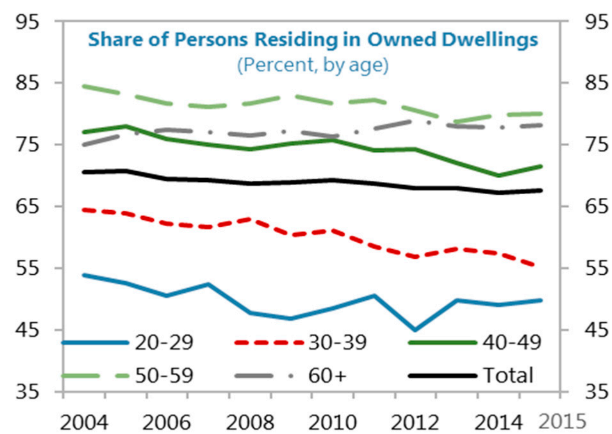
…sparking strong growth in purchases for investment purposes by high-income households.



High house prices have greatly reduced housing affordability since 2007, with affordability in Tel Aviv low by international standards…



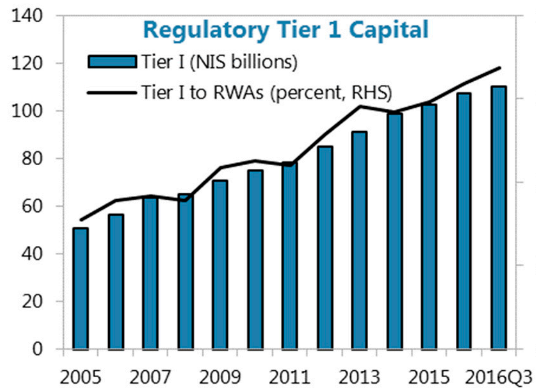
…pushing some households out of home ownership, particularly young families.



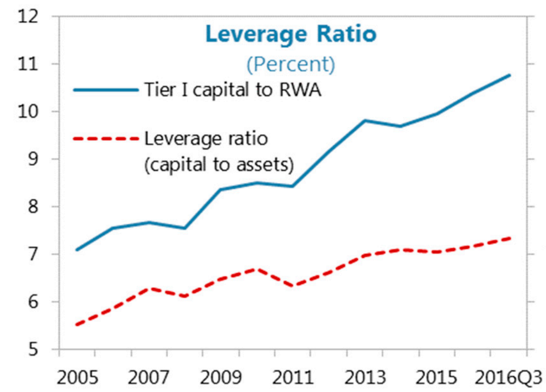
Sources: Central Bureau of Statistics; Haver Analytics; Land and Housing Survey in the UN Sample of Cities (2016); and IMF staff calculations.

Figure 7. Israel: Performance of the Israeli Banking System

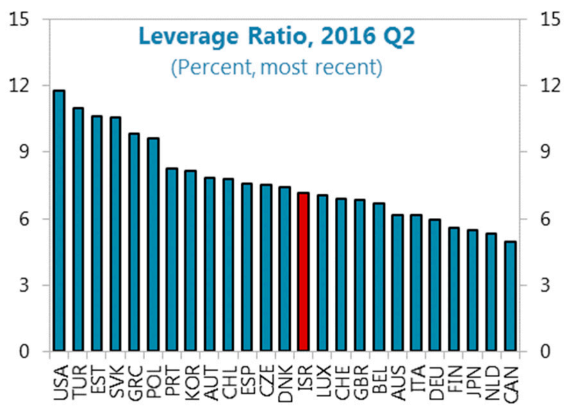
Banks capital has continued to rise...



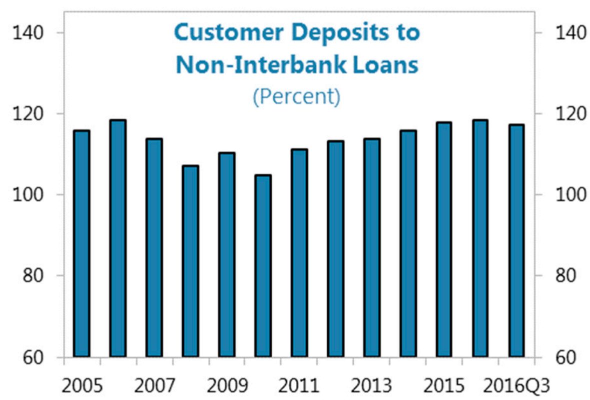
...along with the leverage ratio...



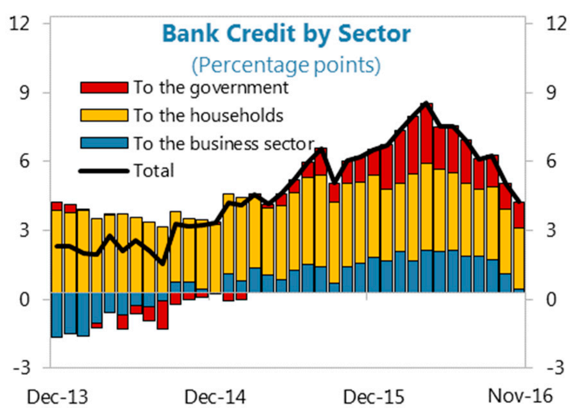
...which is now about the median of OECD countries.



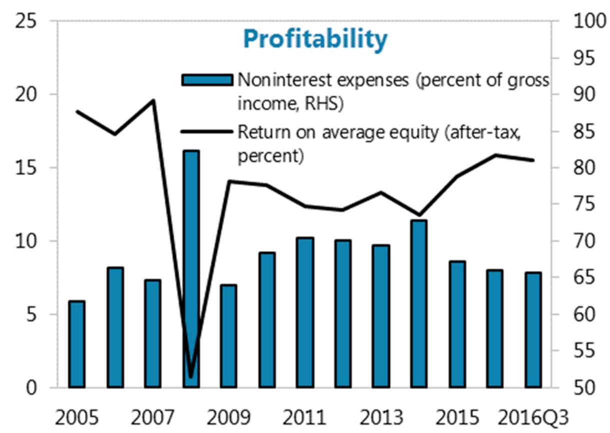
Lending operations have remained fully funded by deposits.



Bank credit has flowed largely to households.



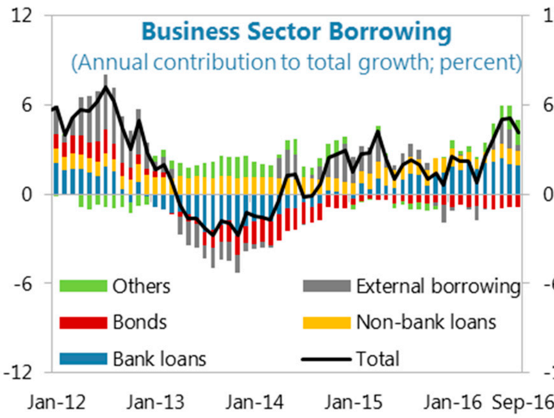
And profitability has risen as the efficiency has



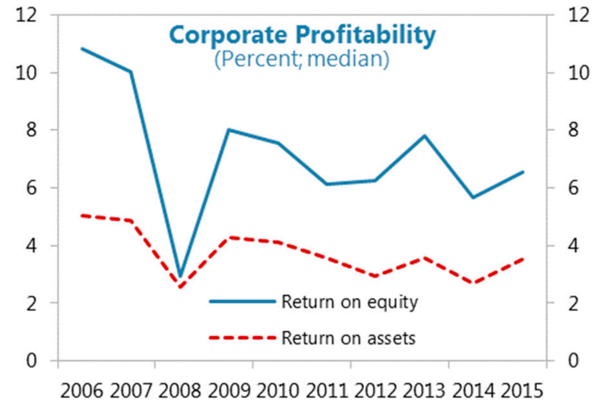
Sources: IMF's Financial Soundness Indicator Database; and Haver Analytics.

Figure 8. Israel: Corporate and Household Sector

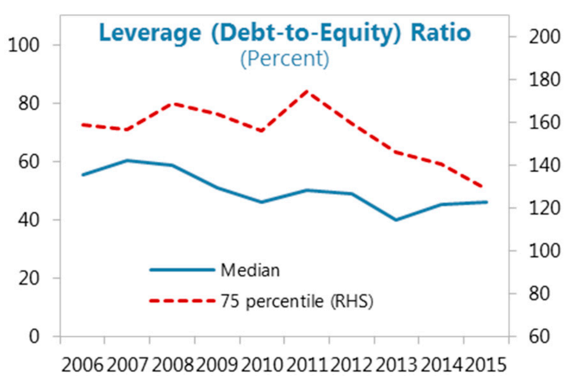
Business sector borrowing has picked up…



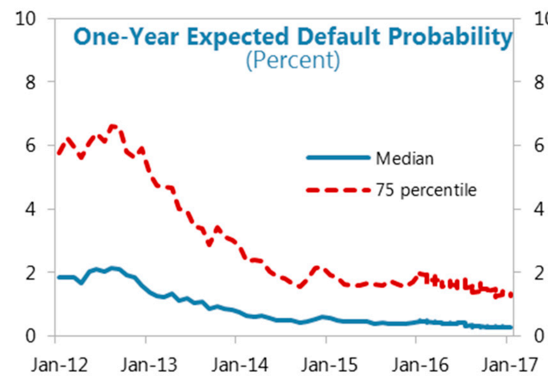
…with profitability trending down in recent years.



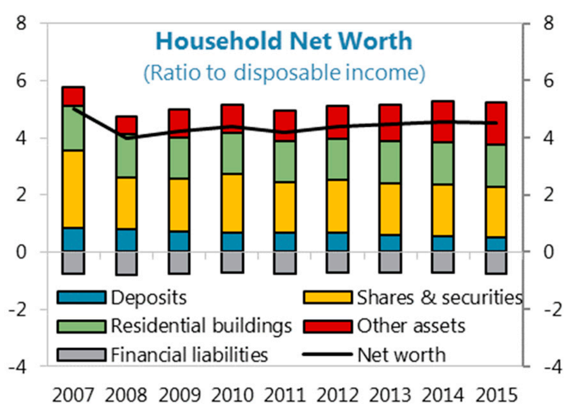
Corporate leverage ratios have declined further…



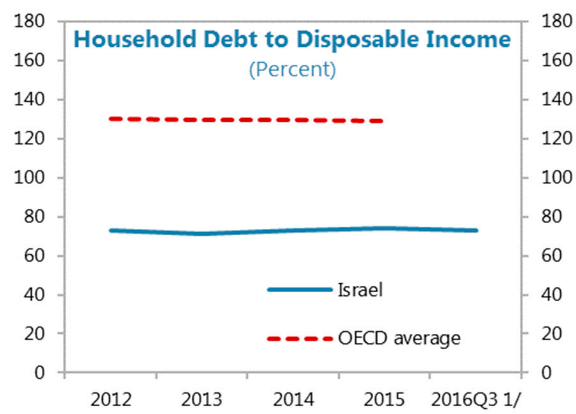
…as have market indicators for corporate default probability.



Meanwhile, household net worth position has remained around four times their disposable income…



…and household debt remains low.



Sources: Bank of Israel; Israel Central Bureau of Statistics; Haver Analytics; IMF CVU database; Moody's CreditEdge; and IMF staff calculations.

1/ The 2016 Q3 data is estimated with a change in household (excluding the self-employed) loans from domestic financial institutions between end-2015 and 2016Q3.

Table 1. Israel: Selected Economic Indicators, 2013–22

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Prel.	Projections					
Real Economy (percent change)										
Real GDP	4.4	3.2	2.5	4.0	2.9	3.0	3.0	3.0	3.0	3.0
Domestic demand	3.0	4.0	3.8	5.6	2.7	2.9	2.9	2.9	3.0	3.0
Private consumption	3.8	4.3	4.3	6.3	3.0	2.9	2.9	2.9	2.9	2.9
Public consumption	3.5	3.7	3.3	3.6	3.5	3.2	3.0	3.0	3.0	3.0
Gross fixed investment	4.5	0.0	0.1	11.0	-0.8	2.8	2.8	2.8	2.8	2.8
Stock changes (cont. to growth)	-0.9	0.7	0.6	-0.9	0.3	0.0	0.0	0.0	0.0	0.0
Net exports (contribution to growth)	1.4	-0.8	-1.3	-1.9	0.5	0.0	0.0	0.0	0.0	0.0
Potential GDP	3.7	3.6	3.2	3.6	3.0	3.0	3.0	3.0	3.0	3.0
Output gap (percent of potential)	0.7	0.3	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Unemployment rate (percent)	6.3	5.9	5.3	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Overall CPI (percent change, end of period)	1.8	-0.2	-1.0	-0.2	1.1	1.8	2.0	2.0	2.0	2.0
Overall CPI (percent change, average)	1.5	0.5	-0.6	-0.5	0.7	1.4	1.9	2.0	2.0	2.0
Saving and investment balance										
Gross national saving (percent of GDP)	23.5	24.1	24.3	23.9	23.1	23.0	22.9	22.8	22.8	22.8
Foreign saving (percent of GDP)	-3.5	-4.0	-4.3	-3.6	-3.4	-3.4	-3.3	-3.3	-3.2	-3.2
Gross capital formation (percent of GDP)	20.0	20.1	19.9	20.2	19.7	19.6	19.6	19.6	19.5	19.5
Public Finance (percent of GDP)										
Central government										
Revenues and grants	25.5	25.7	25.8	26.3	25.6	25.7	25.6	25.6	25.6	25.6
Total expenditure	28.8	28.4	27.9	28.4	28.3	28.4	28.4	28.4	28.4	28.4
Overall balance	-3.3	-2.7	-2.1	-2.1	-2.7	-2.7	-2.9	-2.9	-2.9	-2.9
Cyclically adjusted primary balance 1/	-1.1	-0.6	0.1	-0.2	-0.9	-1.0	-1.1	-1.0	-1.0	-1.0
General Government										
Overall balance	-4.2	-3.4	-2.7	-2.5	-3.3	-3.5	-3.7	-3.7	-3.7	-3.7
Debt	67.0	66.0	64.1	62.2	62.6	63.0	63.2	63.3	63.5	63.7
Of which: Foreign currency external debt	14.4	14.9	13.6	13.2	13.3	13.3	13.3	13.3	13.3	13.3
Balance of Payments (percent of GDP)										
Exports of goods and services 2/	33.4	32.2	30.7	30.1	31.0	31.3	31.4	31.5	31.5	31.4
Real growth rate (percent)	3.6	1.4	-4.3	3.9	3.5	4.0	4.0	3.8	3.5	3.5
Imports of goods and services 2/	31.1	30.4	27.7	27.6	28.2	28.5	28.4	28.4	28.4	28.4
Real growth rate (percent)	-0.3	3.8	-0.5	9.7	1.7	3.7	3.9	3.7	3.5	3.5
Goods and services balance	2.4	1.9	2.8	2.0	2.8	2.9	3.0	3.0	3.1	3.0
Oil imports (billions of U.S. dollars)	14.6	12.8	7.4	5.8	7.8	8.0	8.1	8.3	8.6	9.0
Current account balance	3.5	4.0	4.3	3.6	3.4	3.4	3.3	3.3	3.2	3.2
Foreign reserves (eop, US$ billions)	81.8	86.1	90.6	98.4	105.0	109.1	113.9	118.6	123.4	128.3
Exchange Rate										
NIS per U.S. dollar	3.6	3.6	3.9	3.8	...	...	...	...	...	...
Nominal effective exchange rate (2005=100)	104.1	106.4	108.0	111.6	...	...	...	...	...	...
Real effective exchange rate (2005=100)	103.0	104.5	106.6	108.6	...	...	...	...	...	...

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.

Table 2. Israel: Balance of Payments, 2013–22

(In billions of U.S. dollars; unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Projections					
Current account balance	10.3	12.2	13.0	11.6	11.7	11.8	12.2	12.6	12.9	13.3
Merchandise	-6.8	-6.1	-4.2	-7.9	-4.1	-4.1	-4.0	-3.9	-4.1	-4.4
Exports, f.o.b.	63.2	64.2	55.8	55.5	61.2	63.9	66.6	69.1	71.6	73.8
Imports, f.o.b.	70.0	70.3	60.0	63.4	65.3	68.0	70.5	73.1	75.7	78.3
Services	13.8	12.1	12.6	14.3	13.8	14.2	15.0	15.6	16.3	17.1
Exports	35.0	35.5	35.8	39.1	44.1	46.6	49.2	51.6	54.0	56.5
Imports	21.2	23.4	23.3	24.8	30.3	32.4	34.2	36.0	37.7	39.4
Primary income	-5.8	-3.5	-4.4	-4.3	-6.4	-6.6	-6.9	-7.2	-7.5	-7.8
Receipts	8.3	9.7	9.6	9.7	8.5	8.8	9.2	9.6	10.0	10.4
Payments	14.0	13.2	14.0	13.9	14.9	15.4	16.1	16.8	17.5	18.2
Secondary income	9.1	9.8	9.1	9.4	8.4	8.4	8.1	8.1	8.2	8.5
Receipts	11.6	12.3	11.6	12.2	11.1	11.4	11.3	11.5	11.5	11.8
Payments	2.5	2.5	2.5	2.8	2.7	3.0	3.1	3.4	3.3	3.3
Capital account	1.9	2.7	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Financial account 1/	5.2	8.6	6.7	-1.4	7.3	9.9	9.7	10.0	10.3	10.7
Direct investment, net	-6.9	-3.1	-1.6	0.2	-0.7	-0.3	-0.5	-0.4	-0.4	-0.4
Foreign direct investment abroad	5.5	3.7	9.9	12.5	11.2	11.8	11.5	11.7	11.6	11.6
Foreign direct investment in Israel	12.4	6.7	11.5	12.3	11.9	12.1	12.0	12.1	12.0	12.1
Portfolio investment, net	7.6	0.8	6.8	-1.4	2.7	0.5	1.8	1.3	1.7	1.6
Financial derivatives, net	-0.5	-0.4	-0.3	-0.6	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5
Other investment, net	5.0	11.3	1.8	0.3	5.8	10.2	8.9	9.6	9.5	9.9
Change in reserves	4.4	7.4	7.3	8.5	6.6	4.1	4.7	4.7	4.8	4.9
Errors and omissions	-2.7	1.0	-1.2	-6.7	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Current account balance (percent of GDP)	3.5	4.0	4.3	3.6	3.4	3.4	3.3	3.3	3.2	3.2
Terms of trade (percent change)	-1.2	-3.9	10.6	3.5	-3.9	0.0	0.3	0.1	-0.1	-0.2
Gross external debt (percent of GDP)	34.5	31.1	29.9	28.6	27.9	27.8	29.1	31.3	33.5	35.8
Foreign reserves										
US$ billion	81.8	86.1	90.6	98.4	105.0	109.1	113.9	118.6	123.4	128.3
Percent of GDP	27.9	27.9	30.3	30.9	30.9	30.9	30.9	30.9	30.9	30.9
Months of G&S imports	10.5	12.4	12.3	12.3	12.5	12.5	12.5	12.6	12.6	12.6
GDP (billions of U.S. dollars)	293.3	308.8	299.4	318.3	339.6	352.9	368.1	383.5	399.1	414.9

Sources: Central Bureau of Statistics; Haver Analytics; and IMF staff estimates and projections.
1/ Excludes reserve assets.

Table 3. Israel: International Investment Position, 2008–16

(In percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Net Investment	7.3	5.6	10.4	16.2	20.5	21.3	21.0	22.9	33.3
Direct investment	2.9	0.6	3.3	2.1	-2.1	-3.9	-4.4	-4.9	-3.3
Portfolio investment	-17.6	-22.1	-19.6	-10.5	-3.3	-1.5	-5.2	-5.8	2.3
Financial derivatives	0.0	0.0	-0.1	-0.1	-0.1	0.0	-0.1	-0.2	-0.2
Reserve assets	19.7	29.2	30.3	28.6	29.5	27.9	27.9	30.3	30.9
Other investment	2.4	-2.0	-3.6	-4.0	-3.4	-1.1	2.7	3.6	3.6
Total Assets	90.1	109.6	111.4	101.5	107.3	106.7	108.6	118.0	119.8
Direct investment	25.2	27.7	29.5	27.1	27.6	26.2	25.8	29.9	32.1
Portfolio investment	15.5	23.8	26.6	23.9	29.6	32.6	34.4	38.1	37.3
Reserve assets	19.7	29.2	30.3	28.6	29.5	27.9	27.9	30.3	30.9
Other assets	29.8	28.8	25.0	22.0	20.8	20.1	20.6	20.0	19.7
Total Liabilities	82.9	103.9	101.1	85.3	86.8	85.3	87.6	95.1	86.5
Direct investment	22.3	27.1	26.2	25.0	29.7	30.1	30.2	34.8	35.4
Portfolio investment	33.1	46.0	46.2	34.4	32.9	34.1	39.5	44.0	35.1
Other liabilities	27.5	30.8	28.7	26.0	24.2	21.2	17.9	16.4	16.0

Sources: Central Bureau of Statistics; and Haver Analytics.

Table 4. Israel: Summary of Central Government Operations, 2010–18 1/

(In percent of GDP; unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
							Prel.	Proj.	
Revenue and grants	25.5	25.7	24.9	25.5	25.7	25.8	26.3	25.6	25.7
On income and profits	10.7	11.0	10.8	11.3	11.3	11.6	11.7	11.8	11.9
VAT and customs	11.1	11.0	10.6	10.8	11.2	10.9	10.8	10.7	10.8
Fees	0.6	0.6	0.5	0.6	0.5	0.6	0.6	0.6	0.6
VAT on defense imports	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Interest	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Loans from NII	1.3	1.5	1.4	1.3	1.3	1.4	1.9	1.8	1.8
Grants 2/	1.0	0.9	0.9	0.8	0.8	0.7	0.9	0.0	0.0
Other	0.4	0.4	0.3	0.4	0.3	0.3	0.2	0.4	0.5
Expenditure 2/ 3/	29.0	28.6	28.9	28.8	28.4	27.9	28.4	28.3	28.4
Administrative Departments	4.0	3.9	4.0	4.1	4.1	4.0	4.0	4.1	4.1
Social Departments	11.2	11.2	11.4	11.3	11.2	11.3	12.0	12.5	12.5
Economic Departments	1.9	2.1	2.1	2.5	2.2	2.0	2.1	2.4	2.3
Defense Expenditure 2/	6.7	6.3	6.3	6.1	6.2	6.0	6.0	5.0	5.0
Other Expenditures	0.3	0.3	0.4	0.2	0.3	0.3	0.2	0.4	0.4
Reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3
Interest	4.0	3.9	3.8	3.6	3.5	3.3	2.5	2.5	2.5
Repayment of Principal to NII	0.9	0.9	0.9	0.9	1.0	1.0	1.5	1.5	1.4
Budget deficit	-3.5	-2.9	-4.1	-3.3	-2.7	-2.1	-2.1	-2.7	-2.7
Unsettled Payment Orders 4/	-1.1	-0.3	0.1	0.6	-0.5	0.3	-0.3	0.0	0.0
Financing	2.5	2.6	4.2	3.9	2.2	2.5	1.8	2.7	2.7
Foreign (net)	-0.1	0.0	-0.1	0.0	0.1	-0.5	0.2	0.5	0.5
Loans	1.4	0.6	1.2	1.2	1.1	0.4	1.0	1.0	1.0
Repayment	-1.5	-0.6	-1.3	-1.1	-1.0	-0.9	-0.7	-0.5	-0.4
Domestic (net)	2.0	1.9	4.3	3.7	2.0	2.7	1.4	2.2	2.1
Loans	7.9	9.2	11.4	10.1	8.6	6.1	6.7	8.3	7.7
Repayment	-6.0	-7.3	-7.1	-6.4	-6.6	-3.4	-5.3	-6.1	-5.6
Sale of assets (net)	0.6	0.7	0.1	0.1	0.1	0.3	0.2	0.1	0.1
Memorandum items:									
Primary spending	24.1	23.8	24.2	24.2	23.9	23.7	24.4	24.3	24.5
Primary balance (PB)	0.2	0.8	-0.4	0.2	0.7	1.0	0.3	-0.3	-0.3
Cyclically adjusted balance 5/	-4.1	-3.9	-5.0	-4.5	-3.6	-2.5	-2.5	-3.3	-3.5
Cyclically adjusted PB 5/	-0.3	-0.2	-1.3	-1.1	-0.6	0.1	-0.2	-0.9	-1.0
Deficit limit 3/	...	3.0	2.0	4.0	2.8	2.9	2.9	2.9	2.9
Real expenditure growth (in percent)	0.3	2.1	5.6	4.4	2.5	4.2	7.4	2.8	3.3
Public debt to GDP	70.7	68.8	68.3	67.0	66.0	64.1	62.2	62.6	63.0
Nominal GDP (in billions of NIS)	874	935	993	1,059	1,105	1,164	1,222	1,268	1,323

Sources: Israeli Ministry of Finance; and IMF staff estimates and projections.

1/ Data as per the MOF definition, on a cash basis, covering the budgetary sector and the National Insurance Institute.

2/ Starting from 2017, grants provded by the United States and associated spending are excluded from the MOF's budget presentation.

3/ Excludes state land sales.

4/ Registered spending but for which the equivalent cash has not yet been disbursed, hence it does not appear in financing.

5/ In percent of potential GDP.

Table 5. Israel: General Government Operations, 2010–18

(In percent of GDP; unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
							Est.	Proj.	
	(In billions of NIS, unless otherwise specified)								
Revenue	323.0	346.1	358.7	386.4	405.4	430.0	459.0	475.5	497.3
Taxes	220.1	237.6	244.7	268.7	284.0	301.3	324.0	333.5	350.5
Taxes on income, profits, and capital gains	80.7	89.3	92.8	104.4	108.3	117.6	125.9	130.1	136.7
Taxes on goods and services	107.6	114.6	117.0	128.2	137.4	143.0	154.4	159.5	167.6
Taxes on international trade and transactions	2.7	2.9	2.5	2.3	2.8	2.9	3.1	1.9	2.0
Taxes n.e.c.	29.0	30.8	32.3	33.8	35.4	37.9	40.6	41.9	44.1
Social contributions	53.3	57.0	58.8	62.1	64.6	68.4	71.8	74.5	77.7
Grants	10.4	10.6	11.9	10.9	11.1	12.9	13.4	13.9	13.2
Other revenue	39.3	40.9	43.4	44.6	45.6	47.4	49.8	53.6	55.9
Of which: Interest income	6.3	6.1	6.0	5.8	7.8	9.2	9.7	10.4	10.8
Expenditure	358.6	378.0	408.4	430.7	443.4	461.1	489.8	517.6	544.1
Expense	357.7	376.3	405.6	426.9	440.2	457.6	484.8	512.4	538.8
Compensation of employees	87.0	92.3	99.1	105.4	109.4	114.3	121.1	126.7	133.2
Purchases/use of goods and services	86.5	92.1	99.1	104.6	109.7	102.4	108.5	114.7	119.2
Interest expense	39.3	40.3	42.9	40.9	40.4	39.4	38.1	40.9	44.1
Social benefits	96.3	101.9	109.2	114.7	119.3	135.8	143.9	152.1	159.9
Expense n.e.c.	48.6	49.8	55.4	61.3	61.4	65.6	73.2	78.0	82.3
Net acquisition of nonfinancial assets	0.9	1.7	2.8	3.9	3.2	3.5	5.0	5.2	5.4
Net lending/borrowing	-35.7	-31.9	-49.7	-44.3	-38.0	-31.1	-30.8	-42.1	-46.8
Net acquisition of financial assets	-19.0	-14.1	-8.6	-4.4	-15.2	-5.6	-10.8	-8.5	-11.8
Net incurrence of liabilities	16.6	17.8	41.1	39.9	22.8	25.5	20.0	33.6	35.1
	(In percent of GDP)								
Revenue	37.0	37.0	36.1	36.5	36.7	37.0	37.5	37.5	37.6
Taxes	25.2	25.4	24.6	25.4	25.7	25.9	26.5	26.3	26.5
Taxes on income, profits, and capital gains	9.2	9.5	9.3	9.9	9.8	10.1	10.3	10.3	10.3
Taxes on goods and services	12.3	12.3	11.8	12.1	12.4	12.3	12.6	12.6	12.7
Taxes on international trade and transactions	0.3	0.3	0.3	0.2	0.3	0.2	0.3	0.2	0.2
Taxes n.e.c.	3.3	3.3	3.2	3.2	3.2	3.3	3.3	3.3	3.3
Social contributions	6.1	6.1	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Grants	1.2	1.1	1.2	1.0	1.0	1.1	1.1	1.1	1.0
Other revenue	4.5	4.4	4.4	4.2	4.1	4.1	4.1	4.2	4.2
Of which: Interest income	0.7	0.7	0.6	0.5	0.7	0.8	0.8	0.8	0.8
Expenditure	41.0	40.4	41.1	40.7	40.1	39.6	40.1	40.8	41.1
Expense	40.9	40.2	40.8	40.3	39.8	39.3	39.7	40.4	40.7
Compensation of employees	10.0	9.9	10.0	9.9	9.9	9.8	9.9	10.0	10.1
Purchases/use of goods and services	9.9	9.8	10.0	9.9	9.9	8.8	8.9	9.0	9.0
Interest expense	4.5	4.3	4.3	3.9	3.7	3.4	3.1	3.2	3.3
Social benefits	11.0	10.9	11.0	10.8	10.8	11.7	11.8	12.0	12.1
Expense n.e.c.	5.6	5.3	5.6	5.8	5.6	5.6	6.0	6.2	6.2
Net acquisition of nonfinancial assets	0.1	0.2	0.3	0.4	0.3	0.3	0.4	0.4	0.4
Net lending/borrowing	-4.1	-3.4	-5.0	-4.2	-3.4	-2.7	-2.5	-3.3	-3.5
Net acquisition of financial assets	-2.2	-1.5	-0.9	-0.4	-1.4	-0.5	-0.9	-0.7	-0.9
Net incurrence of liabilities	1.9	1.9	4.1	3.8	2.1	2.2	1.6	2.7	2.7

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

Table 6. Israel: Financial System Structure, 2008–15

	2008			2013			2015		
	Number of	Total assets		Number of	Total assets		Number of	Total assets	
	Institutions /funds	NIS billions	Percent of GDP	Institutions /funds	NIS billions	Percent of GDP	Institutions /funds	NIS billions	Percent of GDP
A. Banks									
Five major banks, consolidated	**5**	**1,013**	**130.7**	**5**	**1,246**	**117.6**	**5**	**1,388**	**119.3**
Bank Leumi	1	311	40.1	1	374	35.3	1	416	35.8
Bank Hapoalim	1	307	39.6	1	380	35.9	1	432	37.1
Israel Discount Bank	1	182	23.5	1	201	18.9	1	205	17.6
Mizrahi Tefahot Bank	1	114	14.7	1	180	17.0	1	209	18.0
First International Bank of Israel	1	99	12.8	1	111	10.5	1	125	10.8
Other Israeli banks	**3**	**49**	**6.3**	**3**	**62**	**5.8**	**3**	**64**	**5.5**
Foreign bank branches	…	…	…	**4**	**16**	**1.5**		**17**	**1.5**
B. Non-bank financial institutions 1/		**765**	**98.8**		**1,390**	**131.3**		**1,586**	**136.3**
Provident and severance pay funds	87	145	18.8	75	204	19.3	75.0	212	18.2
Advanced study funds	…	73	9.4	…	143	13.5	…	169	14.6
Old pension funds	18	237	30.6	18	348	32.8	18.0	394	33.9
New pension funds	13	71	9.2	13	186	17.5	11.0	251	21.5
New general pension funds	…	1	0.1	…	2	0.2	…	4	0.3
New comprehensive pension funds	…	70	9.1	…	183	17.3	…	247	21.2
Mutual funds	1,185	98	12.7	1,247	231	21.8	1,392	229	19.7
Assured yield life insurance plans	…	55	7.1	…	78	7.3	…	83	7.1
Profit sharing life insurance plans	…	86	11.1	…	202	19.0	…	248	21.3
Total financial system (A+B)	…	**1,778**	**229.5**	…	**2,636**	**248.9**	…	**2,975**	**255.6**
Memorandum items:									
GDP (NIS billions)	…	…	774.8	…	…	1,059.1	…	…	1,163.8

Sources: Bank of Israel; Ministry of Finance; Capital Market, Insurance, and Saving Authority; and Israel Securities Authority.
1/ The number of funds include management companies.

Table 7. Israel: Financial Soundness Indicators, Banks, 2010–16:Q3

(End-period, in percentage points)

	2010	2011	2012	2013	2014	2015	2016 Q3
Capital Adequacy							
Regulatory capital to risk-weighted assets 1/	14.1	14.0	14.9	14.8	14.3	14.0	14.6
Regulatory Tier I capital to risk-weighted assets 1/	8.5	8.4	9.2	9.8	9.7	9.9	10.7
Capital as percent of assets (leverage ratio)	6.7	6.3	6.6	7.0	7.1	7.1	7.3
Asset quality and exposure							
Nonperforming loans to total gross loans	…	3.4	3.5	2.9	2.2	1.8	1.6
Nonperforming loans net of loan-loss provisions to capital	…	12.3	12.3	8.9	4.6	3.4	2.5
Sectoral distribution of bank credit (percent) 2/							
Industry	10.5	9.6	8.9	8.5	8.0	7.1	…
Construction and real estate	16.7	16.6	16.4	16.2	16.1	16.4	…
Commerce	7.5	6.4	6.5	6.7	7.4	7.2	…
Finance services	11.7	8.0	7.5	7.4	7.1	6.3	…
Households	38.3	35.2	36.7	38.5	38.9	40.5	…
Of which: mortgages	24.2	17.7	19.0	20.4	20.8	22.0	…
Borrowers with activity abroad	…	13.0	12.6	11.7	11.9	11.8	…
Others	15.2	11.3	11.4	11.1	10.7	10.7	…
Large exposures as percent of regulatory capital	397.2	395.0	364.8	357.9	345.5	349.9	…
Earnings and profitability							
Return on average assets (before tax)	0.9	1.2	0.8	0.9	0.8	1.0	1.1
Return on average equity (before tax)	13.8	12.3	12.1	13.3	11.8	14.4	15.5
Interest margins to gross income	63.5	65.2	60.7	59.1	58.4	56.5	58.6
Trading and fee income to gross income	8.0	7.1	6.4	6.2	6.8	6.2	0.0
Noninterest expenses to gross income	68.4	70.3	70.0	69.3	72.7	67.1	65.7
Personnel expenses to noninterest expenses	57.3	59.0	58.6	59.6	58.8	59.0	58.4
Liquidity							
Liquid assets as percent of total assets	…	…	…	14.2	15.7	15.1	…
Liquid assets as percent of short-term liabilities	…	…	…	25.7	27.7	26.5	…
Customer deposits as a percent of total (non-interbank) loans	104.7	111.3	113.0	113.9	115.8	117.8	117.3
Foreign exchange risk							
Net foreign exchange open position to capital	-43.7	-44.6	-43.7	-55.7	-55.2	-61.1	-59.4
Foreign currency-denominated loans as percent of total loans	16.2	16.6	14.9	13.1	13.2	12.4	12.9
Foreign currency-denominated liabilities as percent of total liabilities	29.6	29.7	27.7	26.8	29.2	26.9	25.6

Sources: Bank of Israel; and IMF Financial Soundness Indicators Database.

1/ The calculation of capital base follows rules under Basel II.

2/ The 2010 data do not include off-balance sheet data and "borrowers with activity abroad" are not classified separately. From 2011 onward, data include off-balance sheet data.

Table 8. Israel: Financial Soundness Indicators, Non-Banks, 2008–15

(End-period, in percentage points unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015
Insurance sector								
Return on equity	-19.0	35.9	19.3	-0.5	14.4	18.3	11.9	6.8
Net premiums as percent of capital	302.6	204.1	192.5	224.5	213.2	201.3	194.3	205.7
Capital as percent of technical reserves	6.0	7.3	7.4	6.4	6.4	6.5	6.6	6.3
Surplus capital as percent of required solvency 1 capital	1.5	25.5	28.8	16.6	32.7	40.4	44.8	53.1
Liquid assets as percent of total assets	41.4	49.5	52.4	51.2	51.9	53.4	53.9	53.8
Households								
Household assets as percent of disposable income	475.1	497.1	518.3	497.3	517.0	516.5	522.8	520.3
Of which: residential buildings	153.5	143.0	143.2	143.5	147.0	145.2	144.9	144.1
Household financial liabilities as percent of disposable income	78.9	75.4	74.2	75.9	72.7	71.1	72.8	73.8
Corporate sector								
Non-financial sector borrowing to GDP ratio	84.5	85.5	82.6	79.7	77.1	74.4	75.3	75.1
From residents	67.4	68.8	67.2	63.8	61.8	60.4	60.6	61.5
From non residents	17.1	16.7	15.5	15.9	15.3	14.0	14.6	13.6
Debt to equity ratio								
All nonfinancial corporate	2.6	2.2	2.2	2.3	2.2	2.0	1.9	1.7
Of which: Manufacturing sector	1.3	1.1	1.1	1.5	1.4	1.2	1.2	1.1
Construction corporate	4.1	3.8	3.0	2.9	2.4	2.3	2.1	2.0
Net income to equity ratio								
All nonfinancial corporate	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Of which: Manufacturing sector	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Construction corporate	-0.2	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Earning before interest and tax to equity ratio								
All nonfinancial corporate	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.1
Of which: Manufacturing sector	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1
Construction corporate	0.0	0.1	0.2	0.2	0.2	0.2	0.1	0.2
Equity markets								
Tel Aviv Stock Exchange Index 75 (annual percent change)	-67.5	149.8	15.7	-25.9	4.8	24.7	-9.8	-5.4
Equity prices of financial institutions (annual percent change)	-55.7	126.9	9.3	-34.0	23.1	18.8	-7.7	4.0
Equity prices of real estate firms (annual percent change)	-80.0	125.2	15.4	-23.2	14.1	26.0	0.9	1.1
Equity prices of banks (annual percent change)	-55.5	114.0	6.8	-34.6	22.9	16.3	-5.6	7.3
Market capitalization in percent of GDP	52.4	87.7	92.2	64.2	60.8	66.6	70.6	81.7
Corporate bond markets								
Corporate bond yields over government bond yields (in percentage points)								
Real estate and construction	20.0	9.7	4.8	8.1	5.7	3.1	3.8	3.7
Manufacturing	7.5	3.6	3.1	4.8	4.2	4.9	4.4	3.8
Corporate bond outstanding (in billions of NIS)	185.6	217.3	240.1	238.7	260.8	271.4	263.7	251.6
Average daily turnover (in billons of NIS)	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.1
Real estate markets (prices; annual percent change)								
Average prices of owner occupied dwelling	6.5	22.4	17.0	0.0	5.8	7.4	7.2	6.0
Jerusalem	13.3	15.5	14.7	8.6	0.6	2.0	7.6	4.3
Tel Aviv	10.7	34.1	16.9	-4.8	-9.2	36.1	7.4	4.9
Memorandum items								
GDP (year on year percent change, constant prices)	3.0	1.4	5.7	5.1	2.4	4.4	3.2	2.5
Nominal GDP (in billions of NIS)	775	815	874	935	993	1,059	1,105	1,164
Total financial sector assets (in billions of NIS)	1,778	2,002	2,137	2,258	2,440	2,636	2,892	2,975
Of which: Five major banks (in percent of total financial assets)	57.0	52.1	50.0	52.1	50.0	47.3	45.9	46.7
Total financial sector assets (in percent of GDP)	229.5	245.6	244.5	241.4	245.6	248.9	261.7	255.6
of which: Five major banks (in percent of GDP)	130.7	127.8	122.3	125.8	122.9	117.6	120.1	119.3

Sources: Bank of Israel; and IMF staff estimates.

Table 9. Israel: Credit by Financial Sector and Nonresidents, 2008–16

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Financial Sector Credit									
Banks	88.4	84.1	84.7	85.3	82.5	78.9	77.9	78.6	77.6
Of which to:									
Business sector	49.1	43.5	43.0	42.2	39.3	35.4	33.9	33.3	31.9
Households	30.4	32.0	33.6	34.4	34.7	35.3	36.1	36.9	37.0
Government	8.8	8.5	8.1	8.7	8.4	8.2	8.0	8.4	8.8
Institutional investors	50.8	51.8	51.0	49.3	52.4	52.8	52.9	53.0	53.2
Of which to:									
Business sector	13.0	14.1	13.5	13.0	13.7	13.4	12.9	12.6	12.7
Households	0.6	0.6	0.6	0.6	0.7	0.7	0.8	1.0	1.4
Government	37.3	37.1	36.9	35.7	38.0	38.8	39.3	39.5	39.2
Credit card companies	0.8	0.9	1.1	1.1	1.1	1.1	1.2	1.3	1.5
Of which to:									
Business sector	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Households	0.6	0.8	0.9	0.9	0.9	0.9	1.0	1.2	1.3
Total financial sector credit	140.0	136.8	136.7	135.6	136.0	132.8	132.1	132.9	132.4
Nonresidents Credit to:									
Business sector	18.2	18.3	17.0	17.4	16.9	15.6	16.2	15.2	14.7
Households	-	-	-	-	-	-	-	-	-
Government	13.7	13.3	11.4	12.7	11.3	9.3	9.8	8.9	8.4
Total nonresidents credit	31.9	31.6	28.4	30.1	28.2	24.9	26.0	24.2	23.1
Government Credit to:									
Business sector	0.3	0.1	0.3	0.2	0.2	0.1	0.0	0.0	0.0
Households	5.6	4.9	4.0	3.3	2.8	2.4	2.0	1.4	1.2
Total government credit	5.9	5.1	4.2	3.5	3.0	2.5	2.1	1.5	1.2
Households and Nonfinancial Corporations Credit to:									
Business sector	3.0	8.0	9.3	7.7	7.9	8.7	8.2	8.2	9.1
Government	15.8	19.9	18.7	15.7	16.1	15.8	15.5	14.1	11.5
Total HH and NFC credit	18.8	27.9	28.0	23.3	24.1	24.5	23.7	22.3	20.6
Total Credit	196.6	201.3	197.4	192.6	191.3	184.7	183.8	180.9	177.3

Source: Haver Analytics.

Table 10. Israel: Business and Household Sector Borrowing 2008–16

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Total business sector borrowing	93.2	87.2	84.3	83.4	79.8	73.7	71.7	69.9	68.6
Bank loans	49.8	44.3	43.6	42.4	39.2	35.4	33.8	33.3	32.1
Institutional investor loans	1.4	1.7	2.0	2.6	3.4	4.0	4.4	5.0	5.4
Bonds	18.1	13.9	12.1	12.0	11.7	9.8	9.1	8.0	7.4
External borrowing	18.2	18.3	17.0	17.4	16.9	15.6	16.2	15.2	14.7
Others	5.7	9.0	9.6	8.9	8.6	8.9	8.3	8.3	9.0
Total household sector borrowing	37.7	38.8	39.5	39.6	39.5	39.7	40.3	40.8	41.2
Mortgage	24.5	25.1	26.2	26.6	26.8	27.0	27.2	27.5	27.5
Others	13.2	13.7	13.3	13.0	12.7	12.7	13.1	13.3	13.7

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

Annex I. Status of Key Recommendations from 2015 Article IV Consultation and Technical Assistance on Enhancing Medium-Term Fiscal Management

Recommendations	Status
Reduce fiscal deficits to put debt on a firmly downward path and build fiscal space.	Central government deficits for 2015 and 2016 came in below the budget targets, but deficit targets for 2017 and 2018 have been revised up. Debt is not projected to decline in the medium term.
Establish a stronger medium-term fiscal framework, with an explicit revenue and expenditure plan consistent with the deficit target.	The government has (i) started publishing a medium-term fiscal framework—although with gaps that need to be closed to meet the deficit targets—since the 2015–16 budget; (ii) introduced a mechanism to strengthen transparency and ability to control future commitments; (iii) for the Defense Ministry, agreed on a medium-term budget framework and specified conditions to deviate from it; and (iv) established a Spending Review Committee, which published the procedure for a spending review in 2017. However, the recommendation to clearly define the criteria for revisions to the deficit targets—in order to promote adherence to the targets—was not implemented.
Monetary policy can be put on hold.	The BOI has maintained the policy rate since February 2015.
Boost the supply of housing by accelerating zoning and planning procedures, and enhancing local authority resources to cover costs of infrastructure and services.	The government has moved the Land Authority and the Planning Commission under the MoF, but it is not yet clear if procedures have been accelerated. There has been no change in the local property tax framework to incentivize local governments to facilitate more residential development.
Macroprudential measures should continue to be used to contain household leverage.	Macroprudential measures are unchanged since September 2014, with BOI analysis indicating that the share of high risk loans remains low and stable.
Establish a Financial Stability Committee (FSC) to coordinate macroprudential oversight. Strengthen the BOI's toolkit for early intervention and resolution.	A governmental decision has been made to establish a Financial Stability Committee with a clear focus on macroprudential policies in normal times and with the BOI in the lead. The required legislative changes are yet to be concluded. Legislation to establish emergency liquidity assistance for banks and nonbanks, including eligibility requirements and collateral policies, is currently being drafted.
Raise productivity by boosting competition, and improving infrastructure and education.	The government has been implementing various product and labor market reforms. For example, (i) effective September 2016, import barriers for pasta, breakfast cereals, cookies, crackers, rice, and beans were lowered to allow independent traders to enter; (ii) the Poultry Council Law and Antitrust Law have been amended to eliminate the cartel in the poultry sector; and (iii) a decision was made to establish a Consolidated Electricity Authority aiming to improve the competition in the electricity market.
Reduce poverty by addressing structural problems hindering inclusion of Haredi and Israeli-Arab populations	The 2017–18 budget aims to improve the quality of Israeli-Arab education and build roads to minority communities. Yet, legislation requiring Haredi schools to teach a core curriculum (of English, mathematics, and science) was repealed.

Annex II. Risk Assessment Matrix (as of March 3, 2017) 1/

Source of Risk and Relative Likelihood	Impact if Realized
External risks	
Medium/High Weaker-than-expected global growth, including lower medium-term growth in key advanced and emerging economies	**Medium** Weaker global growth would hurt the ongoing recovery of exports, and hence lead to lower output. A rise in inflation would likely be delayed.
Policy response:	The BOI could signal that monetary policy would remain accommodative for a longer period and lean against excessive shekel volatility. Fiscal policy can allow automatic stabilizers to operate fully, but if prolonged there would be a need to moderate the growth in spending over the medium term.
Medium/High Tighter and more volatile global financial conditions	**Low/Medium** Investor flight to safety would impact Israel's risk premia, although to a modest extent given relatively moderate public debt, the low reliance of the banks on wholesale funding, and comfortable foreign reserves. If it relieved appreciation pressures on the shekel this would be supportive for exports.
Policy response:	Protect confidence in Israel through sound fiscal policy and financial sector supervision. FX intervention could be used if needed to smooth excessive exchange rate volatility.
High Heightened regional security/geopolitical tensions	**Medium/High** Regional tensions would hit tourism receipts—equivalent to about 5 percent of exports in 2015—and more adverse developments could damage business confidence and investment. Likely depreciation would help cushion the overall impact on the economy.
Policy response:	Fiscal policy should allow automatic stabilizers to operate fully, and in case of a more severe shock, proactive measures could be used to contain the rise in unemployment and protect those on low incomes.
Domestic risks	
Medium A significant reversal in housing prices	**Medium/High** Impacts on household debt service payments are likely to be contained by macroprudential policies, while bank losses are moderated by full recourse and relatively low LTV ratios. However, domestic demand growth could fall significantly, especially construction activity, potentially having adverse effects on corporate loan quality.
Policy response:	Contain vulnerabilities by maintaining the current macroprudential policies and tighten these through targeted measures if needed to protect the financial resilience of households. If house prices fall sharply, ease monetary policy as feasible, allow automatic fiscal stabilizers to operate, and ensure weak credit supply does not aggravate the adjustment, including by adjusting macroprudential policies if needed.

[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihoods of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff's views on the sources of risk and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex III. Fiscal Implications of the "Buyer's Price" Program

Since 2015, the Israeli government has been implementing several measures that aim to contain housing prices. Many of the measures have fiscal implications:

- Temporarily raising transaction taxes for investors by eliminating the two low rates for investors (2015–2021)—implying additional revenue of NIS 0.3–0.4 billion per year.
- Introduction of a new recurrent property tax on owners of three or more residential dwellings—generating additional revenue of NIS 0.9 billion per year.[1]
- Introduction of a "Buyer's Price" program (2015–18)—with a total fiscal cost of NIS 7 billion.
- Relocation of the military bases from the Tel Aviv region to free up land for constructing about 60,000 housing units—total fiscal cost of NIS 5.3 billion for 2015–2027.
- Provision of "blanket agreements" with local authorities to cover expenses associated with residential construction projects.

The "Buyer's Price" program, which is a temporary measure for 2015–18, aims to lower the cost of purchasing a home for eligible people winning a lottery.[2]

- The program focuses on high-density construction, mainly outside areas of high demand. No Buyer's Price tenders will be conducted in areas where home prices exceed a certain amount, therefore the program is expected to have minimal impact on housing prices in Tel Aviv or Jerusalem.
- The eligible population includes all couples that do not own a home and all unmarried individuals over the age of 35, with no further conditions. Since the number of dwellings made available through the program will be less than that of eligible individuals, the dwellings will be allocated by lottery, and winners will choose an apartment according to their order in the lottery draw: the first winner will choose an apartment first, the second winner will choose an apartment second, and so forth. The program distinguishes between eligible buyers and local eligible buyers and allocates dwellings to these two groups separately.

The Buyer's Price program is designed to lower housing costs through three channels. The channels are: (i) privatizing state-owned land at discounted prices, (ii) providing grants to purchasers, and (iii) providing subsidy for development costs (Table 1).[3] The discount on the price of land sold by the Land Authority is up to NIS 120,000 per housing unit. However, because land prices

---

[1] The tax is set at 1 percent of the value of assets, up to a ceiling of NIS 1500 per month.

[2] This program was chosen among other programs, such as a zero-VAT for purchases of new apartments. Notably, the Buyer's Price tenders themselves are not a new concept: they were instituted in a 1994 government decision. However, the eligibility criteria are different between the old and new programs: the eligibility for the old program is tighter, based on criteria, such as personal status, number of years of marriage, and number of children, whereas that for the new program allows all couples that do not own a home and individuals of 35 years and older.

[3] Under the Government Finance Statistics Manual 2014, sales of state-owned lands should be recorded as a negative entry to "net acquisition of nonfinancial assets," which is part of expenditure (above the line). However, the Israeli government records such sales as "privatization proceeds," which is part of financing in the budget presentation (below the line). Starting from the 2015 outturns, the government started reporting land sales as part of an above-the-line expenditure to the Government Finance Statistics.

in the peripheral areas may be below NIS 120,000 per housing unit, the program additionally offers a grant to buyers and a subsidy for the developer, resulting in a total fiscal cost of about NIS 120,000 per unit in total.[4]

Table 1. Israel: Parameters of "Buyers' Price" Tenders

Price of land per unit before development cost (NIS)	Discount on the price of land	Grant to purchasers (NIS)	Subsidy to development costs (NIS)
Up to 50,000	80%	60,000	40,000
50,000–100,000	80%	40,000	40,000
100,000–150,000	80%	0	0
Above 150,000	NIS 120,000	0	0

The estimated fiscal cost—off budget—of the program peaks at 0.2 percent of GDP annually in 2017–18. The authorities expect about 15,000 annual transactions of housing would go through the program with a fiscal cost of NIS 2.5 billion (0.2 percent of GDP) per year in 2017–18 and NIS 7 billion in total (Table 2). Because the Land Authority is not a budgetary entity, both proceeds from land sales and its expenditure are excluded from budget, although remain included in the general government presentation on a *Government Finance Statistics* basis.

Table 2. Israel: Estimated Fiscal Cost of "Buyers' Price" Tenders
(Millions of NIS, unless otherwise indicated)

	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**Total** 1/
Grant and subsidy	0	60	658	664	377	50	1,809
In percent of GDP	*(0.0)*	*(0.0)*	*(0.1)*	*(0.1)*	*(0.0)*	*(0.0)*	*(0.1)*
Foregone income	341	1,300	1,800	1,800	0	0	5,241
In percent of GDP	*(0.0)*	*(0.1)*	*(0.1)*	*(0.1)*	*(0.0)*	*(0.0)*	*(0.4)*
Total	**341**	**1,360**	**2,458**	**2,464**	**377**	**50**	**7,050**
In percent of GDP	***(0.0)***	***(0.1)***	***(0.2)***	***(0.2)***	***(0.0)***	***(0.0)***	***(0.6)***

1/ In percent of the 2016 GDP.

[4] To receive the grant, a buyer must hold the apartment for a least five years from the occupancy date, although the buyer is allowed to rent it out.

Annex IV. Macroprudential Policy Measures For Housing Markets

Type of Measure	Target and Nature of Measure
Capital surcharges	• **Group loans:** 100 percent capital surcharge on groups of borrowers who buy newly-built residential properties collectively, and/or who engage with third parties to construct and develop residential projects (March 2010). • **Debt-service-to-income (DSTI)**: Capital surcharge on mortgages with DSTI ratios between 40–50 percent (August 2013). • **Mortgage lending:** Banks must increase Common Equity by 1 percent of the outstanding mortgage lending gradually by January 1, 2017 (September 2014).
Risk weights	• **Group loans:** Classify loans extended to "purchasing groups"—individuals who organize themselves for the joint purchase of land rights, in part, for tax benefits—as "construction and real estate" credit, with higher risk weight (March 2010). • **Larger mortgages with higher risk:** Raise the risk weight for mortgages with a floating component of over 25 percent, an LTV of at least 60 percent, and a mortgage value higher than NIS 800,000 from 35 to 100 percent (October 2010). • **High LTV loans:** Raise the risk weight for loans with an LTV between 45 and 60 percent from 35 percent to 50 percent; and for loans with an LTV above 60 percent to 75 percent (March 2013).
Provisioning	• **High LTV loans:** Require additional provisions of 0.75 percent for all outstanding mortgages with an LTV ratio exceeding 60 percent (July 2010). • **Total mortgage loans:** Raise the allowance for credit losses from mortgage loans—such that the ratio between the allowance and the outstanding of mortgage loans is at least 0.35 percent (March 2013).
Mortgage lending ratios	• **Loan-to-value (LTV) caps:** Limit LTVs on mortgage loans up to 70 percent (75 percent for first-time buyers); and up to 50 percent on mortgage loans for purchasing properties for investment purposes (November 2012). • **DSTI caps:** Limit DSTI of new loans at 50 percent (August 2013). • **Floating interest component caps:** (i) Limit the variable-interest-rate component of mortgages with variable-interest rates that change within 5 years at 1/3 of the total mortgage loans (May 2011); and (ii) limit the overall variable-interest component of mortgages at 2/3 of the total mortgage loans (August 2013).
Mortgage maturity	• **Maximum mortgage maturity:** Limit the maximum repayment period to 30 years (August 2013).
Other	• **Reporting requirement:** Require detailed reporting on residential mortgage loans (May 2011).

Annex V. Recent Steps to Enhance Medium-Term Fiscal Management

Reductions in Israel's structural deficit have been deferred repeatedly. Since 1991, fiscal policy in Israel has been regulated by multi-year deficit ceilings aiming to lower debt. The expenditure rule was subsequently introduced in 2005 to reduce fluctuations in government spending. However, the fiscal targets have not served as an effective fiscal policy anchor as they are not binding, and in practice they have been revised whenever political needs arose or a slippage was anticipated.

As part of the efforts to strengthen the medium-term fiscal management, the government started publishing a medium-term fiscal framework (MTFF) in the 2015–16 budget and medium-term budget framework (MTBF) in the 2017–18 budget. The MTFF sets aggregate fiscal objectives (anchors) while the MTBF presents a more detailed spending framework that is consistent with both macro-fiscal objectives and the government's priorities. Because the commitments made by the government in the coming years are exceeding the expenditure ceilings and inconsistent with the deficit ceilings, the MTFF shows the "adjustments required to converge with the deficit ceiling" for each year.

The government has also introduced measures to enhance control of medium-term commitments and reduce uncertainties with defense spending. The lack for control over the informal yet firm spending commitments of line ministries was one of the key factors that make it difficult to adhere to the fiscal targets. In addition, regular and significant spending reallocation to the Defense Ministry with each year have complicated budget planning and management. In order to address these challenges, the government introduced the following measures:

- **"Numerator" mechanism to strengthen monitoring and control of future commitments.** In 2016, the government started applying a mechanism that restricts the government's ability to make new expenditure commitments outside the budget approval process, unless it finds offsetting resources. It will take some time to yield gains from the mechanism as it controls only new commitments for the future while near-term expenditure will continue to be governed by legacy commitments made before 2016.

- **Multi-year defense budget for 2016–2020.** In May 2016, the MoF and Ministry of Defense agreed on a MTBF, which disaggregates the human resource-related budget for wages, pensions, and rehabilitations and that for the core military objective (i.e., strengthening and maintaining competency and preparedness). Agreement was also reached on specific conditions under which the budget could be changed. According to the MTBF, the real growth rate of defense spending is expected to decline to 1.3 percent year for 2018–2020, from 1.5 percent per year for 2007–2017, reducing defense spending by 0.3 percentage points of GDP between 2017 and 2020.

- **Spending Reviews.** The government created the Spending Review Central Committee and initiated Spending Reviews in 2016 in order to improve the composition of the budget and enhance spending efficiency while reducing deficits. The procedure included all the government offices with an objective of cutting 0.2 percent of the overall budget to be implemented by 2019. In 2016, the Committee approved several streamlining plans as per the criteria set out in the procedure; e.g., setting realistic strategies to make changes, establishing success indexes to examine the implementation status of the plans, and evaluating the estimated savings from the plans. The 0.2 percent budget cut for the ministries with approved plans—e.g., Ministry of National Infrastructure, Energy, and Water (streamlining liquefied petroleum gas storage), Ministry of Health (consolidate ministry sites in Tel Aviv)—have been differed to 2019 while the budget for the ministries without approved plans is cut already in the 2017–18 budget.

Appendix I. External Sector Assessment

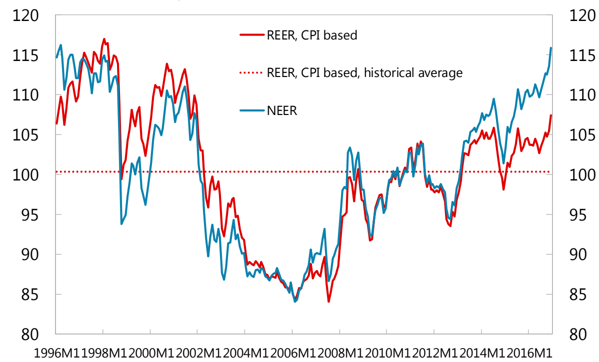
The shekel has appreciated substantially in real effective terms over the last decade and is now above its long-term average even as the current account remains in modest surplus. Although there is no clear evidence of the shekel being misaligned with fundamentals from an economy-wide perspective, the real appreciation appears to have had a significant impact on merchandise exports.

Model Based Current Account and Exchange Rate Valuations

Israel's real exchange rate (REER) experienced large swings in recent decades and it is currently above its historical average. The REER fell to low levels in 2002 after the dot-com bust which had a sizable impact on Israel. But since the 2008/09 crisis it has shown an upward trend amid significant volatility. Along with easy monetary conditions in the major advanced economies, this appreciation partly reflects promising prospects for natural gas production and strong FDI inflows in recent years, including foreign purchases of high-tech start-ups. As of end-2016, the shekel had appreciated by about 13 percent in CPI-based real effective terms relative to its average level in 2009, and was 7 percent above its two-decade average. During the same period, the ULC-based REER appreciated significantly more than the CPI-based REER—by about 26 percent—and was 17 percent above its historical average as of 2016Q3.

Effective Exchange Rates

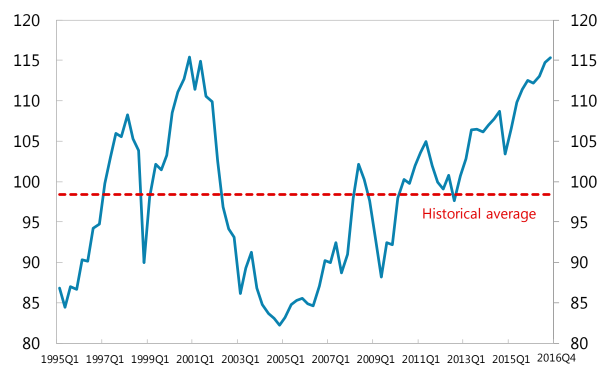
(Index, 1996-2015 average=100)



Sources: INS; Haver Analytics; and IMF staff calculations.

Real Effective Exchange Rate, ULC Based

(Index 2010=100)



Sources: INS; Haver Analytics; and IMF staff calculations.

While this real appreciation of the shekel may have contributed to sluggish growth in goods exports in recent years (see the next section), Israel's overall external position remains solid. The current account (CA) balance declined from 4.3 percent of GDP in 2015 to 3.6 percent of GDP in 2016 as imports rose partly owing to a surge in vehicle purchases. The positive CA largely reflects resilient service exports as well as consistently high official and private transfer net inflows of about 3 percent of GDP. The CA balance is expected to stabilize around 3 percent in the medium-term. The net international investment position (NIIP) rose 10 percentage points to about 33 percent of GDP as of end 2016, partly due to an increase in foreign reserves owing to FX intervention by the Bank of Israel of about $6 billion (or about 2 percent of GDP) in 2016.

Estimates of exchange rate misalignment vary across methodologies. The IMF's External Balance Assessment (EBA) CA analysis suggests the REER is undervalued by 15.6 percent, given a 2016 CA balance some 3.9 percentage points above its estimated norm of slightly below zero. However, this approach doesn't take into account actual pension contributions, which is particularly important for Israel owing to the enactment of the Mandatory Pension Law in 2008. A modified CA analysis, that estimates the impact of pension contributions across the full set of countries, implies a higher norm for Israel. As a result, the estimated CA gap narrows to 2.4 percent of GDP, indicating the shekel is moderately undervalued by 9.6 percent.[1] In addition, the EBA CA analysis does not include indicators of net official and private transfers, which have remained high for Israel and could warrant a higher CA norm. In contrast, the EBA-Lite REER index analysis—which does consider aid and remittances—indicates the REER is broadly in line with fundamentals and desirable policies.

External Balance Assessment (EBA) Methodologies 1/

Methodology	CA gap (Percent of GDP)	REER gap (Percent)
(1) EBA CA Analysis (RES)	3.9	-15.6
(2) Modified EBA CA Analysis (Pension)	2.4	-9.6
(3) Modified EBA CA Analysis (Pension & FE)	-0.2	0.8
(4) EBA-Lite REER (Index) Analysis	--	-3.0

Source: IMF staff calculations.
1/ The assessment is done for the year of 2016. CA gaps: minus indicates overvaluation. REER gaps: minus indicates undervaluation. REER gaps between -5 and +5 percent are considered to indicate the REER is broadly in line with fundamentals. Estimates based on data available in February 2017.

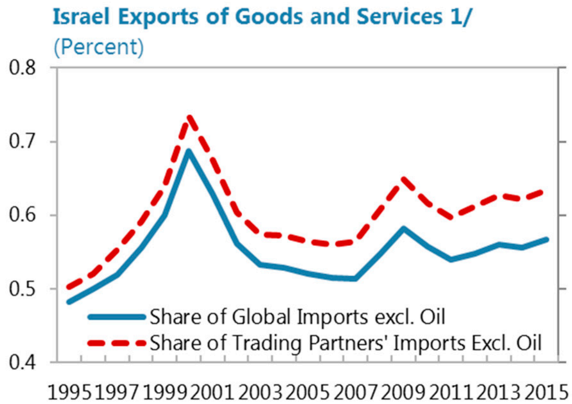
Overall, it is difficult to conclude that there is a significant deviation of the shekel from fundamentals. Among the methodologies, staff considers the modified CA analysis (approach (2)) and the EBA-Lite REER index analysis (approach (4)) to be most likely to be reliable in Israel's case, which show modest undervaluation of 9.6 percent and 3 percent respectively. Taking into account that two measures of the real exchange rate have appreciated significantly in recent years to be above their historical averages, staff do not see adequate evidence to conclude that the shekel deviates significantly from fundamentals.

Recent Export Performance and the Impact of the Exchange Rate Appreciation

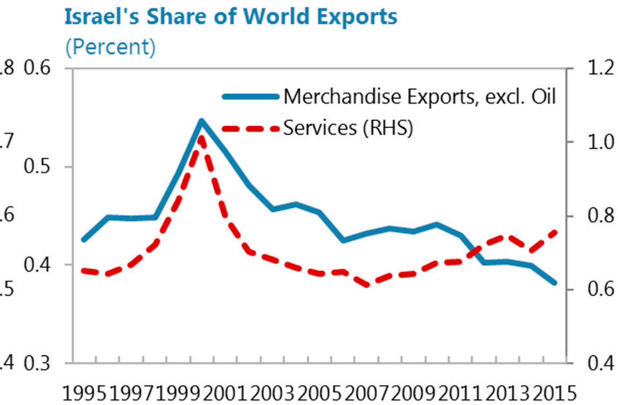
Israel's export developments have reflected diverging outcomes for merchandise and services exports. After a severe slump in the early 2000s, Israel's overall export share in global trade has gradually recovered. This overall trend relies on a steady rise in the share of services exports from a low in 2007, led by IT-related services rising 78 percent since 2011 to some 4.1 percent of GDP in

[1] A further modified CA analysis—adding a country fixed effect to capture persistent country-specific factors that are not accounted for by the model (such as dependence on large aid, remittance inflows, commodity exports, or tourism)—indicates the REER is around its fundamental value.

2016. However, merchandise exports (excluding aircraft, ships and diamonds), started to lose market share from 2011, suggesting that factors going beyond subdued external demand may be at work.[2]



Sources: Haver Analytics; WEO; and IMF staff calculations.
1/ Excluding ships, aircraft and diamonds.



Sources: WEO; and IMF staff calculations.

Since 2011, several major sectors have been losing global market share, although some declines reflect idiosyncratic shocks. Some idiosyncratic shocks affected major companies in a number of industries: Israel Chemicals Ltd. (chemicals & oil refining industry); Intel (computer electronic & optical products industry); and Teva Pharmaceutical Industries Ltd (pharmaceutical industry). This can partly explain the dip in exports in 2015, but it is notable that the slowdown became broadly spread across other exporting sectors.

Israel Exports' Share of World Exports by Industries (Percent)

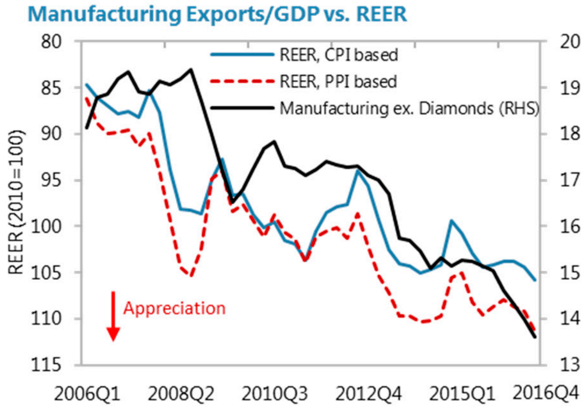
	2011	2015	Δ	Sector Share as 2015 Israel's goods exports
Agricultural products	0.17	0.16	-0.01	3.3
Minerals and Fuels	0.03	0.04	0.01	1.1
Pharmaceuticals	**1.54**	**1.35**	**-0.19**	**10.2**
Chemicals	**0.92**	**0.79**	**-0.13**	**11.6**
Rubber & Plastics	0.35	0.36	0.01	3.8
Textiles, Clothing, Footwear, Hide Skins, and Woods	0.10	0.10	0.00	2.1
Diamonds	**3.57**	**3.24**	**-0.32**	**28.4**
Stone and Glass exl. Diamonds	0.19	0.25	0.06	0.7
Metals	0.19	0.20	0.01	3.2
Electronics, Opticals, and Electrical Machinery and Equipments	0.35	0.40	0.06	29.0
Transport	0.12	0.19	0.06	4.9
Other Manufacturing	0.13	0.12	-0.01	1.7

Sources: WITS; and IMF staff Calculations.

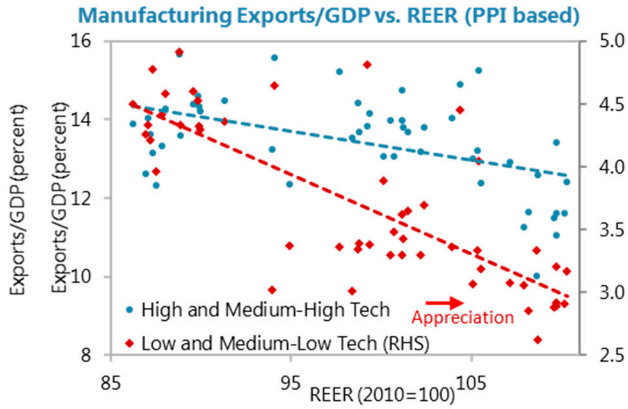
This period of market share losses in merchandise exports may reflect a combination of real appreciation, weak productivity growth, and low diversification:

- **Accumulation of real appreciation.** The large cumulative real appreciation, especially on a PPI basis, has coincided with a notable decline in the share of manufacturing exports relative to GDP in the last decade, although this decline is in part a valuation effect. Within the manufacturing sector, it is notable that exports of lower technology goods declined notably more than higher technology goods, suggesting less differentiated products with narrower margins, and hence greater sensitivity to exchange rate appreciation.

[2] Israel occasionally sells aircraft and ships that are recorded as exports, while it also processes diamonds, and these exports can be volatile from year to year.

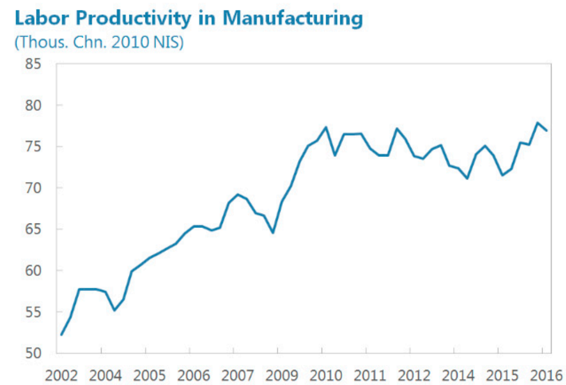


Sources: IMF's Information Notice System; and Haver Analytics.



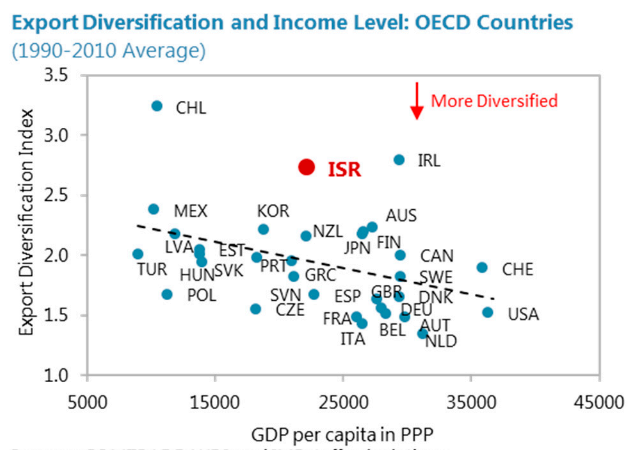
Sources: IMF's Information Notice System; and Haver Analytics.

- **Slowdown in productivity growth.** After trending upwards strongly in the 2000s, labor productivity in manufacturing appears to have been broadly flat since 2010. The absence of growth in trend labor productivity falls short of the productivity growth seen in the United States and is also below the Euro area average.



Sources: Haver Analytics and IMF staff calculations.

- **Low diversification**. Israel's exports are concentrated, with four industries (pharmaceutical, chemical, diamonds, electronics) accounting for two-thirds of total goods exports in 2015. Moreover, a few major enterprises have a large share of the exports in each industry. Consequently, the export diversification index points to a less diversified profile for Israel compared with countries at the same income level, implying higher risk of periods of weak export performance.



Sources: COMTRADE; WDI; and IMF staff calculations.
Note: Lower diversification index value means more diversified in exports.

Appendix II. Debt Sustainability Analysis 2017

Israel's debt-to-GDP ratio fell from 94 percent in 2003 to 62 percent in 2016. The structure of this debt helps assure resilience to shocks, with a maturity averaging 7 years and nonresidents holding only around 14 percent of the total. Nevertheless, relatively high interest payments and elevated gross financing needs are a source of vulnerability. Although most indicators are below early warning benchmarks, Israel's debt outlook appears to be most sensitive to growth shocks.

Under staff's baseline scenario, public debt-to-GDP ratio is projected to gradually rise to 63½ percent of GDP by 2021 (Figures A2.1–A2.2). The DSA covers debt of the general government.[1] Gross financing needs would increase from 8½ percent of GDP in 2016 to 10 percent in 2017 and then remain around 10 percent throughout the projection period. The baseline scenario is underpinned by the following assumptions:

- Real GDP is projected to grow at around 3 percent annually on average.

- CPI inflation is projected to return to around 2 percent—the mid-point of the target range—by 2019 and remain at around 2 percent throughout the projection period.

- The central government deficit is expected to increase from 2.1 percent of GDP in 2016 to 2¾ percent of GDP in 2017 and 2018, and then to 2.9 percent of GDP in 2019 and stay at the level thereafter. The general government deficit is assumed to be larger than the budget deficit by 0.5 percentage points of GDP in 2016, 0.6 points in 2017, and 0.8 points annually from 2019 through 2022.

- Non-debt creating financing is assumed to be ½ percent of GDP annually.

- Primary expenditure is projected to increase from 37 percent of GDP in 2016 to around 37⅔ percent of GDP.

- The effective interest rate is projected to increase gradually from 5 percent in 2016 to 5⅔ percent in the medium term, reflecting the normalization of monetary policy.[2] Borrowing conditions—facilitated by comfortable sovereign ratings (A+ and A1) and the U.S. debt guarantee program (about 3 percent of GDP)—are assumed to remain favorable.

---

[1] The analysis is for the general government, including both tradable and non-tradable debt. Non-tradable debt has been issued to institutional investors with the terms set based on long-standing arrangements. This non-tradable debt has been declining over time given the reduction in designated bond issuances to pension funds.

[2] Israel's high effective interest rates partly reflect high-yield non-tradable government bonds issued to pension funds, which guarantee a stable return of approximately 4 percent in real terms. Currently, such bonds constitute 19 percent of general government debt.

Shocks and Stress Tests

A range of stress tests indicate that debt sustainability is reasonably resilient to growth, interest rate, and combined macro-fiscal shocks (Figures A2.3–A2.4).

- **Growth shock**. Lower real GDP growth rates (by 1 standard deviation for 2 years starting in 2017) would lead to a larger deficit as revenues fall while expenditure remains unchanged. The debt-to-GDP ratio would rise to about 65 percent by 2018 and then to 68¼ percent by 2022. Financing needs would increase to 12 percent of GDP by 2019 and then decline to 11 percent of GDP.

- **Interest rate shock**. A geopolitical shock might push up borrowing costs by 200 basis points. Public debt would increase moderately to around 65½ percent of GDP by 2022 with a moderate increase in financing needs to around 11 percent of GDP over the same period.

- **Combined macro-fiscal shock**. A shock that combines exchange rate depreciation, an expansion of the primary deficit, and a decline in real GDP, would raise debt to 66 percent of GDP by 2018 and financing needs to 11 percent of GDP. Debt is projected to keep increasing to around 71½ percent by 2022 while financing needs would stay around 11½–12½ percent of GDP.

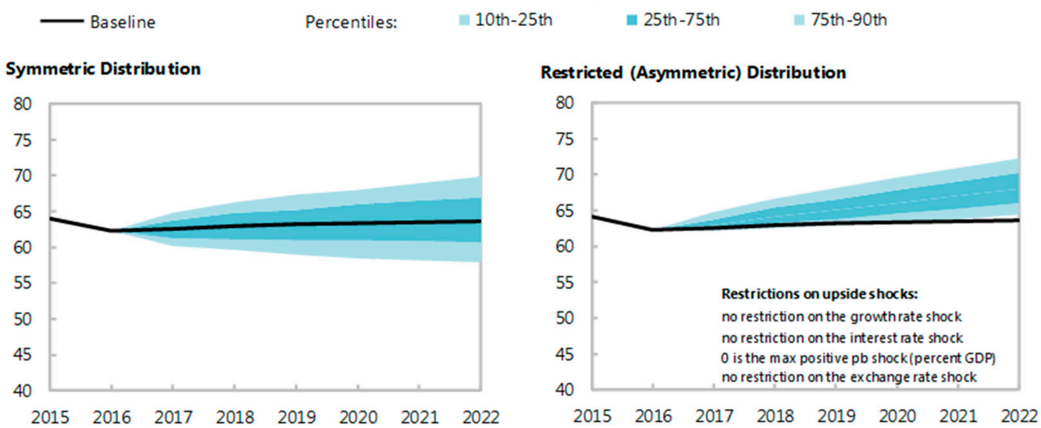
Figure A2.1. Israel: Public DSA—Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

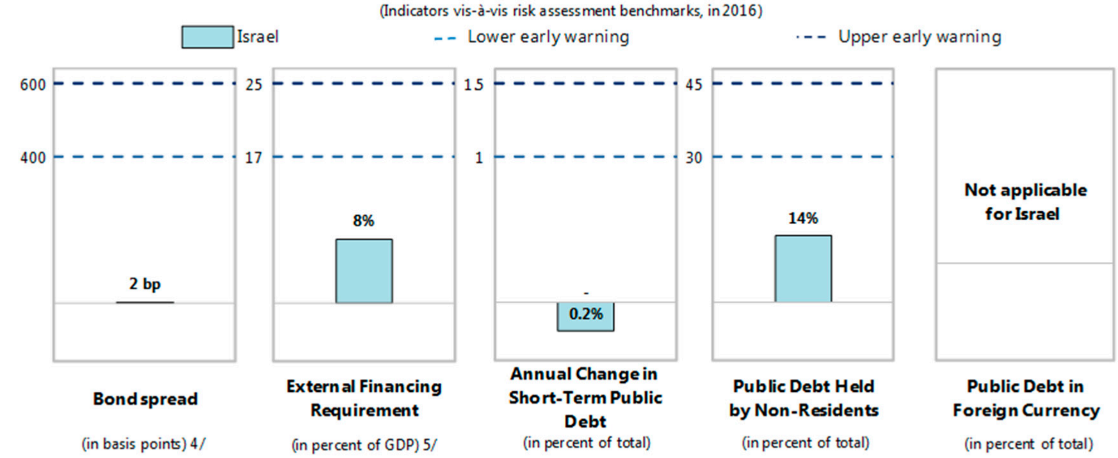
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 25-Nov-16 through 23-Feb-17.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A2.2. Israel: Public DSA—Baseline Scenario

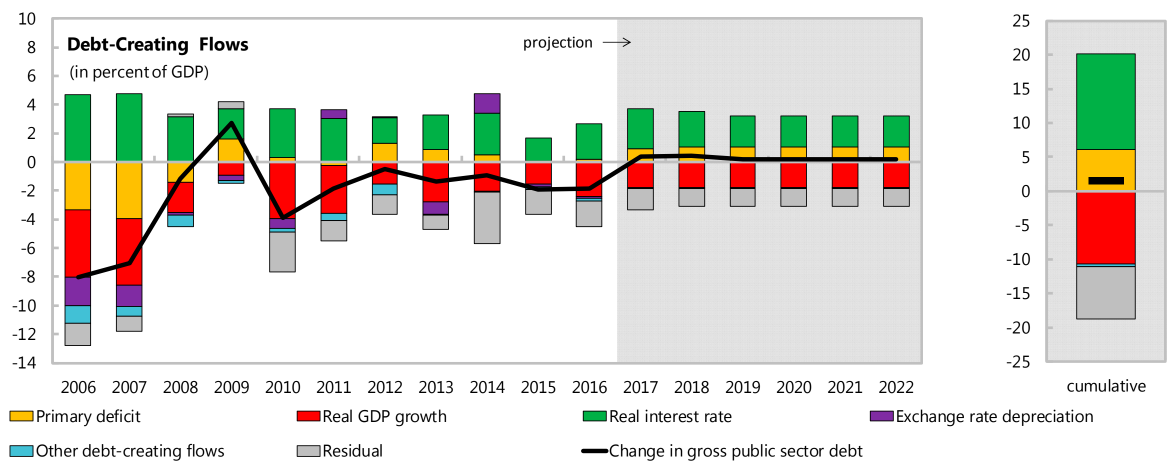
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2006-2014 [2]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	71.2	64.1	62.2	62.6	63.0	63.2	63.3	63.5	63.7
Public gross financing needs	10.8	6.9	8.8	10.2	9.8	10.1	10.1	10.2	10.3
Real GDP growth (in percent)	4.1	2.5	4.0	2.9	3.0	3.0	3.0	3.0	3.0
Inflation (GDP deflator, in percent)	2.1	2.8	1.0	0.7	1.3	2.0	2.0	2.0	2.0
Nominal GDP growth (in percent)	6.3	5.3	5.0	3.7	4.4	5.0	5.0	5.0	5.0
Effective interest rate (in percent) [4]	6.6	5.4	5.1	5.4	5.6	5.7	5.7	5.7	5.7

As of February 23, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		2
5Y CDS (bp)		68
Ratings	Foreign	Local
Moody's	A1	A1
S&Ps	A+	A+
Fitch	A	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	-2.5	-1.9	-1.9	0.4	0.4	0.2	0.2	0.2	0.2	1.4	
Identified debt-creating flows	-1.1	-0.2	-0.1	1.8	1.7	1.4	1.4	1.4	1.4	9.0	
Primary deficit	-0.5	0.1	0.2	0.9	1.0	1.1	1.0	1.0	1.0	6.2	0.3
Primary (noninterest) revenue and grants	37.3	36.2	36.8	36.7	36.8	36.7	36.7	36.7	36.7	220.1	
Primary (noninterest) expenditure	36.8	36.2	36.9	37.6	37.8	37.7	37.7	37.7	37.7	226.2	
Automatic debt dynamics [5]	-0.1	-0.1	-0.1	1.0	0.7	0.4	0.4	0.4	0.4	3.3	
Interest rate/growth differential [6]	0.3	0.0	0.0	1.0	0.7	0.4	0.4	0.4	0.4	3.3	
Of which: real interest rate	3.1	1.6	2.5	2.8	2.5	2.2	2.2	2.2	2.2	14.0	
Of which: real GDP growth	-2.9	-1.6	-2.4	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-10.7	
Exchange rate depreciation [7]	-0.4	-0.1	-0.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.5	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.4	
Privatization (negative)	-0.5	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	-1.3	-1.7	-1.8	-1.5	-1.2	-1.2	-1.2	-1.2	-1.2	-7.6	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

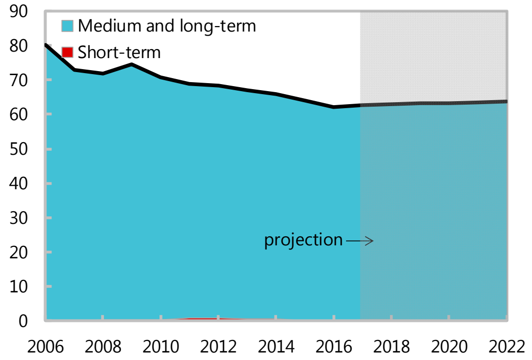
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

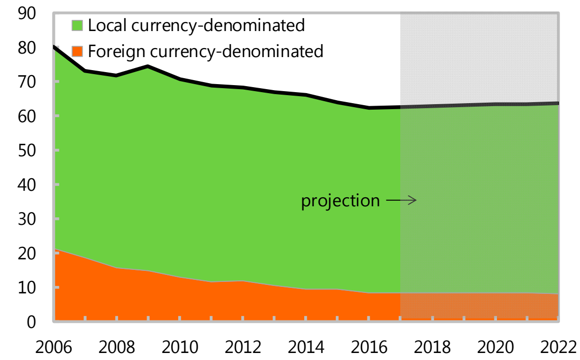
Figure A2.3. Israel: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



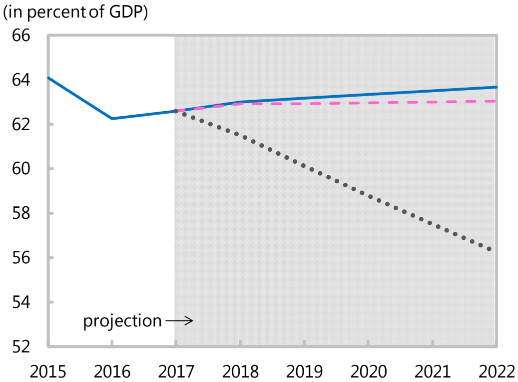
By Currency
(in percent of GDP)



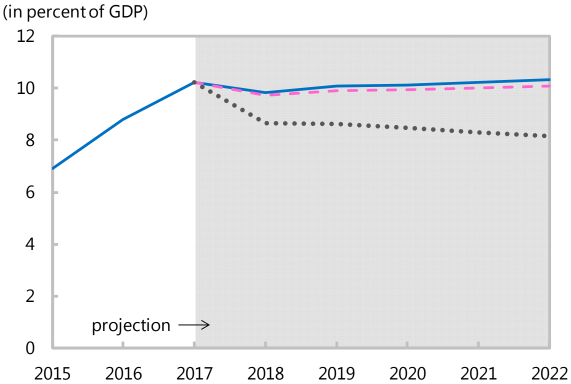
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

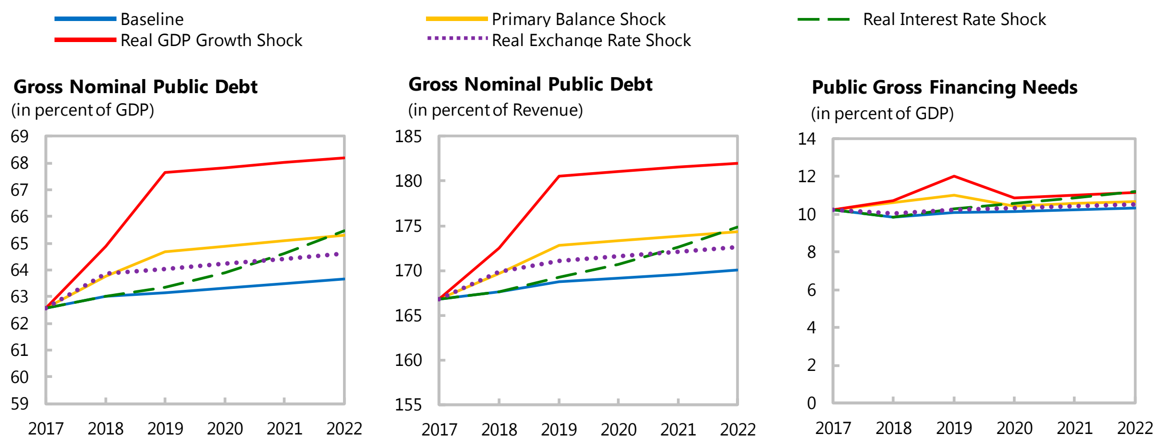
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	2.9	3.0	3.0	3.0	3.0	3.0
Inflation	0.7	1.3	2.0	2.0	2.0	2.0
Primary Balance	-0.9	-1.0	-1.1	-1.0	-1.0	-1.0
Effective interest rate	5.4	5.6	5.7	5.7	5.7	5.7
Constant Primary Balance Scenario						
Real GDP growth	2.9	3.0	3.0	3.0	3.0	3.0
Inflation	0.7	1.3	2.0	2.0	2.0	2.0
Primary Balance	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Effective interest rate	5.4	5.6	5.7	5.7	5.7	5.7

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	2.9	3.8	3.8	3.8	3.8	3.8
Inflation	0.7	1.3	2.0	2.0	2.0	2.0
Primary Balance	-0.9	0.1	0.1	0.1	0.1	0.1
Effective interest rate	5.4	5.6	5.7	5.8	5.7	5.7

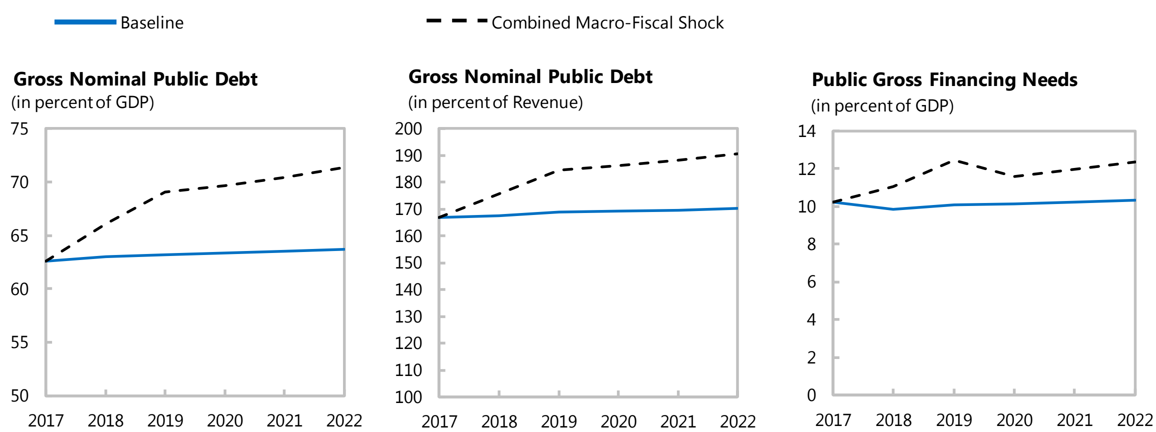
Source: IMF staff.

Figure A2.4. Israel: Public DSA—Stress Test

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	2.9	3.0	3.0	3.0	3.0	3.0
Inflation	0.7	1.3	2.0	2.0	2.0	2.0
Primary balance	-0.9	-1.8	-1.9	-1.0	-1.0	-1.0
Effective interest rate	5.4	5.6	5.7	5.7	5.7	5.7
Real Interest Rate Shock						
Real GDP growth	2.9	3.0	3.0	3.0	3.0	3.0
Inflation	0.7	1.3	2.0	2.0	2.0	2.0
Primary balance	-0.9	-1.0	-1.1	-1.0	-1.0	-1.0
Effective interest rate	5.4	5.6	6.0	6.3	6.6	6.8
Combined Shock						
Real GDP growth	2.9	1.4	1.4	3.0	3.0	3.0
Inflation	0.7	0.9	1.6	2.0	2.0	2.0
Primary balance	-0.9	-1.8	-2.5	-1.0	-1.0	-1.0
Effective interest rate	5.4	5.7	6.1	6.4	6.7	6.9

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	2.9	1.4	1.4	3.0	3.0	3.0
Inflation	0.7	0.9	1.6	2.0	2.0	2.0
Primary balance	-0.9	-1.8	-2.5	-1.0	-1.0	-1.0
Effective interest rate	5.4	5.6	5.7	5.8	5.7	5.7
Real Exchange Rate Shock						
Real GDP growth	2.9	3.0	3.0	3.0	3.0	3.0
Inflation	0.7	1.7	2.0	2.0	2.0	2.0
Primary balance	-0.9	-1.0	-1.1	-1.0	-1.0	-1.0
Effective interest rate	5.4	5.7	5.7	5.7	5.7	5.7

Source: IMF staff.

INTERNATIONAL MONETARY FUND

ISRAEL

March 9, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By	European Department

CONTENTS

FUND RELATIONS

(As of February 28, 2017)

Membership Status: Israel became a member of the Fund on July 12, 1954.[1]

General Resources Account:

	SDR Million	Percent Quota
Quota	1,920.90	100.00
Fund Holdings of Currency (Holdings Rate)	1,888.77	98.33
Reserve Tranche Position	32.19	1.68
Lending to the Fund		
New Arrangements to Borrow	58.95	…

SDR Department:

	SDR Millions	Percent Allocation
Net cumulative allocations	883.39	100.00
Holdings	779.63	88.26

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Oct 20, 1976	Oct 19, 1977	29.25	12.00
Stand-By	Feb 14, 1975	Feb 13, 1976	32.50	32.50
Stand-By	Nov 08, 1974	Feb 14, 1975	32.50	32.50

Overdue Obligations and Projected Payments to Fund[2]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2017	2018	2019	2020	2021
Principal					
Charges/Interest	0.26	0.33	0.33	0.33	0.33
Total	0.26	0.33	0.33	0.33	0.33

[1] For purposes of Fund relations, the West Bank and Gaza (WBG) fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement.

[2] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement:

The *de jure* exchange rate arrangement is classified as "free floating." The *de facto* exchange rate arrangement, however, is classified as "floating" as the BOI has intervened more than three times over the last six months.

Israel accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 21, 1993. Israel maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, with the exception of measures introduced for security reasons pursuant to Decision No. 144-(52/51). 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.

Last Article IV Consultation:

The last Article IV consultation was concluded on September 4, 2015. Israel is on the standard 12-month consultation cycle.

ROSCs:

- Financial System Stability Assessment was conducted in 2000 issued in August 2001.
- Fiscal Transparency ROSC was conducted in 2003, issued in April 2004.
- Monetary and Financial Policy Transparency was conducted in 2003, issued as IMF Country Report No. 03/76 in March 2003.
- AML/CFT ROSC was conducted in 2003, issued in June 2005.
- Data Module ROSC was conducted in 2005, and issued as IMF Country Report No. 06/125 in March 2006.
- Financial System Stability Assessment Update was conducted in 2011, issued in April 2012.

Technical Assistance:

The Fund has been providing policy advice and technical assistance to the Palestinian Authority (PA) since the 1993 Oslo Accords, and presently has a senior resident representative based in Jerusalem. Staff missions to the West Bank and Gaza (WBG) have been assisting the PA in designing and implementing its macroeconomic and fiscal framework, and reforms aimed to strengthen economic institutions. The most recent progress report was presented at the Ad-Hoc Liaison Committee (AHLC) meeting of donors held in New York on September 19, 2016. Technical assistance has also been stepped up since 2007, particularly in the areas of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), banking supervision and regulation, public financial management, revenue administration, and macroeconomic statistics.

Recent technical assistance to Israel covered issues on systemic risk assessment and stress testing, fiscal regime for mining, a medium-term budget framework, and the effectiveness and efficiency of the Banking Supervision Department.

Resident Representative:

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

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance	
General: Macroeconomic statistics are of generally high quality and broadly adequate for surveillance, although there are few shortcomings particularly in monetary and government finance statistics. A Report on the Observance of Standards and Codes—Data Module, a Detailed Assessments Using the Data Quality Assessment Framework (DQAF), and a Response by the Authorities were published on the IMF website on March 24, 2006 (*IMF Country Report No. 06/125*).	
National Accounts: No issues to report.	
Price statistics: No issues to report.	
Government finance statistics: The methodology underlying the reported overall annual fiscal balance is not in conformity with internationally accepted best practice, as interest expenditure excludes the inflation component. The authorities are gradually moving toward implementation of the methodology that is standard in other countries, so that the discrepancy will decline over time. Quarterly data submitted by the Central Bureau of Statistics broadly follows the GFSM 2001 format. However, for financial assets and liabilities, only transaction data are currently submitted, although a financial balance sheet (stocks of financial assets and liabilities) is under preparation. Within-year monthly reports on central government operations—compiled by the MOF—cover only the main aggregates of budgetary accounts, not broken down by components.	
Monetary statistics: Banking statistics are not based on balance sheet reporting, but instead on a selection of data reported by banks to the regulatory authorities. Current information does not permit full sectorization of the economy in the monetary statistics, and more detailed information on instruments also would be useful.	
Balance of payments: Balance of payments and international investment position data are compiled on a quarterly basis and follow the sixth edition of the *Balance of Payments Manual*. External sector data were not examined in the Report on the Observance of Standards and Codes.	
II. Data Standards and Quality	
Participant in the Special Data Dissemination System (SDDS) since April 1996, and in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars.	Data ROSC published on March 24, 2006.
III. Reporting to STA (Optional)	
Data are regularly reported for publication in the *Government Finance Statistics Yearbook* and in the *IFS*.	

Table of Common Indicators Required for Surveillance

(As March 9, 2017)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	Same day	Same day	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb-17	Mar-17	M	M	M		
Reserve/Base Money	Jan-17	Feb-17	M	M	M	LNO, LO, NO, LO	O, O, O, NA, NA
Broad Money	Jan-17	Feb-17	M	M	M		
Central Bank Balance Sheet	Jan-17	Feb-17	M	M	M		
Consolidated Balance Sheet of the Banking System	Q3-16	…	Q	Q	Q		
Interest Rates[2]	Same day	Same day	D	D	D		
Consumer Price Index	Jan-17	Feb-17	M	M	M	O, O, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2015	Nov-16	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Feb-17	Mar-17	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q3-16	Jan-17	Q	Q	Q		
External Current Account Balance	Q4-16	Mar-17	Q	Q	Q	NA	NA
Exports and Imports of Goods and Services	Q4-16	Mar-17	Q	Q	Q		
GDP/GNP	Q4-16	Mar-17	Q	Q	Q	O, O, O, LO	LO, O, LO, O, LO
Gross External Debt	Q4-16	Mar-17	Q	Q	Q		
International Investment Position[6]	Q4-16	Mar-17	Q	Q	Q		

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[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, extra budgetary, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects the assessment provided in the data ROSC for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[9] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Mr. Anthony De Lannoy, Executive Director for Israel and Mr. Yossi Yakhin, Senior Advisor to the Executive Director
March 24, 2017

On behalf of the Israeli authorities, we thank the Article IV mission team for an excellent report and for the candid, constructive and friendly dialogue. The authorities broadly agree with the analysis and recommendations in the report. Overall, the macroeconomic performance of the economy is strong, especially compared to other advanced economies. Growth has accelerated in 2016, labor force participation is at an all-time high, the unemployment rate is at its lowest level since the 1970s, debt-GDP ratio has been on a declining path for over a decade and the financial system is strong. Nevertheless, the economy faces structural challenges, mainly demographic dynamics that weigh on labor productivity and rising house prices. The authorities acknowledge these challenges and are taking actions to confront them. In the following comments we elaborate on the authorities' views and actions and provide additional perspectives to the staff report.

Economic Activity: Flying on One Engine

The Israeli economy grew by 4.0 percent in 2016. This performance is mainly a results of robust domestic demand, but recovery in export services and one-off factors also contributed their share.

Israel weathered the global financial crisis relatively well, but as a small and open economy it depends on strong trading partners and a vibrant global economy. In the aftermath of the crisis, external conditions have been challenging, export growth weakened and lost power as the main growth engine of the economy. From 2007 to 2016, the export share in GDP dropped 20 percent from 34.7 percent to 27.5 percent. With a weaker external sector, economic activity had to shift gears and rely more heavily on domestic demand. Since 2008, domestic absorption (private and public consumption and investment) has grown at an annual pace of 3.7 percent compared to export growth of 2.1 percent, while during the decade prior to the global financial crisis, exports was clearly the major growth engine with an annual growth rate of 7.2 percent compared to a growth rate of 3.1 percent of domestic absorption. Stable financial environment, robust labor market and civilian government expenditure supported domestic demand in the aftermath of the financial crisis.

In 2016 domestic demand accelerated and continued to grow strong, especially private consumption (6.3 percent) and investment in fixed assets (11.3 percent), on the back of a strong labor market with robust wage growth and acceleration in the construction sector. A one-off surge in vehicles purchase, due to changes in the tax policy, have also contributed to growth this year. Notably, exports have accelerated as well in 2016 and grew 3.0 percent. The recovery in exports, alongside the WEO projections for accelerated world trade and global growth, provide encouraging signs that Israel's second growth engine may be reigniting.

Medium-Term Fiscal Framework

The authorities broadly agree with staff's assessment, and in particular they recognize the need to establish a better record of medium-term fiscal management.

The debt-GDP ratio has declined persistently for over a decade – from 93.8 percent in 2003 to 62 percent in 2016. This decline was supported by strong growth rates, but with potential growth moderating, a further reduction in the debt-GDP ratio will become more challenging and will require maintaining lower deficits.

While the strong fiscal performance in 2016 is certainly a positive development, the more important one is the adoption of a robust medium-term budget management framework. In fact, following the recommendations of an IMF TA, 2016 was the first year during which a mechanism to control medium-term budget obligations was implemented. In the past, frequent government decisions regularly accumulated budgetary obligations for years to come and as a result the path of future deficit ceilings had to be revised upward every year. However, under the current framework, the government has to identify resources whenever it commits to new obligations, and it publishes semi-annual reports on its expenditure commitments and their expected sources of revenue. In addition, bi-annual expenditure reviews help prioritizing past programs and make space for new ones. It should be noted that the stock of past obligations has brought yet another upward revision for the 2017–18 deficit ceilings (2.9 percent of GDP in both 2017 and 2018, compared to the envisaged deficits at the time of approving the 2016 budget of 2.5 percent in 2017 and 2.25 percent in 2018). Nevertheless, the new fiscal framework has reduced substantially the pace at which the government accumulates new obligations, and while the legacy of previous budgetary commitments may still press on future deficit ceilings, their weight will decline going forward.

Monetary Policy, Inflation and the Exchange rate

In the face of low inflation environment, a strong Shekel and low interest rates in advanced economies, monetary policy has remained expansionary, employing both interest rate and foreign exchange interventions. The authorities concur with staff's recommendation to maintain an accommodative policy stance until inflation and inflation expectations gain more solid ground.

Headline inflation has undershot the target range, 1–3 percent, persistently since mid-2014, reaching rates as low as -1.0 percent. Inflation has edged up in recent months, but it is still well below the target range with 0.4 percent for the 12 months ending in February 2017.

Nevertheless, decomposition of the CPI to its tradable and non-tradable components reveals that the low inflation rate is driven primarily by the price of tradable goods, with tradable inflation at -1.3 percent and non-tradable inflation at 1.3 percent. This result is consistent with staff's appraisal, and indicates that mainly external factors, including exchange rate appreciation, are a drag on inflation. Recent analysis by the Bank of Israel suggests that a substantial rise in online retail trade has put pressure on prices due to increased competition and may have also lifted exchange rate pass-through to inflation. That said, non-tradable inflation, is also below desirable levels.

In the face of inflation undershooting the target, the Bank of Israel has appropriately maintained an accommodative policy stance, with the interest rate at 0.1 percent since early 2015.[1] Nonetheless, with most of the weakness originating from the external sector and while facing persistent exchange rate appreciation pressures, partly generated by spillovers from extraordinary accommodative monetary policy in other advanced economies, it was considered appropriate to address further relaxation of the monetary stance through quantitative tools of purchasing foreign currency rather than further reducing the interest rate to uncharted negative territories. This consideration was reinforced by concerns of further fueling domestic house prices.

The Housing Market

House prices have risen 90 percent in real terms since end 2007, though from a low base after a decade-long real price depreciation of about 25 percent. The authorities agree that increasing supply is the key factor for effectively addressing housing affordability. We note that this is true for both house prices and rents, as the latter has also been rising rapidly, though at a slower pace than house prices.

The government is taking an array of measures to increase supply and expedite the planning process. These, among other measures, include: the establishment of the “Housing Cabinet” (under the Ministry of Finance) which brings all the authorities involved in the housing market under one roof, in order to improve coordination and reduce red-tape; bringing large housing projects to the approval of a special planning committee that is authorized to operate in an expedited schedule; the “Blanket Agreements” that provide municipalities with financing of necessary infrastructure to support new neighborhoods; and bringing foreign companies to introduce new technologies and improve the industry’s productivity.

These efforts start to bear fruits as is evident by the substantial rise of “planned units” available for issuing construction permits (100,000 units in 2016 alone) and by housing starts accelerating to an annual pace of over 50,000 units. To appreciate these figures we note that the last time housing starts exceeded the 50,000 bar was in 1997 in the aftermath of the massive immigration wave from the former Soviet Union. Staff rightly argues that there is still a long way to go and appropriately puts the figure on relevant bottlenecks. The authorities are well aware of the impediments and the necessary progress that still need to be

[1] It should be noted that while economic activity has firmed up during 2016, the early readings of the national accounts pointed to substantial weakness. At the time, they provided further support for maintaining an accommodative monetary position.

made, they are highly committed to the goal of improving housing affordability, including by investing their own political capital, and it is high on the agenda of the Ministry of Finance.

As increasing supply is a slow process, demand-side measures such as the "buyer's price" program and taxation of owners of more than one apartments, are invoked to provide a short-term relief. We note that the appropriateness and effectiveness of these measures are subject to ongoing public debate. That said, there is a broad consensus among the authorities that the key for resolving this issue lies in the supply side, and as described above, progress is being made in the right direction.

Financial Stability and Macroprudential Measures

As indicated by staff, the banking system is stable and healthy, and currently the main concerns are directed to improving its competitiveness while preserving financial stability. The main financial risks are associated with the high level of house prices, and this is appropriately reflected in the risk assessment matrix. Nevertheless, loan-to-value and payment-to-income ratios in the mortgages market are low in international comparison, and, since 2009, the Bank of Israel has launched a series of macro-prudential measures to contain these risks (see Annex IV of the staff report). We note that these measures are aimed at safeguarding financial stability rather than suppressing house prices by means of constraining demand as they mostly target the marginal mortgage with the riskiest profile, not the average one. Risk indicators suggest that these efforts are fruitful; for example, following Banking Supervision directives the share of mortgages with payment-to-income ratio higher than 40 percent has fallen from 19.0 percent in 2012 to 0.5 percent in 2016, and the share of mortgages with loan-to-value ratio higher than 60 percent has fallen from 41.0 percent to 30.1 percent over the same period. Mortgages with leverage ratio higher than 75 percent have practically vanished.

The Labor Market, Productivity and the Demographic Challenge

The labor market is strong. Unemployment rate is at a multi-decade low and the participation rate is at a record high. This achievement is supported by protracted measures for over a decade aimed at incentivizing employment, e.g. through earned income tax credit, and disincentivizing unemployment and labor market detachment, e.g. by stricter eligibility criteria for unemployment benefits and reducing child allowances. The improvement in the labor market is however accompanied by sluggish productivity growth, which is at least partly driven by a benign factor—the increased labor market attachment of workers with weaker labor market skills. Nevertheless, the demographic composition of these workers, largely associated with the Haredi (ultra-orthodox Jews) and Arab populations, poses one of the greatest long-term macroeconomic challenges to the Israeli economy, as these groups are expected to become a majority in Israeli society within a few decades. Strengthening their labor market skills and keep improving on their labor market attachment will also address, at least partly, the inequality and poverty challenges as rightly emphasized by Staff.

Increasing labor force participation is probably one of the most effective mechanisms for improving growth inclusiveness. The Haredi society and Arab women have traditionally had the lowest participation rates in the Israeli labor market. Nevertheless, the participation rate of both populations have increased markedly over the past decade. In 2001–05 the participation rate of Haredi population in main working-age (25–64) averaged 46.4 percent while in 2015 it reached 63.7 percent, where most of the improvement was driven by the entry of Haredi women in the labor market. Over the same period and age group the participation rate of Arab women has increased from 25.1 percent to 34.6 percent.[2] Clearly there is much room for further improvement in both populations, but the trend is robust and encouraging. That said, new workers from these groups typically have weaker labor market skills, thereby reducing average labor productivity. The challenge is therefore to keep increasing their participation rate while equipping them with stronger labor market skills. This would boost labor productivity and support more inclusive growth.

The macroeconomic importance of integrating Haredi and Arabs workers in the labor market in both extensive (participation) and intensive (skills) margins goes well beyond inclusiveness. The fertility rates of both groups, although declining, are higher than that of the rest of the population, and the demographic projection of the Israeli Central Bureau of Statistics envisages that within 40 years the Haredi and Arab communities combined will account for about 50 percent of the total population, compared to 32 percent in 2015. Putting projections aside, in 2015 Haredi and Arab children aged 0–9 have already accounted for 43 percent of that age group, compared to a share of 26 percent of these communities in the main working age population (25–64). The authorities recognize that with such demographic dynamics it is crucial to keep making progress with improving labor market participation and strengthening the skillsets in these communities.

The authorities see this issue as one of their greatest long-term macroeconomic challenges and have embarked numerous programs for promoting labor market attachment and improving productivity, in addition to providing better incentives through the tax system and social benefits. While some programs apply to the general population, many specifically target the Haredi and Arab communities. We list a few of them here to provide a general sense of the type of programs available: “One-Stop Career Centers” aim to enhance employment in the Haredi, Arab and Ethiopian immigrant communities, and they also target people with disabilities. These centers provide vocational training, help developing soft skills, provide guidance and assist with job placement. To better integrate Arabs in the high-tech industry, the government assists students and academics with job placement and subsidizes employee salaries through an "employment track" program for interns. Haredi students of high-tech professions at the Vocational Training System are entitled to scholarships. Other programs, through the Small and Medium Businesses Agency, support

[2] For comparison, the participation rate of the non-Haredi non-Arab population has improved as well but at much less impressive rates, from 79.8 percent to 87.4.

and guide entrepreneurship initiatives in both Arab and Haredi communities. Micro-finance loans are available to Arab women entrepreneurs. Special daycare subsidies also target Arab women.

The substantial rise in labor force participation over the past decade occurred on the back of such programs and other incentives. Staff rightly point the high poverty rate and inequality in Israel compared to other OECD countries, however these are on a persistent declining path, albeit a moderate one, since 2006 alongside improvement in labor market attachment. The authorities concur that pressing ahead with reforms to improve skills and increase labor market participation is the right way forward and they are crucial for the long-term outlook of the economy.

Conclusion

The macroeconomic performance of the Israeli economy is strong. Growth has accelerated in 2016, labor force participation is at an all-time high, the unemployment rate at its lowest level in decades, inflation is under check, debt-GDP ratio is on a declining path for over a decade and the financial system is strong. Challenges are mostly structural. High house prices driven by supply-side shortages are most pressing, and demographic dynamics weigh on long-term labor productivity. The authorities recognize these challenges and take actions to confront them. There is substantial progress on both fronts, but plenty remains to be done.

The authorities thank Mr. Beaumont and his team for the excellent discussions and report and look forward to future cooperation with the IMF.