INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/20

ISRAEL

January 2021

2020 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 2020 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 January 19, 2021 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 January 19, 2021, following discussions that ended on November 18, 2020, 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 December 18, 2020.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Staff Representative** for Israel.
- 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.

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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR21/19

IMF Executive Board Concludes 2020 Article IV Consultation with Israel

FOR IMMEDIATE RELEASE

Washington, DC – J**anuary 21, 2021:** On January 19, 2021, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Israel.

The COVID-19 pandemic has severely impacted Israel's society and economy. While Israel's strong growth and large pre-crisis buffers mean Israel entered the crisis with relatively low vulnerabilities, real GDP still contracted by 3 percent (yoy) in the first three quarters of 2020. The scale of the COVID-19 spread required strict containment and mitigation measures, including three nation-wide lockdowns. Nonetheless, the economic contraction was smaller than in other advanced economies in part due to the resilience of the Israeli economy, supported by its large high-tech sector.

The authorities introduced policies to curb the economic fallout of the pandemic. On the fiscal front, a fiscal package of 10¼ percent of GDP for 2020 was approved by parliament. The package included expanded health funding, benefits for unemployed and furloughed workers, grants for the self-employed, and grants and loan guarantees for small and medium enterprises. The central bank's response included measures to ease financial conditions, provide liquidity, and ease access to financial services and credit, including for households and SMEs. Macroprudential and supervisory requirements were also eased, allowing banks to utilize their capital and liquidity buffers in support of the economy.

Executive Board Assessment[2]

Executive Directors commended the authorities for the appropriately rapid and large monetary and fiscal support in response to the COVID-19 pandemic, which has helped soften its impact on the country. They also welcomed the authorities' efforts for early wide-spread vaccination, which could lead to a faster recovery. Going forward, as uncertainties remain high, Directors saw merit in continued supportive policies, as well as measures to strengthen social protection and reforms to enhance the resilience of the economy.

Directors concurred that fiscal policy should remain supportive and gradually become more targeted. Prompt adoption of the 2021 budget would help prioritize spending, position the economy for growth, and reduce economic uncertainty associated with the pandemic. Directors considered that, if further downside risks materialize, fiscal support should be maintained beyond mid-2021. They also noted that once the recovery is on firm ground, fiscal efforts will be needed to restore pre-crisis buffers and rebuild fiscal space.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] 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.

Directors commended the Bank of Israel's swift response to the crisis and concurred that monetary policy should remain accommodative. They agreed that, going forward, as inflation trends toward the target band, FX intervention should cease as a tool for managing inflation expectations and its use be limited to addressing disorderly market conditions.

Directors noted that Israel's financial system is well prepared to face the impact of the pandemic. Banks' capital remains strong, with substantial capacity to face large shocks. Nonetheless, Directors stressed that unless downside risks materialize, the minimum regulatory capital should not be lowered further, and structural buffers should eventually be restored. They also noted that efficient handling of a potential increase in nonperforming loans would help limit debt overhang and spur capital reallocation.

Directors emphasized that structural reforms should aim to tackle pre-COVID legacies, including low productivity and high inequality. Better funded labor activation policies, digitalization, and education reforms would help strengthen marketable skills of low-skilled workers, who were especially affected by the pandemic. Directors also encouraged completing governance reforms, particularly in procurement and AML/CFT.

Israel: Selected Economic Indicators, 2016–2022

	2016	2017	2018	2019	2020	2021	2022
					Projections		
Real Economy (percent change)							
Real GDP	3.8	3.6	3.5	3.4	-4.0	4.1	5.0
Domestic demand	6.7	3.9	3.4	3.5	-6.8	6.4	5.4
Private consumption	6.4	3.3	3.7	3.8	-10.0	7.3	6.7
Public consumption	4.2	3.5	3.9	2.8	2.3	5.0	3.0
Gross capital formation	10.4	6.0	2.5	3.5	-7.7	5.6	4.9
Gross fixed investment	12.7	4.6	5.1	2.5	-9.2	7.3	4.9
Foreign demand (contribution to growth)	-2.7	-0.4	0.0	0.0	2.8	-2.1	-0.4
Potential GDP	3.5	3.4	3.4	3.0	1.8	3.4	3.3
Output gap (percent of potential)	-0.2	0.0	0.1	0.6	-5.2	-4.6	-3.0
Unemployment rate (percent)	4.8	4.2	4.0	3.8	4.5	5.9	4.9
Overall CPI (percent change, end of period)	-0.2	0.4	0.8	0.6	-0.7	0.5	0.5
Overall CPI (percent change, average)	-0.5	0.2	0.8	0.8	-0.6	0.1	0.5
GDP Deflator (percent change, average)	1.0	0.2	1.3	2.2	-0.8	1.1	0.7
Saving and investment balance							
Gross national saving (percent of GDP)	24.4	24.6	23.8	24.8	24.7	24.4	24.2
Foreign saving (percent of GDP)	-3.3	-3.1	-2.1	-3.4	-4.0	-3.7	-3.5
Gross capital formation (percent of GDP)	21.1	21.5	21.7	21.4	20.6	20.7	20.6
Public Finance (percent of GDP)							
Central government							
Revenues and grants	26.3	26.5	25.5	24.7	23.1	24.7	24.7
Total expenditure	28.4	28.4	28.4	28.4	36.5	34.0	31.7
Overall balance	-2.1	-2.0	-2.9	-3.7	-13.2	-9.0	-6.7
General Government							
Overall balance	-1.4	-1.1	-3.6	-3.9	-13.3	-9.7	-6.8
Debt	62.1	60.6	60.9	60.0	73.0	79.1	81.6
Balance of Payments (percent of GDP)							
Current account balance	3.3	3.1	2.1	3.4	4.0	3.7	3.5
Goods and services balance	1.4	1.1	0.7	1.9	4.2	3.1	2.9
Foreign reserves (eop, US$ billions)	98.4	113.0	115.3	126.0	161.3	165.6	169.5
Exchange Rate							
NIS per U.S. dollar (period average)	3.84	3.60	3.56	3.45	...	...	...
Nominal effective exchange rate (2005=100)	111.3	118.7	123.2	125.5	...	...	...
Real effective exchange rate (2005=100)	103.3	108.1	108.6	109.1	...	...	...
Terms of trade (2010 = 100)	108.2	104.6	95.3	98.7	101.9	100.4	100.5

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

INTERNATIONAL MONETARY FUND

ISRAEL

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION

December 18, 2020

KEY ISSUES

- **The economic impact of the COVID-19 pandemic is unprecedented**. Israel's economic activity recorded a historic contraction, and the outlook remains challenging, with possible long-term scarring. Uncertainty is high, mainly driven by the evolution of the pandemic, the prospects for widespread vaccine distribution, and political uncertainty.
- **The fiscal relaxation has been appropriate, and the 2021 budget should be adopted promptly to ensure that fiscal stimulus remains available**. The timing of fiscal withdrawal should balance the need to support the economy with that of preserving fiscal space to face a potentially prolonged disruption. During the recovery period, the authorities should place greater focus on labor activation policies, strengthening the social safety net, and job-rich investment. Fiscal consolidation, which should commence only once the recovery is firmly established, will be needed to address medium-term debt vulnerabilities and create space for more inclusive growth.
- **Bank of Israel's response to the crisis has been fast and effective, helping to arrest market overreaction, restore confidence, and sustain credit flow**. With subdued inflation and a negative output gap likely to prove persistent, monetary accommodation and liquidity support to financial markets and institutions needs to be maintained. Should extending liquidity support in response to new lockdowns prove necessary, it should target viable businesses. Further financial policies will need to reflect the state of the pandemic, potential deterioration in asset quality, and the capacity of the financial system to face larger shocks. Measures to prepare the financial and the judicial systems to deal efficiently with a potential increase in business insolvencies need to be put in place.
- **Structural policies should aim to mitigate long-term scarring and strengthen the resilience of the economy**. Addressing vulnerabilities in the labor market should take priority. The current crisis is also an opportunity to tackle pre-COVID legacies that have stalled productivity and raised inequality and poverty. The focus should be on better funded activation policies, digitalization, education, and investment. Progress in improving governance is welcome and further efforts would support the effective use of public money into structural programs.

Approved By
Philip Gerson (EUR) and Martin Sommer (SPR)

Virtual discussions were held during November 2–18, 2020. Mission members included Iva Petrova (head), Enrique Flores, Seng Guan Toh, and Jing Zhou (all EUR). Shay Tsur (OED) joined the discussions. Indra Mahadewa and Hyun Woo Park supported the mission. The mission met with Bank of Israel Governor Yaron, senior representatives of the Ministry of Finance and the Prime Minister's Office, other senior officials, and private sector representatives.

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CONTEXT

1. The Israeli economy enjoyed strong growth prior to the pandemic. Real annual GDP growth averaged about 3.5 percent in 2000–19, reflecting rapid accumulation of capital, work-age population growth, and rise in labor force participation. Israel's dynamic information and communication technology (ICT) sector—a breeding ground for startups and hosting R&D centers of large technology companies—contributed significantly to Israel's gross value added and high-paced growth. However, productivity in other sectors is low, and overall labor productivity is well below that of other small open advanced economies.[1]

2. Large precrisis buffers mean Israel entered the crisis with relatively low vulnerabilities. At end-2019, household debt was about 42 percent of GDP, with high-quality mortgage loans accounting for about two-thirds of that total. Corporate debt (68 percent of GDP) is largely domestic. Banks enjoy strong capital, sound leverage ratios, and high asset quality and liquidity indicators. Current account balances averaging 3½ percent of GDP in the last five years have helped double Israel's net international investment position to 40 percent of GDP and reduce gross external debt to 27 percent of GDP.

3. Inequality and poverty are high compared to other advanced economies. Relative poverty—based on disposable income—is prevalent among the Israeli-Arab and Haredi groups, reflecting their relatively low labor force participation and skills.[2] Welfare reforms that took place in the early 2000's aimed at addressing market income inequality by encouraging labor force participation. However, these reforms also reduced child benefits, deepening poverty among the Israeli-Arab and Haredi population.

4. A fragile coalition keeps the political situation uncertain. The coalition—formed after three inconclusive elections—allows Likud and Blue and White to share power, with Blue and White leader (and current defense minister) Benny Gantz scheduled to take over as prime minister from Likud's Benjamin Netanyahu in November 2021. The coalition agreement also envisaged a two-year budget being adopted by August 24, but the deadline has since been extended, and failing to pass a 2021 budget would result in new elections. While a change in the course of economic policies is not expected in such an event, short-term uncertainty could be significant.

5. The geopolitical environment remains complex. Recent events in Lebanon and Iran and tensions in the eastern Mediterranean have raised risks of regional conflicts. On the positive side, Israel's historic peace accords with the UAE and Bahrain raise hopes for a normalization of the country's political and economic relations in the Middle East.

6. Traction on previous Article IV advice is mixed. Monetary policy has remained accommodative pending durable rise in inflation and inflation expectations. Legislation establishing a Financial Stability Committee (FSC) was approved in November 2018, and the FSC has been

[1] See Argov and Tsur (2019) and Hazan and Tsur (2019) for a comparison across sectors and with peer countries.

[2] Haredi—ultra-orthodox Jews—have low equivalized incomes, reflecting high number of children and lack of marketable skills among Haredi male.

actively engaged in policy discussions during the pandemic. A new bank was approved in September 2019. Limited progress was made in reducing public debt, with land sales playing a significant role, and planned consolidation frequently slipping due to tax cuts. Progress toward setting up a deposit insurance and plans for a deep education reform are pending.

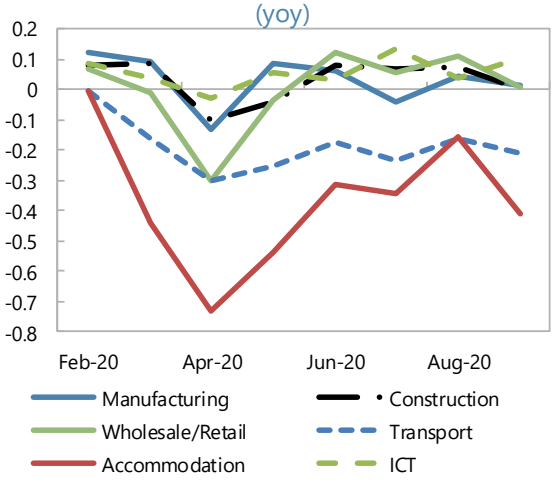
RECENT ECONOMIC DEVELOPMENTS

7. The impact of the pandemic is without precedent. As the spread of the virus accelerated globally in March, the authorities implemented a series of early containment measures (Figure 1). Travel restrictions, social distancing measures, and a nation-wide lockdown with closures of schools and businesses, except for essential services, successfully flattened the curve, sparing hospital resources and keeping the mortality rate well below that in other advanced economies. Reopening started early—in mid-April—with gradual easing steps, allowing larger share of employees in the workplace and reopening schools, stores, and restaurants in a phased way. In June, a resurgence in morbidity surpassed the initial peak of daily cases and accelerated with the start of the new school year. Containing the second wave proved more challenging and led to the eventual imposition of a second nation-wide lockdown in mid-September.

8. Economic activity recorded a historic contraction in the first three quarters of 2020. Real output collapsed by 3 percent yoy in January–September. Private consumption fell by 10 percent yoy, contributing the most to the plunge (Figure 2). Net exports dampened the contraction by 3.3 percentage points due to a large decline in imports and some resilience in ICT exports. Across sectors, accommodation and food services, transportation, and wholesale and retail trade were the most severely affected by the lockdown and social distancing measures. As of September, revenues in the accommodation and transportation sectors were still 41 and 21 percent below pre-COVID levels, even as revenues in other sectors have recovered. Nonetheless, the small share of heavily affected sectors in gross value added—about 15 percent—has made Israel's real output contraction somewhat milder than that of other advanced economies.

Growth in Revenue Indices by Sector

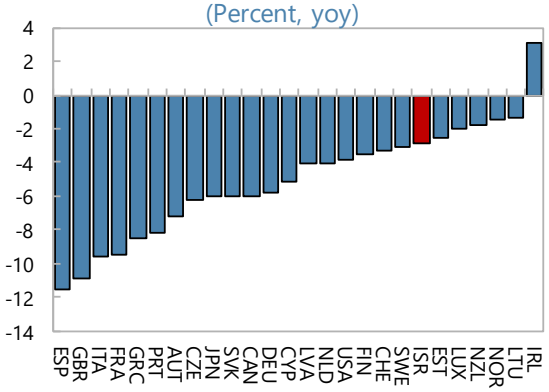
(yoy)



Source: Haver Analytics.

Real GDP Growth, January-September 2020

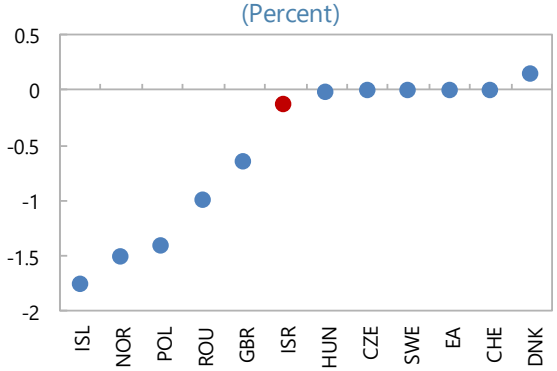
(Percent, yoy)



Sources: Haver Analytics; Eurostat; IMF Staff calculations.

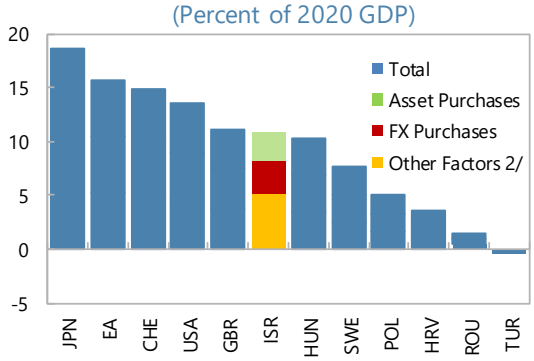
9. Bank of Israel's (BoI) response was fast and effective. With policy rates near the zero bound, the policy interest rate was reduced by only 15 basis points to 0.1 percent. Instead, the BoI launched aggressive unconventional measures via asset purchases to ease financial conditions, provide liquidity, and strengthen monetary policy transmission. Repos, FX swaps, and a government bond purchase program that reached a total ceiling of about 6½ percent of GDP (NIS 85 billion), about 3.4 percent of GDP of which was utilized as of end-November, pumped liquidity into the financial system. BoI's innovative tools also included corporate bond purchases, with a ceiling of NIS 15 billion (around NIS 3.5 billion purchased by end-November and two tranches (3-year and 4-year terms respectively, at low rates) of term funding to banks for on-lending to small and medium enterprises (SMEs).

Policy Rate Changes
(Percent)



Source: Haver Analytics.

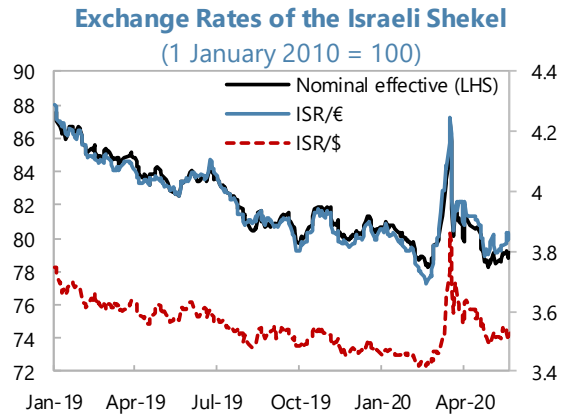
Balance Sheet Expansion by Central Banks 1/
(Percent of 2020 GDP)



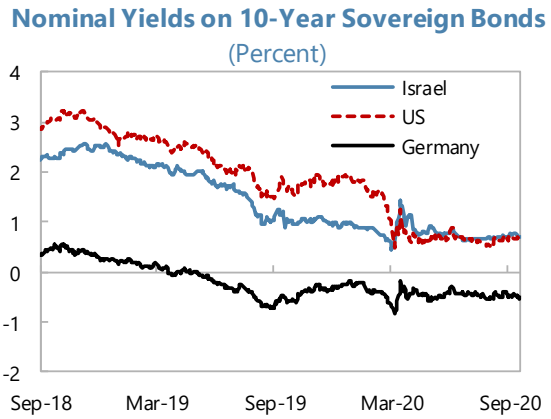
Sources: Central Banks; Haver Analytics; IMF, World Economic Outlook.
1/ The expansion is calculated as difference between CB's asset value in latest available month and February 2020.
2/ Other Factors includes FX proceeds held as foreign assets at BoI from sovereign bond issuances.

10. The BoI also eased macroprudential and supervisory requirements. Allowing banks to utilize their strong capital buffers, the BoI reduced regulatory capital by 1 percentage point and eliminated an additional Tier-1 capital charge on housing loans. Leverage ratio requirements were also reduced in November. Measures in support of households and businesses included raising the loan-to-value cap on residence-backed loans from 50 to 70 percent, allowing banks to use pre-crisis income in mortgage debt-service-to-income ratios, raising the cap on construction company loans in banks' loan portfolios from 20 to 22 percent, increasing limits on overdraft credit facilities, suspending restrictions on accounts of customers with bounced checks, supporting a framework for banks to negotiate loan deferrals, and a range of pandemic-related consumer protection measures.

11. The measures have arrested the initial market overreaction and supported confidence. Uncertainty about the severity of the pandemic in March caused a major financial market shock, creating a liquidity shortage in foreign exchange, bond, and equity markets, and raising concerns about the continued orderly provision of credit by financial institutions. Since then, a rebound has



Sources: Bank of Israel; Datastream.



Source: Datastream.

taken place. Aided by unprecedented global monetary easing and BoI's actions, exchange rate volatility has abated, and 10-year government bond yields have reverted to pre-pandemic levels. Corporate bond spreads have narrowed from their earlier spike, and the equity market index has partially recovered from its March loss, with new debt and equity issuances also rebounding.

12. Fiscal policy measures were rolled out gradually. Parliament approved a stimulus package in April and several subsequent packages amounting to an overall planned stimulus of NIS 138 billion (about 10¼ percent of GDP) in 2020, including: (i) expanded health funding; (ii) benefits for unemployed and furloughed workers[3], grants for the self-employed, and universal grants; (iii) guaranteed loans for companies, temporary property tax exemptions, tax and payment deferrals, and (iv) infrastructure and investment support. The execution rate will likely exceed 86 percent by year end, and the deficit outturn is expected to be about 13 percent of GDP—a fiscal expansion unprecedented in Israel's recent history (Figure 3).

Fiscal Support in Response to COVID-19
(Percent of GDP)

	Execution Mar-Nov 2020	Planned
Total	**7.10**	**10.38**
Health	**0.79**	**1.20**
Households	**2.87**	**3.89**
Grants	0.74	0.86
Unemployment	2.13	2.93
Others	0.01	0.10
Business	**3.31**	**4.95**
Tax relief	0.21	0.29
State-guarantees	1.67	2.64
Others	1.43	2.02
Growth	**0.13**	**0.34**
Infrastructure	0.09	0.16
Others	0.04	0.19

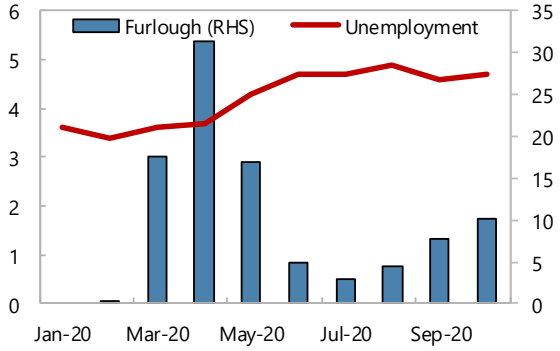
Sources: Ministry of Finance; IMF Staff calculations

13. Nonetheless, unemployment has picked up. Following the lockdown in March-April, 1.8 million workers (31 percent of labor force) were furloughed due to COVID-19. Cushioned by the unemployment benefit program, more than 80 percent of these workers recouped their jobs before the second lockdown. The seasonally adjusted unemployment rate increased to 4.7 percent in October, compared with 3.6 percent at the beginning of 2020 (Figures 4–5). Meanwhile, real wages

[3] Additional funding of NIS 72½ billion has been approved for 2021, including to extend benefits for unemployed and furloughed workers.

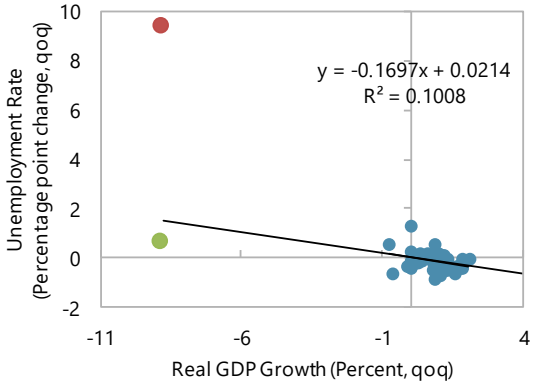
increased by 7 percent in the first eight months, as low-paid workers were more likely to be furloughed or dismissed.

Unemployment and Furlough
(As share of total labor force)



Sources: Bank of Israel; Haver Analytics; IMF Staff Calculations.

Okun's Law Fit
(2006:Q1-2020:Q2)

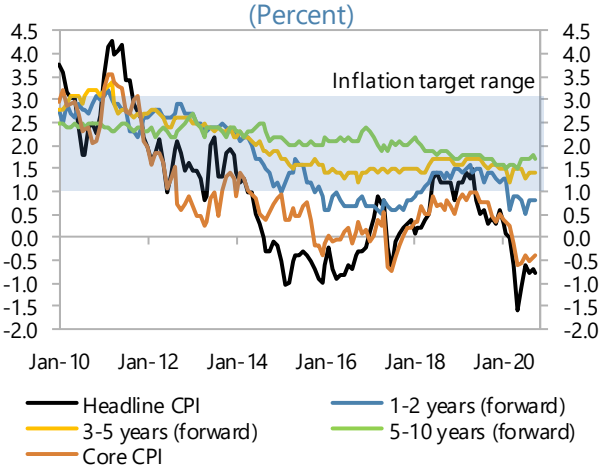


Sources: Haver Analytics; IMF Staff Calculations.
Note: The Okun's Law is estimated for 2006Q1-2019Q4 period. Green dot is change in unemployment in 2020Q2, red dot is change in unemployment and furlough in 2020Q2.

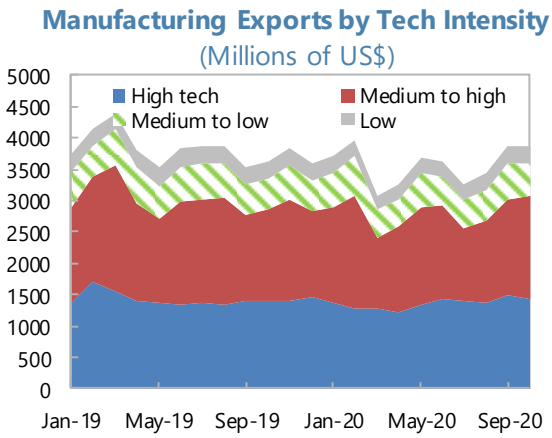
14. The inflation rate dropped well into negative territory due to low energy prices and subdued demand. The price level declined by 1.6 percent yoy in May and has remained suppressed since then (Figure 6). Core inflation has also remained negative with the collapse in demand due to the lockdowns and precautionary savings. Clothing and footwear, transportation, and communication prices declined by 3–5 percent. Notwithstanding cyclical disinflation factors, 5- and 10-year inflation expectations remain anchored within the 1–3 percent inflation target band.

15. The current account remained resilient. Imports plummeted by 10 percent yoy in January–September, mainly due to a 40 percent drop in transportation equipment and fuel imports. Exports increased by 0.3 percent (Figure 7), due to a rebound in the high-tech industries, which contribute 50 percent to total goods exports and over 50 percent to service exports. Despite residents' strong portfolio investment abroad, capital inflows accelerated in in the first nine months supported by bond issuance and stronger FDI. Net international reserves reached $166.9 billion in November 2020 (18 months of imports), up from $126 billion at end-2019, $19 billion of which was due to Israel's sovereign bond issuances.

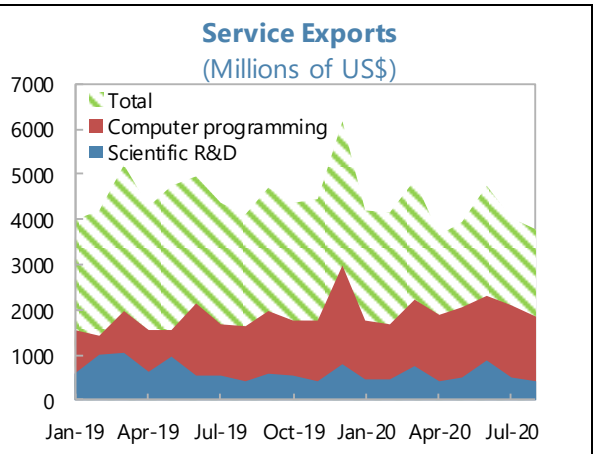
Inflation and Inflation Expectations
(Percent)



Sources: Haver Analytics; IMF Staff calculations.



Source: Haver Analytics.



Source: Haver Analytics.

OUTLOOK AND RISKS

A. The Near-Term Recovery Will Be Gradual

16. Output fell sharply in 2020. Staff's baseline projection envisages a decline of 4.0 percent despite tentative signs of recovery during the summer. The resurgence of COVID-19 cases and reintroduction of lockdown measures weighed on activity in Q4. Re-opening in the last two months of the year is likely to have driven an improvement in domestic demand and investment. The unemployment rate is projected to have risen to over 5 percent by end-2020, reflecting difficulties in re-employing furloughed workers in the hardest hit sectors. Headline and core inflation are projected to have declined to –0.5 and –0.4 percent, respectively, on average in 2020, mainly due to compressed demand and output gap of 5.2 percent of potential GDP.

17. A mild rebound will emerge in 2021. Real GDP is projected to increase by 4.1 percent in 2021, carrying over the slow 2020Q4 momentum. Recovery is likely to remain tentative in 2021Q1, with voluntary social distancing continuing to constrain domestic demand. Real GDP is thus projected to remain 5.7 percent below its pre-COVID level. Inflation will pick up moderately, undershooting BoI's lower end of the target band, while unemployment would remain high during the reallocation of the stock of furloughed and dismissed workers.

B. Scarring May Dent the Medium-Term Outlook

18. The medium-term recovery is likely to be partial. Both real GDP and potential output are projected at about 1 percent below the 2025 pre-COVID trend (Annex II). Scarring is projected to be relatively limited compared to other advanced economies due to the relatively larger share of the ICT sector in Israel's value added (19 percent) compared to the average in OECD countries

(11 percent). Nonetheless, the COVID-19 shock is likely to be more persistent than Israel's previous crises—including the Global Financial Crisis—which had no or marginal long-term scarring impact. Staff's baseline projection assumes that social distancing will continue into 2021 but fade over time as vaccine coverage expands and therapies improve.

Israel: Macroeconomic Outlook

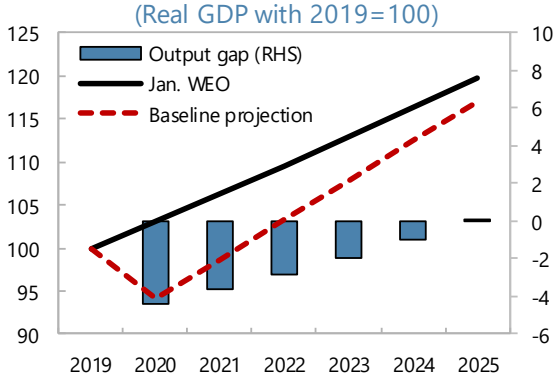
	2019	2020	2021	2022	2023	2024	2025
	(In percent)						
Real GDP growth	3.4	-4.0	4.1	5.0	4.6	4.1	3.6
Unemployment	3.8	4.5	5.9	4.9	4.5	4.2	4.0
Inflation (eop)	0.6	-0.7	0.5	0.5	0.8	0.8	0.8
	(In percent of GDP)						
Fiscal balance	-3.9	-13.3	-9.7	-6.8	-4.9	-4.5	-4.3
Current account balance	3.4	4.0	3.7	3.5	3.3	3.1	2.9

Source: Haver Analytics; IMF Staff calculations.

Bankruptcies are expected to pick up, resulting in some destruction of physical capital and resource misallocation. In the labor market, scarring would leave the unemployment rate slightly higher than the pre-COVID level by 2025. With significant slack in the economy—the negative output gap is not projected to close until 2025—inflation would stay below BoI's target well into the medium term.

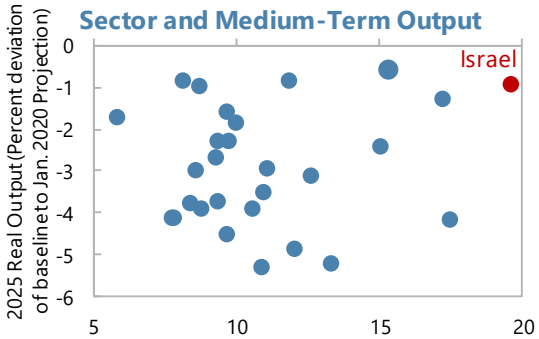
Real GDP and Output Gap

(Real GDP with 2019=100)



Sources: IMF, World Economic Outlook; IMF Staff calculations.

Advanced Economies: Value Added of ICT Sector and Medium-Term Output

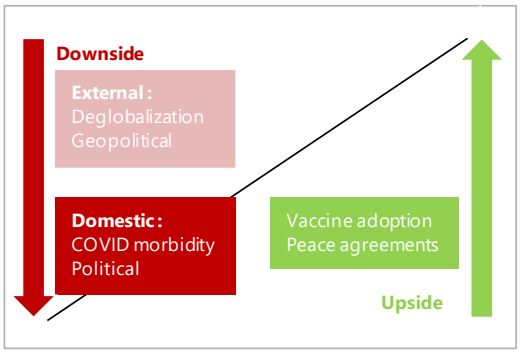


Sources: IMF, World Economic Outlook; OECD; World Input-Output Database; IMF Staff calculations.
Note: January WEO real output projections for 2025 are imputed by applying 2024 real growth rates.

C. Risks are Unprecedented

19. Multidimensional risks widen uncertainty around the baseline. Early widespread vaccine distribution could boost confidence in the near term, allow activity to resume faster, and prevent medium-term scarring. Israel's contracts with major vaccine producers for early delivery and vaccination commencing in December make this a plausible upside scenario. On the downside, a reescalation of the pandemic may result in tightening or a prolonged use of lockdown measures, heightened vigilance and voluntary social distancing, bringing further disruptions to economic activity (Box 1). In this case, larger fiscal support would be needed, which could exhaust fiscal space and jeopardize fiscal sustainability. These challenges would be amplified if market risk appetite wanes and financing conditions tighten.

Balance of Risks



20. Failing to contain the pandemic could drain political capital and raise discontent. The government coalition agreement would be tested if lack of control over a resurgence of cases or ongoing disagreements (e.g., over the 2021 budget) fuel a perception of unnecessary social and economic cost despite significant fiscal policy support. A broad consensus over the course of economic policies across the political spectrum is a mitigating factor in the event of new elections, but short-term uncertainty could be significant.

21. External challenges remain significant. Adverse regional geopolitical developments could damage confidence, derail the fragile recovery, and absorb fiscal resources badly needed to support the economy. On the upside, the recent peace agreements with the UAE and Bahrain may reduce regional tensions and lead to enhanced trade and commercial relations.

22. Deglobalization continues to be a risk. Advanced countries' efforts to reshore industries and protect supply chains may result in more intense trade barriers. Border closures to contain the spread of COVID-19 could also become more widespread. Israel's large export share of high-tech industries is a mitigating factor.

23. The authorities broadly shared staff's views on the outlook. The high unemployment and furlough rate, especially of low-productivity workers, was a cause for concern, particularly as it appeared disproportionately larger than the output contraction. Nonetheless, they considered that hysteresis is unlikely to cause long-term scarring due to Israel's relatively flexible labor market and that investment in high productivity sectors would benefit the economy in the long run. They also considered deglobalization to be a low risk for Israel, as the ICT-related exports performed well even during the lockdown periods.

POLICY DISCUSSIONS: NAVIGATING THE BUMPY ROAD TO REOPENING AND RECOVERY

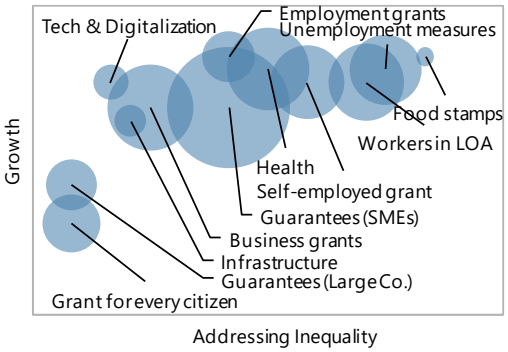
Policy discussions focused on the near-term options to limit the risks associated with the pandemic and promote the recovery. Fiscal policy needs to become more targeted to maximize the impact of the available fiscal space, while monetary policy needs to remain accommodative. Structural policies should aim to mitigate labor market vulnerabilities, strengthen economic resilience and foster a more inclusive recovery. Over the medium term, as the recovery becomes fully established, fiscal consolidation—to restore pre-COVID fiscal buffers—should resume in a growth friendly way, while exceptional monetary easing should be gradually withdrawn.

A. Fiscal Policy

24. Fiscal support has helped soften the impact of the pandemic. Urgently needed additional healthcare funding—about 1 percent of GDP—has boosted capacity to fight the pandemic. Support for households— benefits for unemployed and furloughed workers and grants for the self-employed—has mitigated the negative distributional impact of the pandemic, as

low-skilled workers were more likely to be driven out of jobs than were higher-skilled ones. Given low-income households' high propensity to consume, these measures also likely had a significant impact on aggregate demand. Poorly targeted programs like "grants for every citizen" likely had a lower impact on growth and income distribution. Support for businesses has largely focused on providing liquidity through guaranteed loans to SMEs, tax deferrals and grants.

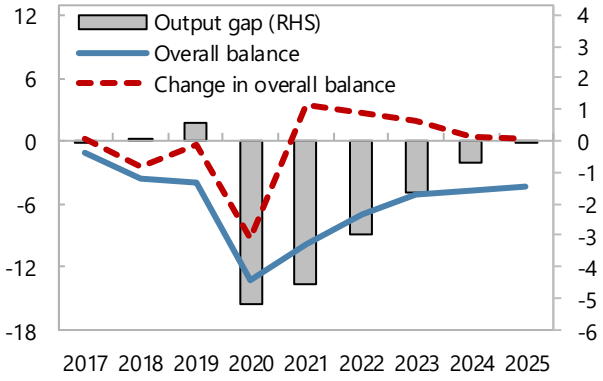
Stylized Characteristics of the Stimulus Plan



Sources: Ministry of Finance; IMF Staff calculations.
Note: Bubble size proportional to planned spending. The capacity of the measures to address inequality and support growth reflects staff's views and not a formal impact assessment.

25. The volume of fiscal support has been adequate. Given the authorities' current plans, staff estimates that the general government deficit has reached about 13 percent of GDP in 2020—an increase of about 9 percent of GDP relative to 2019. Nonetheless, in view of the exceptional uncertainty, the fiscal expansion has balanced reasonably well the tradeoff between protecting the economy from a larger downturn and preserving some fiscal space to meet a potentially larger shock. The government continues to have affordable access to funding in domestic and global markets, with average maturity increasing from 8.2 years at end-2019 to 9.5 years at end-June 2020.

Overall Balance and Output Gap
(Percent of GDP)



Sources: Central Bureau of Statistics; IMF Staff calculations.

26. Fiscal policy should remain supportive in 2021. Prompt adoption of the 2021 budget would help prioritize and reallocate spending to areas of greatest need, plan for growth-boosting reforms, and make contingencies for downside risks, thereby supporting transparency and confidence. Some stimulus measures are expected to expire by end-2020. Unemployment benefits and grants for businesses have been extended to mid-2021, and infrastructure spending, which has low implementation rate, is likely to carry over to 2021.[4] In addition, revenues are projected to recover with the economic rebound. The general government deficit is projected to decline by about 3½ percent of GDP in 2021 in the absence of further support measures. The authorities should consider maintaining fiscal support, particularly if downside risks materialize by allocating additional funding for health services, extending unemployment benefits beyond mid-2021, and providing further grants for the self-employed.

27. Assessing the appropriate timing to withdraw fiscal stimulus will be challenging, given heightened uncertainty. Staff's model-based analysis suggests that the withdrawal of fiscal support

[4] The stimulus package comprises "budgetary boxes" approved by parliament outside the budget process as one-off measures that will be discontinued by end-2021.

may need to occur more slowly than projected under the baseline, particularly if the output gap and scarring are larger than envisaged (Annex III). This analysis assumes higher multipliers than typical for Israel (slightly below one)[5], commensurate with the higher than typical output gap. As projections are subject to great uncertainty, the authorities need to continue balancing support to the economy with preserving fiscal space to face a potentially prolonged disruption.

28. The fiscal policy mix has been appropriate during the lockdown and reopening phases; it should gradually become more targeted. Fiscal support for the health sector should remain a priority to ensure adequate hospital capacity, testing and tracing, and to address care needs that may have been postponed during the lockdown and are now more urgent. Beyond health, a detailed plan for recovery is still needed (Text Table 1):

- **Lockdown.** During the lockdown, life-support to households included grants and unemployment benefits with greater coverage and duration.[6] Tax deferrals, property tax cuts, and SME loan guarantees supported firms' liquidity.[7] Modest public investment also took place.
- **Reopening.** Unemployment benefits, including for the furloughed were extended and linked to overall unemployment levels.[8] Grants introduced during the lockdown were allowed to expire. New employment encouragement grants started in July, but take-up remained minimal as of August. The provision of guaranteed loans gradually slowed.
- **Recovery.** While blanket transfers and benefits will be appropriately discontinued, plans for bolstering social protection need to be developed. Strengthening targeted benefits and preserving incentives to work could be achieved by raising the earned income tax credit. The one-off employment encouragement grants, which will be terminated during the recovery phase, need to be replaced with active labor market policies (ALMPs). Plans to scale up public investment projects that have been in the pipeline before the pandemic should focus on job-rich and inclusive projects. A comprehensive tax and benefit reform to stabilize debt while supporting productivity and growth should also be part of the policy mix.

29. Once the recovery is on firm ground, fiscal consolidation will be needed to place debt on a solid downward path. Staff's baseline projects that general government debt will increase from 60 percent of GDP at end-2019 to 80 percent by end 2021 and will remain on a mildly upward path over the medium term even with the roll-off of pandemic-related measures (Annex IV). Public debt will also become more vulnerable to shocks, including to feasible pandemic-related scarring risks. As stimulus measures expire and the output gap narrows over the medium term, the deficit is expected to decline to about 4½ percent of GDP. The 2025 primary deficit is projected to be slightly above the debt-stabilizing primary balance and higher than the level needed gradually to rebuild

[5] Multipliers embedded in 3 models used by the BoI average about 2/3 for public consumption and indirect taxes, and about 1/3 for direct taxes.

[6] Providing unemployment benefits for furloughed workers is similar to short-term work programs—to the extent that the beneficiaries actually return to work for the same employer.

[7] It took 4-months to execute 80 percent of the SME allocation.

[8] Benefits will be reduced by 10 percent if unemployment and furlough declines below 10 percent and eliminated if it falls below 7.5 percent or after June 2021—whichever is earlier.

buffers.[9] Once the recovery is on firm ground, a structural consolidation of about 2–2½ percent of GDP would be needed to place debt on a solid downward path under the baseline. Such a consolidation would be sufficient to stabilize debt even under a severe economic scarring scenario. However, even with concerted efforts, rebuilding pre-crisis buffers will take a long time. Moreover, further measures would be needed to create fiscal space to strengthen the safety net and improve infrastructure.

Text Table 1. Israel: Roadmap of Fiscal Actions 1/

	Lockdown	Reopening	Recovery
Households			
Transfers	Grants	Phase out untargeted grants and implement food stamps	Develop plan to enhance social protection
Unemployment benefits	Extended coverage to self-employed and furloughed and duration to mid-2021.	Benefit for furloughed now linked to labor market indicators	Develop plan to enhance social protection
Employment			
Short-term work	None	Scale up in line with scaling down unemployment benefits.	Reduce access for long-term cases.
Temporary hiring subsidy, other ALMPs	None	Initiated employment encouragement grant	Transition to ALMPs, especially improving skills.
Public Investment	Funded modest plans.	Boost execution of public works.	Scale up and specify multiyear public investment plans.
Tax Measures			
Temporary deferrals	VAT, social security and utility bills deferred	Discontinued tax deferrals	Consider tax debt restructuring plans, as needed.
Tax cuts	Property tax cut in March-May	One-off measure discontinued.	Consider tax cuts only as part of a package if fiscal space available.
Accelerated depreciation and tax credits	None	The accelerated depreciation is welcome, consider tax credits for firms that have resumed activity.	Consider options to encourage private investment, especially in job-rich and green activities.
Liquidity Support			
Loan guarantees	*Schemes for SMEs, large companies, and firms in high-risk sectors*	*Continue providing loan guarantees.*	*Plan for timely exit and manage risks by updating the guarantee inventory, properly record and disclose them, and include adequate budget provisions.*

1/ See October 2020 Fiscal Monitor, Chapter 2, which presents a roadmap of appropriate actions for the three stages of the pandemic. Description of Israeli authorities' actions as of November 2020. Colors from yellow to green indicate increasing degree of consistency with suggested roadmap. White blocks indicate recommended future steps.

[9] The pre-COVID debt-to-GDP target of the government was 60 percent.

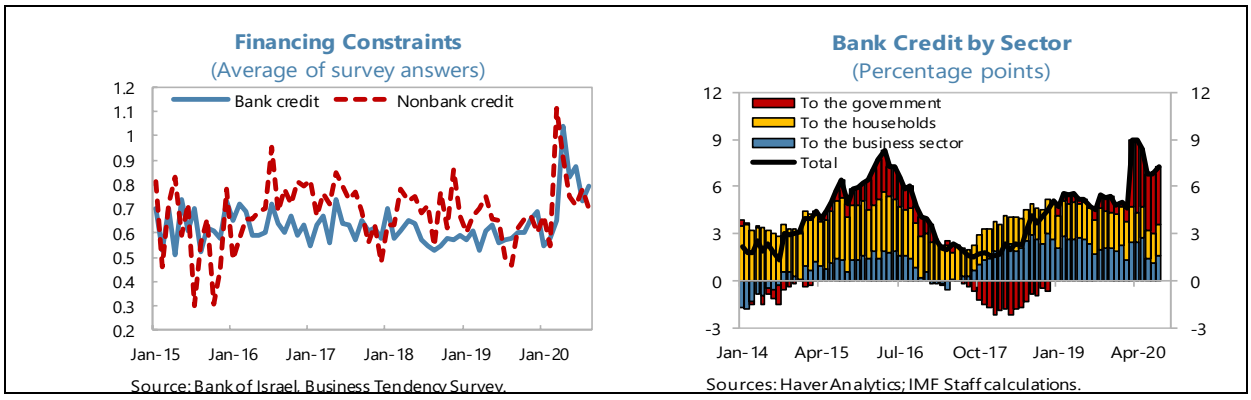
30. Tax reforms should help restore fiscal buffers while also addressing structural weaknesses. Israel's low level of civilian spending, and the need to raise infrastructure, education, and ALMP spending indicates revenues should be the main driver of fiscal adjustment (See 2018 Article IV Staff Report). Reducing tax benefits could preserve incentives for labor force participation—particularly of minority segments. There is scope to increase personal income tax rates to raise revenues at higher incomes without hurting marginal work incentives and raising the earned income tax credit to protect the poor, thereby also improving the progressivity of the system. Reducing tax incentives that disproportionately favor selected subgroups (e.g., training fund allowances) could also be considered. Pension tax exemptions could be streamlined as they reduce revenues and undermine equity and efficiency. There is scope to scale back profit-based corporate tax incentives and to increase statutory rates on intellectual property income.

31. The authorities concurred that fiscal policy should support the economy in the short term and plan for consolidation in the long run. They agreed on the need to pass a 2021 fiscal budget that remains supportive of the economy, along with approving important reforms that would encourage growth. The Ministry of Finance expressed confidence in the authorities' ability to address the impact of the pandemic even if a budget was not approved on time. The authorities also emphasized that adjusting household support should be done so as to enhance incentives to return to work. They concurred with the need for fiscal consolidation once the recovery was on firmer ground and saw scope to introduce spending cuts in addition to revenue raising reforms.

B. Monetary and Financial Policies

Monetary Policy: Accommodation and Targeting

32. Decisive, early, and appropriate monetary policy measures have helped provide market liquidity and sustain the flow of credit to households and businesses (Text Table 2). In response to these measures, pressures on exchange rates, bond yields and corporate spreads have diminished noticeably since the onset of the crisis in March. The measures have also helped accommodate the increase in government financing needs in response to the crisis, with the bond market protected from severe disruptions. Problem assets have not emerged as a pressing concern thus far.



Text Table 2. Israel: Roadmap of Monetary and Financial Actions 1/

	Lockdown	Reopening	Recovery
Monetary Policy	Moderate rate easing of 15 bps given zero lower bound and greater use of unconventional tools via asset purchase programs.	Accommodation maintained to date.	Maintain monetary policy accommodation until the policy objectives (e.g., inflation target) are achieved.
Liquidity to core funding markets	Secondary market purchases of government bonds (up to NIS 85 bill); FX swaps (up to $15 bill).	BoI asset purchases keep market financing costs and premia contained. Adjust pricing as appropriate to prepare for exit.	Withdraw support.
Liquidity to financial institutions	Secondary market purchases of government bonds and repos providing liquidity.	Maintain monetary operations and asset purchase operations.	Maintain liquidity support as required for monetary policy accommodation.
Provision of credit: ease macropru, support households and businesses, suspend dividends	Released 1 pp of capital buffers and 1 pp tier 1 capital requirement on housing loans; reduced banks' leverage ratio by 0.5 pp in November; allowed leniency on LTV caps; encouraged but no explicit ban on dividend and buybacks.	Macroprudential flexibility has been retained; the initial government guaranteed loan allocation to SMEs (NIS 18 bn) was fully disbursed, second NIS 18 bn allocation adopted.	Re-build capital and liquidity buffers gradually over time while ensuring financial institutions' capacity to extend credit.
Addressing problem assets	Guidance on asset classification and provisioning encourages restructuring of affected borrowers. Banks allowed to use pre-COVID income for capital calculation.	Measures have been maintained through the reopening phase.	Require banks to develop credible plans to reduce problem assets. Handle weak banks with significant credit losses. Create asset management companies and markets for problem assets.
Private debt restructuring	Mortgage forbearance allowed, and a framework for loan deferrals adopted (about NIS 10 bn in loans of 0.8 mill borrowers deferred in March-October, representing about 15 percent of banks' total loan portfolio and a quarter of mortgages).	Deadline for deferral requests was extended to prevent widespread insolvencies in the face of ongoing lockdowns. Banks' discretion to defer household loans should be gradually restored.	Facilitate debt restructuring to reduce debt burden. Prepare for efficient and effective insolvency procedures.

1/ See October 2020 Global Financial Stability Report, Chapter 1, which presents a roadmap of appropriate actions for the three stages of the pandemic. Description of Israeli authorities' actions as of November 2020. Colors from yellow to green indicate increasing degree of consistency with suggested roadmap. White blocks indicate recommended future steps.

33. Monetary accommodation through unconventional measures and liquidity support should be maintained. Extending the current set of policies remains broadly appropriate given low near-term inflation expectations, negative output gap projections, and uncertainties on renewed lockdowns. While keeping the policy rate around the zero-lower bound, the authorities' emphasis on unconventional measures, such as asset purchases, is also appropriate. Term premia, most notably for corporate bond spreads, remain elevated, and preserving bond market functioning anchored by the benchmark government yield curve remains crucial for financing. Some scope exists

for continuing government and corporate bond purchases.[10] The bank-based approach to relief programs has been relatively well-received to date, with Israel's traditionally rigorous bank supervision providing a safeguard against potential excessive credit risks.

34. Liquidity support extended in response to new lockdowns could be more targeted and needs to be supported by adequate corporate data analysis. In the event of new outbreaks, liquidity pressures on firms and households may re-emerge. If lockdowns and distancing measures are prolonged, the potential deterioration of credit quality as borrower's buffers are exhausted and/or authorities' stimulus measures fade could emerge as a key downside risk, especially if economic disruptions continue well into 2021. While support to hard-hit firms and households should continue as policy space permits, the modalities of prolonged support may need to be adjusted, conditional on the evolution of the pandemic. First, targeted fiscal measures instead of credit could be a more efficient way to help the most vulnerable firms and individuals. Second, while financing support would remain helpful, eligibility criteria would gradually have to be tightened to ensure that support goes only to viable firms. This would help limit debt overhang further down the road, support necessary business adjustments and debt restructuring, and facilitate post-pandemic reallocation of resources. Strengthening data collection and methodologies would also be critical to better assess vulnerabilities of households and firms against an uncertain outlook. Building on the collaboration among regulators since the start of the COVID-19 crisis, the FSC should play a focal role ahead in the analysis and policy coordination in addressing such vulnerabilities.

35. Given comfortable reserve levels, exchange rate flexibility should be the first line of defense against external shocks. Proceeds from sovereign bond issuances contributed about half of the total reserve accumulation to date in 2020. Furthermore, after the initial outflow pressures in March abated, sizable FX inflows associated with the unprecedented global monetary easing, exerted downward pressure on inflation and inflation expectations.[11] With near-term inflation expectations below target, the BoI used over $14 billion in FX purchases as an unconventional monetary policy tool to curb the exchange rate pass-through from the shekel appreciation to prices and thus counter deflationary pressures. This also stemmed an increase in real interest rates, which could have potentially undermined the impact of other monetary easing measures. It has, however, increased Israel's net international reserves well beyond adequacy metrics and precautionary motives, and staff assesses the external position as moderately stronger than fundamentals and desirable policies (Annex I). As inflation trends toward the target band, the BoI should cease FX intervention in managing inflation expectations and limit its use to addressing disorderly market conditions. Alongside, structural measures to boost the resilience of the economy, including public investment and strengthening the social safety net, would help improve resource allocation and reduce Israel's large precautionary savings.

36. The Bank of Israel concurred that monetary accommodation should continue until the policy objectives are achieved. Having undertaken wide-ranging measures to contain the

[10] The BoI's asset purchase program ceilings for government bonds is 6.6 percent of GDP, 40 percent of which unutilized, and the ceiling for corporate bonds is 1.1 percent of GDP, 75 percent of which unutilized, as of end-November 2020.

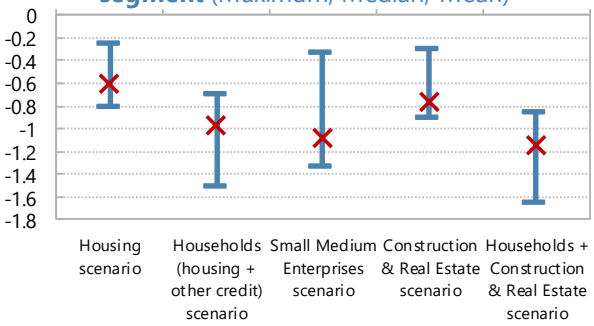
[11] The BoI estimates the passthrough from the NIS/USD exchange rate to inflation at approximately 10 percent.

pandemic-related pressures early on, the BOI has now focused on supporting a sustained flow of credit to businesses and households, with unemployment and the inflation target as major considerations. The BOI sees synergies in monetary accommodation, financial policy easing, and facilitating loan guarantee schemes for SMEs. In view of the shekel's ongoing appreciation, FX intervention is curbing price-dampening pressures from tradables to inflation. Furthermore, the BoI considers the shekel overvalued and FX purchases necessary to soften the overvaluation and facilitate a smoother path of the ongoing economic transition and reallocation of resources in Israel. Given comfortable reserve levels and the strong cyclical position of the current account, the BoI considers that exchange rate flexibility should continue to be the first line of defense in the event of external shocks, with FX intervention limited to addressing disorderly market conditions, which may arise from significant exchange rate deviations from fundamentals. The BOI emphasized that this view is consistent with the views adopted by the IMF in Israel's 2018 Article IV report.

Financial Policies: Keeping an Eye on Emerging Risks

37. Israel's financial system was well prepared to face the COVID-19 shock. Israel's banks weathered the global financial crisis unscathed, a result of rigorous and comprehensive banking supervision that had preserved financial stability. The banks entered the COVID-19 crisis with strong capital and profitability positions, underpinned by conservative business models (Figure 8). Banks are funded predominantly by domestic deposits (rather than cross-border funding), and a focus on diversified household lending has contained credit risks. The relatively tight macroprudential stance at the COVID-19 onset (instated to address earlier real-estate boom concerns) allowed space for meaningful relaxation in support of the economy. Capital buffers remain strong even after the release of 1 percentage point of capital and elimination of additional Tier-1 equity capital requirements for housing loans. Lowering banks' leverage ratio by 0.5 percentage points in November provided additional lending space. The relaxation of the LTV cap from 50 to 70 percent for residential loans remains still conservative on a cross-country basis. Insurance and pension sectors have benefitted from the rebound in global capital markets and raised their share of foreign equity investments.

Sensitivity Tests: Difference in capital adequacy ratio of banks under credit loss scenarios by loan segment (Maximum, Median, Mean)



Source: Bank of Israel, Financial Stability Report.

38. Banks have substantial capacity to face large shocks. The BoI's sensitivity tests for severe credit losses show that banks have ample capital to absorb losses in the face of medium severity scenarios, but some banks will approach their minimum capital targets in the most severe scenario. Given current exposures, banks are particularly sensitive to credit losses generated by households and SMEs.[12]

[12] The sensitivity tests applied the distribution of adverse loan segment-specific shocks derived from the US Dodd-Frank stress tests methodology. In every scenario all banks remain above the regulatory minima (9 percent for

39. In the event of a significant deterioration in asset quality, the BOI should strike a balance between providing accommodation and ensuring prudent buffers. While realized credit losses to date have been modest and less-than-expected by the authorities, banks have started raising credit loss provisions in 2020 in anticipation of larger losses. If loan portfolios deteriorate materially, loan classification standards should be maintained, but use of capital buffers can be accommodated while allowing a longer period to rebuild them. Unless downside risks materialize, the level of minimum regulatory capital should not be lowered further, and should eventually be restored, as structural buffers in the banking system are necessary given Israel's longstanding geopolitical risks.

Israel: Credit Loss Provisions
(Percent of total credit balances)

	2015-19 average	Q4-2018	Q1-2019	Q4-2019	Q1-2020
Bank Hapoalim	0.194	0.21	0.17	0.44	1.07
Bank Leumi	0.135	0.18	-0.03	0.22	1.20
Israel Discount Bank	0.316	0.32	0.33	0.40	1.42
First International Bank of Israel	0.124	0.19	0.17	0.16	0.71
Mizrahi Tefahot Bank	0.140	0.16	0.15	0.18	0.66

Source: Bank of Israel, bank financial statements.

40. Preparations need to be in place for efficiently handling a potential increase in business insolvencies, which would help mitigate scarring. [13] The BoI has established a framework for bank loan deferrals of smaller loans (including for SMEs), which has been extended several times.[14] Nonetheless, a surge in business insolvencies is still likely. Effective insolvency procedures will be crucial to minimize barriers to corporate restructuring and spur productivity-enhancing capital reallocation. Israel's insolvency framework overall appears effective (OECD, 2020), and a new Insolvency Law, in effect as of September 2019, added provisions for out-of-court restructuring. Adequate resources and mechanisms to implement the legislation efficiently need to be put in place ahead of a possible insolvency surge.

41. The authorities expressed satisfaction in the strength of the financial system, which allowed banks to support hard hit segments of the economy during the pandemic. Credit losses have been limited to date, and conservative loan loss provisioning has been actively encouraged and undertaken. The authorities considered that banks could continue financial accommodation in 2021 with ample capacity to absorb an adverse shock of longer duration. Given high uncertainty related to the evolution of the pandemic, they felt it was too early to commit to normalizing prudential standards or phasing out financial accommodation, including loan deferrals.

largest two banks; 8 percent for others). The household scenario (housing loans and household related credit) erased 0.7–1.5 percentage points of bank capital, while the SME scenario erased 0.3–1.3 percentage points of capital.

[13] See IMF, 2020, "Private Debt Resolution Measures in the Wake of the Pandemic".

[14] It provides deferrals of up to 6 months, based on type and loan size criteria. See https://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/7–5-2020b.aspx.

C. Macro-Structural Policies

42. Structural policies need to mitigate long-term scarring and strengthen the resilience of the economy. Addressing vulnerabilities in the labor market should take priority. The current crisis is also an opportunity to tackle pre-COVID legacies that have stalled productivity growth and raised inequality and poverty.

43. Repairing the labor market would require robust activation policies. More than 30 percent of employed workers were furloughed, and while most individuals have returned to their jobs, job losses are borne disproproprotionately by specific sectors and groups. A majority of employees in the contact-intensive sectors (retail, construction, transportation, and accommodation and food services) were furloughed and about 26 percent of them have remained furloughed as of end-October. These sectors have accounted for more than half of job losses (Figures 4–5). While female and male unemployment remains similar, female workers have been furloughed at a greater rate. Arab workers have also likely suffered a relatively larger number of job losses, given their high share of employment in construction. While full-time employees have almost fully recovered their pre-COVID employment, employment among those working part-time remains 37 percent below its pre-COVID level. Importantly, as more than two thirds of employees in the affected sectors are low-skilled—with a high-school degree or less— retraining and reallocation to other sectors would be challenging. Hysteresis effects could lead to lower employability and larger structural unemployment over the long-term. Ensuring long-term retention of employees, reemployment, and efficient reallocation of jobs from sectors and businesses that downsize would call for better funded activation policies. Funding should increase significantly for ALMPs that promote reskilling and upskilling, encourage job search and reduce hiring costs. The recent grant encouraging companies to rehire workers is welcome. Vocational training programs could also be expanded to address skill gaps of low-skilled workers.

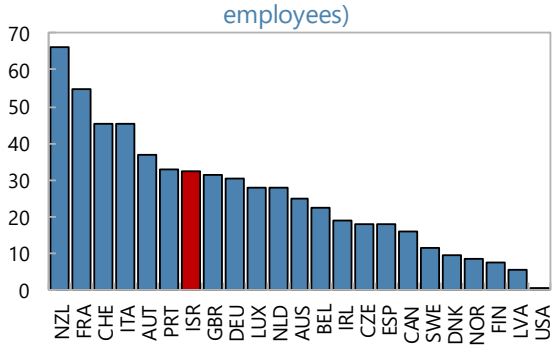
Share of Vulnerable Jobs by Sector
(Percent of total number of employees in each sector)

Sector	SME	Low-skilled	Arab & Haredi	Female	Uenmployment Rate Sept. 2020
Accommodation and food service activities	85	81	17	47	34
Arts, entertainment and recreation	76	49	8	46	32
Transportation, storage, postal and courier activities	59	73	23	28	19
Administrative and support service activities	29	63	18	44	19
Other service activities	64	56	16	58	17
Wholesale, retail trade and repair of motor vehicles	73	68	26	50	14
Real estate activities	NA	42	1	50	14
Professional, scientific and technical activities	85	18	13	52	12
Education	31	26	54	76	10
Construction	94	72	53	22	9
Human health and social work activities	30	35	27	81	9
Information and communications	58	25	7	37	8
Households as employers	NA	79	8	93	8
Manufacturing; Mining and quarrying	59	50	15	31	7
Agriculture, forestry and fishing	94	73	37	36	5
Financial and insurance activities	40	32	8	63	5
Local, public and defence admin and social security	9	64	9	42	3

Sources: Central Bureau of Statistics Labour Force Survey (2018); Ministry of Finance, Chief Economist Department; OECD Structural Statistics for Industry and Services (2018); IMF Staff calculations.

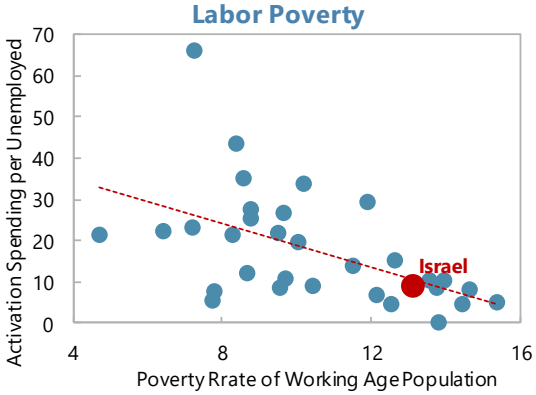
Note: Low skilled workers are workers with high-school degree; Bars along groups of workers are visible/bigger only if the share of the group is disproprotionately large in the respective sector.

Participation in Job Retention Schemes
(Approved applications in percent of dependent employees)



Sources: OECD, 2020, "Employment Outlook"; Israel Employment Service; IMF Staff calculations.
Note: Retention scheme definition differs across countries.
May data for LUX, CHE, AUT, FIN, NOR, BEL, IRL, ESP;
10 May-6 June for CAN; April data for ISR.

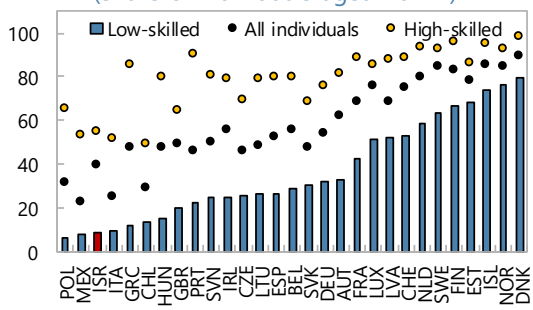
OECD Countries: Activation Spending and Labor Poverty



Sources: OECD; IMF Staff calculations.
Note: Total spending on active labor market policies per unemployed in percent of GDP per capita in 2017. Poverty rate measured as the percentage of persons living with less than 50 percent of median equivalised disposable income; 2018 data for Australia and Israel.

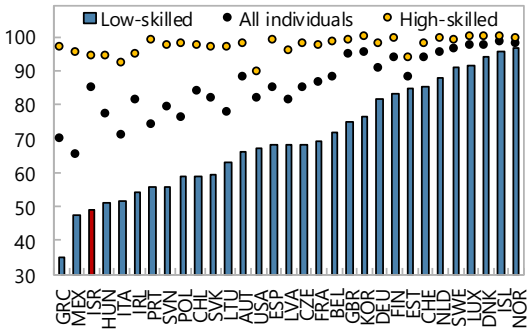
44. Digitalization provides an avenue to strengthen the labor market and improve productivity. Despite its high share in Israel's value added the ICT sector is underutilized in many of Israel's economic and social activities compared to those of OECD peers. Less than 40 percent of Israelis visit or interact with the existing online/electronic government platforms vs. 70 percent in OECD countries. There is a significant disparity in digital penetration between low- and high-skilled individuals. While most high-skilled individuals in Israel have access to the internet, only half of low-skilled ones do (vs. near 70 percent on average in OECD). Only 9 percent of low-skilled individuals in Israel interact with public authorities via the internet (vs. a third of low-skilled in OECD countries) and an even smaller share of low-skilled female individuals do. Policies that broaden digital penetration among low-skilled individuals have very high potential to increase knowledge diffusion and productivity and mitigate skill shortages, including in Israel's ICT sector. Greater digitalization of government services could also improve their reach and effectiveness—e.g., social protection or ALMPs—enhance government spending transparency, and strengthen revenue compliance and collection.

OECD: Internet Access to Public Authorities, 2017
(Share of Individuals aged 16-74)



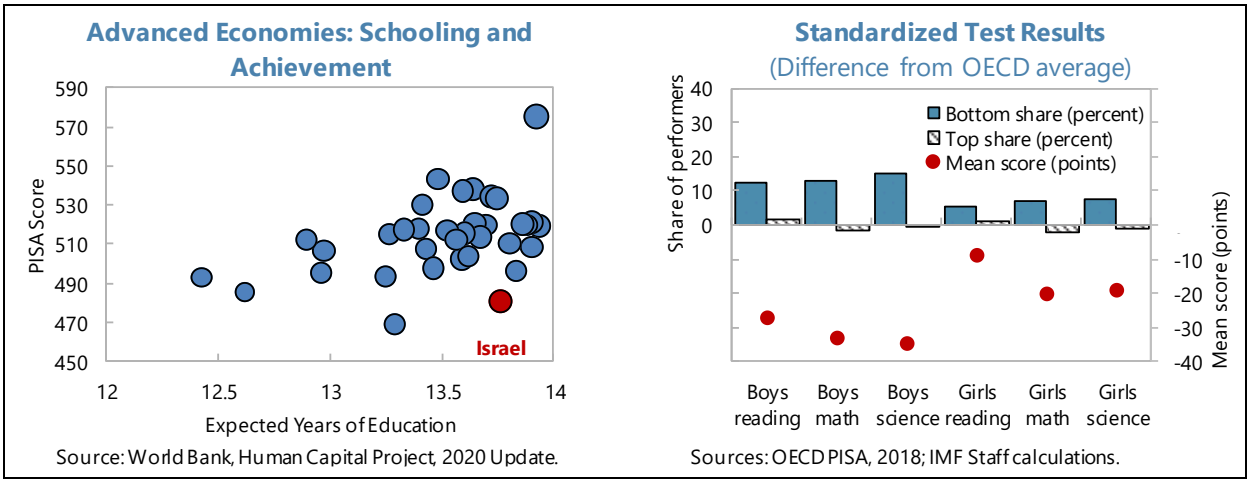
Sources: OECD; IMF Staff calculations.

OECD: Use of Internet, 2017
(Share of Individuals aged 16-74)



Sources: OECD; IMF Staff calculations.

45. The lockdowns have created educational setbacks that could have lasting productivity and equality implications. Overcoming these setbacks will require planning, training, and investment in technology to ensure continuity and sustain the quality of education. Placing greater emphasis on key subjects providing marketable skills (math, sciences, and technology) would prepare students for an increasingly more digitalized marketplace. Longstanding needs for education reforms also need to be addressed. Among advanced economies, Israel has one of the highest numbers of expected years of education—especially among women—yet the second lowest PISA score. The share of low-score performers in Israel is significantly larger than the average in OECD countries. The weak performance reflects to a great extent the large disparities in education achievement between Haredi and non-Haredi Jews and between Arab- and Hebrew-speaking students, despite recent progress in the education achievement of Arab women (See 2018 Article IV Staff Report). Education reforms that raise schooling achievement scores above the average in advanced economies could boost (pre-COVID) productivity by 5–15 percent in the long run.[15]



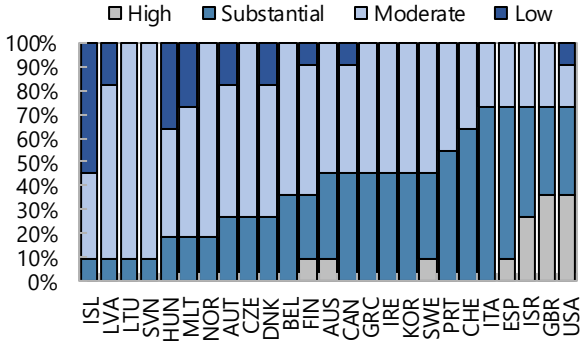
46. Boosting physical capital is also important to support the recovery and prevent long-term scarring. Israel's stock of public capital is below that of peer countries and has long been due for an upgrade (See 2018 Article IV Staff Report). Given the significant output gap and ample underutilized resources, the growth impact of public investment is likely to be unusually powerful now.[16] Public investment can directly help in creating jobs, easing the hike in COVID-induced unemployment rate and facilitating job reallocations. This would also help mitigate the domestic demand shock, which is expected to leave long-term scars in the growth trajectory. Indirectly, the crowding-in effect of public investment can encourage private investment which has declined in the midst of plummeting business confidence. Public investment projects—particularly in health care, transportation, digitalization infrastructure—can also strengthen crisis resilience.

[15] World Bank, 2020, The Human Capital Project. World Bank, Washington, DC.

[16] For instance, "Public Investment for the Recovery", Fiscal Monitor, October 2020, IMF. Blanchard, O., and D. Leigh. 2013. "Growth Forecast Errors and Fiscal Multipliers." *American Economic Review* 103 (3): 117–20.

47. Israel's governance frameworks are well positioned to meet the challenges of the pandemic, and their further strengthening would support the expansion of public investment. Improvements in the AML/CFT framework have raised Israel's capacity to one of the most effective among advanced economies. Nonetheless, there is scope to improve the AML/CFT regime and risk-based supervision of certain categories of unregulated entities (e.g., real estate agents) and to ensure that financial institutions consistently apply enhanced due diligence. Further efforts are also needed to close gaps in Israel's government procurement system. Reducing exceptions from competitive bidding rules, banning entities convicted of crimes abroad from participating in procurement tenders, publishing the verified beneficial owners of procurement contracts, and developing a strategy for assessing procurement risks would reduce the possibility for misuse of public money (See 2018 Article IV Staff Report). It would also help strengthen public investment management ahead of ramping up pandemic-related investment spending. Given the large share of public procurement in GDP—15 percent relative to a 12-percent OECD average—completing procurement reforms would promote efficiency and competition more broadly.

Assessment Ratings of AML/CFT Effectiveness



Source: Financial Action Task Force (FATF), Consolidated Assessment Ratings, October 2, 2020.
Note: Includes only advanced countries for which assessments under the 2013 FATF Methodology are available. Assessors differ for different countries. Ratings reflect the extent to which a country's measures are effective. The assessments are conducted on the basis of 11 immediate outcomes, which represent key goals that an effective AML/CFT system should achieve.

48. The authorities agreed on the need for structural reforms and broadly concurred with staff's emphasis. While they were less concerned about scarring, the authorities concurred on the need to enhance labor market policies, strengthen digitalization, improve the education system, and accelerate investment. The authorities placed greater emphasis on the need to boost infrastructure. They concurred that further resources are needed to improve education for Arab-speaking students but saw greater challenges in the efforts to close the education gap for Haredi boys.

STAFF APPRAISAL

49. The Israeli economy entered the COVID-19 pandemic from a position of strength. With robust GDP growth, unemployment had reached its lowest rate in the last two decades. Public, private, and external debts were at comfortable levels, and banks enjoyed strong capital positions, high asset quality, and ample liquidity. Israel's international investment position exceeds 40 percent of GDP. Nonetheless, the pandemic inflicted an historic contraction on the Israeli economy, albeit a milder one than in other advanced economies.

50. Appropriately rapid and large monetary and fiscal support has helped soften the impact of the pandemic. The Bank of Israel launched aggressive measures to provide domestic and foreign currency liquidity, prevent a credit crunch, and ease access to financial services, including for

small businesses and households. Fiscal policy measures provided ample support to the health sector, households, and businesses.

51. Real GDP is projected to rebound in 2021 but to remain below its pre-COVID trend, and risks to the outlook are significant. Despite signs of recovery, social distancing will likely continue to constrain domestic demand in 2021. Real output is likely to be below its pre-COVID trend even in the medium term. Early wide-spread distribution of an effective vaccine would lead to a faster-than-projected recovery and could limit the long-term damage to the economy. An escalation of the pandemic could result in further disruptions to economic activity, narrower fiscal space, and more depleted political capital.

52. Fiscal policy should remain supportive and gradually become more targeted. Prompt adoption of the 2021 budget would help prioritize spending, position the economy for growth, and reduce economic uncertainty associated with the pandemic. Fiscal support should be maintained beyond mid-2021, particularly if further downside risks materialize. The focus should be on providing support for the health sector, bolstering social protection and active labor market policies, and undertaking job rich public investment projects. Once the recovery is on a firm ground, fiscal effort will be needed to restore pre-crisis buffers and to rebuild fiscal space.

53. Monetary policy should remain accommodative. Extending the current set of monetary policies remains broadly appropriate, with emphasis on asset purchases to keep term premia in check and preserve bond market functioning. As inflation trends toward the target band, the BoI should cease FX intervention as a tool for managing inflation expectations and limit its use to addressing disorderly market conditions. Staff assesses that the external position is moderately stronger than warranted by fundamentals and desirable policies.

54. Israel's financial system is well prepared to face the COVID-19 shock. Banks' capital remains strong, with substantial capacity to face large and prolonged shocks. Nonetheless, unless downside risks materialize, the level of minimum regulatory capital should not be lowered further, and structural buffers should eventually be restored. Efficiently handling a potential increase in nonperforming loans and insolvencies would help limit debt overhang, support business adjustment and debt restructuring, and spur productivity-enhancing capital reallocation.

55. Structural policies need to strengthen the resilience of the economy. Labor activation policies could ensure long-term retention of employees, reemployment, and efficient reallocation of jobs from downsizing sectors. Policies that broaden digital penetration have very high potential to increase productivity, mitigate skill shortages, and improve the effectiveness of government services. Education reforms need to place greater emphasis on key subjects providing marketable skills. Completing ongoing governance reforms would support the ramping up of public investment.

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

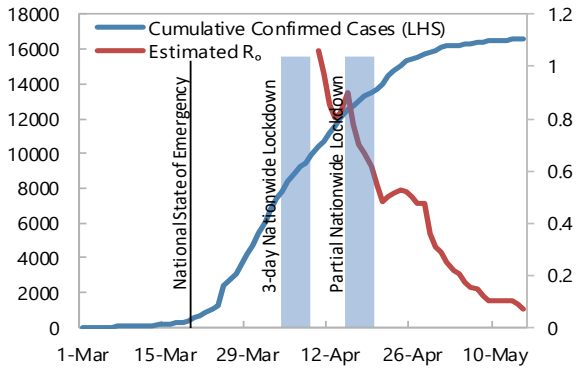
Box 1. Risk Assessment Matrix[1]

Risks	Likelihood of Risk	Impact of Risk	Policy Response
	(High, Medium, Low)	(High, Medium, Low)	
Unexpected shift in the Covid-19 pandemic. ▪ **Downside.** The disease proves harder to eradicate (e.g., due to difficulties in finding/distributing a vaccine), requiring more containment efforts and impacting economic activity directly and through persistent behavioral changes (prompting costly reallocations of resources). ▪ **Upside.** Alternatively, recovery from the pandemic is faster than expected due to the discovery of an effective and widely available vaccine and/or a faster-than-expected behavioral adjustment to the virus that boosts confidence and economic activity.	**High (downside):** Failure to contain heightened morbidity leads to prolonged lockdowns. **Low (upside):** Earlier than expected vaccine and/or low mortality ease concerns of hospital congestion and allay precautionary behavior.	**High (downside):** Recovery would be more uneven and scarring deeper. Higher solvency risks would lead to corporate bankruptcies and labor market hysteresis, with spillovers to the financial system. Need for greater fiscal support could exhaust limited fiscal space and jeopardize sustainability. **Medium (upside):** Strong confidence impact in the near term; activity recovers faster than expected over the medium term and limits or eliminates scarring.	Provide adequate support to the health system and to ensure effective containment through testing and tracing. Target fiscal policy: provide support to viable companies and vulnerable households and workers.
Widespread social discontent and political instability. Social tensions erupt as the pandemic and inadequate policy response cause economic hardship and exacerbate preexisting socioeconomic inequities. Growing political polarization and instability weaken policy-making and confidence.	**High:** A lack of political consensus on the approach to contain the pandemic raises social discontent. Unresolved disagreements in the weak government coalition result in early elections.	**High:** Further damage to confidence (e.g., due to failure to reach an agreement on 2021 budget) could exacerbate precautionary behavior and slow down the recovery. Uneven participation of the vulnerable groups in the recovery could deepen poverty and inequality.	Provide targeted support to vulnerable groups, including through ALMPs to ensure inclusive recovery; adopt the 2021 budget promptly to ensure continued support to the economy.
Intensified geopolitical tensions and security risks (e.g., in response to pandemic) cause socio-economic and political disruption	**High:** Adverse developments could further damage confidence and demand.	**High:** The recovery could be derailed. Increased defense spending could further limit fiscal space available to support the economy. Recent peace accords may reduce regional tensions and lead to enhanced trade and commercial relations.	Allow temporary deviation of defense spending. Gradually rebuild structural and contingency buffers for geopolitical risks.

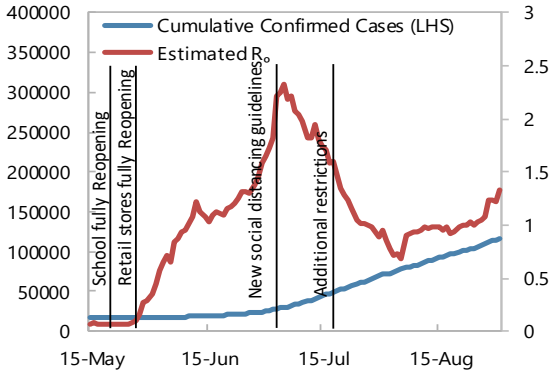
[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent).

Figure 1. Israel: COVID-19: Morbidity and Containment

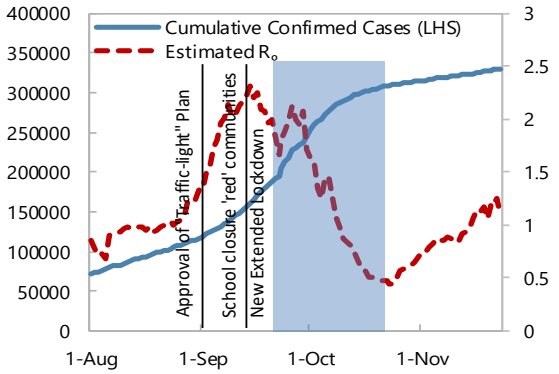
In the spring, the lockdown effectively reduced morbidity...



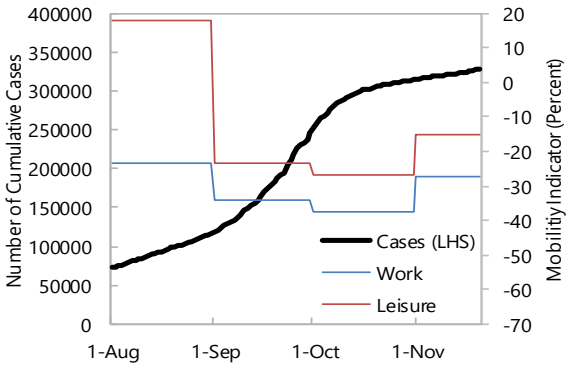
..but cases intensified after restrictions were lifted.



A second nationwide lockdown followed...

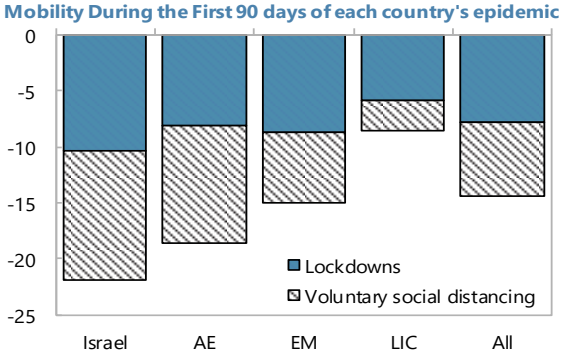


..but the impact on mobility has been modest.



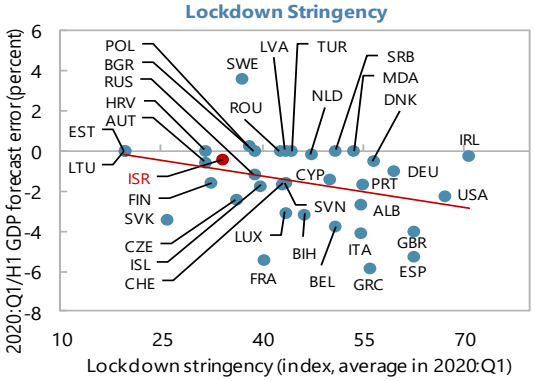
In the spring, the lockdown and voluntary social distancing had a similar impact on mobility...

Impact of Lockdowns and Voluntary Social Distancing on Mobility During the First 90 days of each country's epidemic



...and the impact on growth has been broadly in line with the stringency of the lockdown.

GDP Forecast Errors in 2020:Q1/H1 and Lockdown Stringency



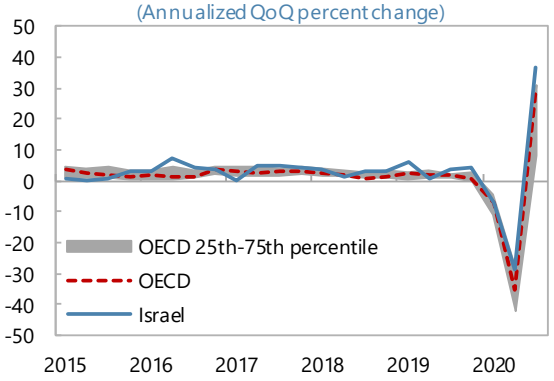
Sources: Bloomberg; Google Community Mobility Report; IMF, World Economic Outlook; Oxford University; IMF Staff calculations.

Note: Ro is the average number of people who will contract the disease from one person with the disease.

Figure 2. Israel: Recent Economic Developments

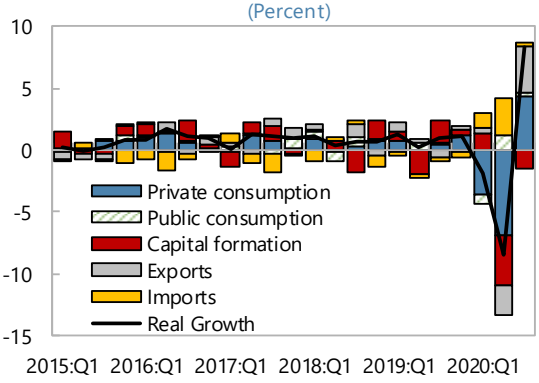
The pandemic caused a severe contraction in the first half of 2020...

Real GDP Growth
(Annualized QoQ percent change)



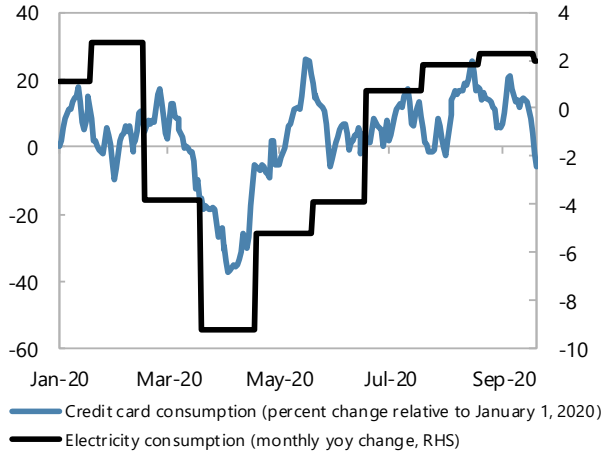
...with private consumption and investment affected the most.

Contributions to Real GDP Growth
(Percent)



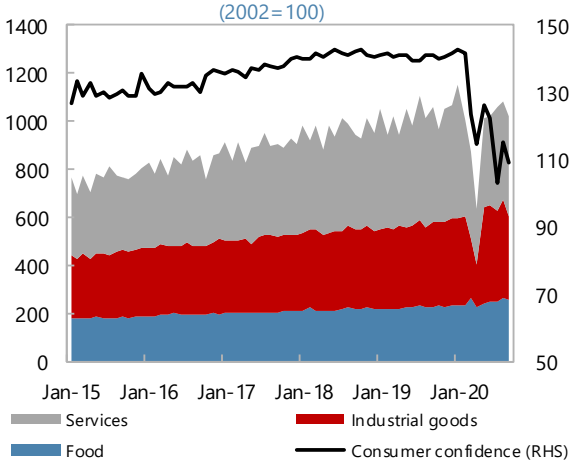
High frequency indicators are consistent with the partial rebound in consumption during the third quarter...

High Frequency Indicators
(Percent deviation compared with baseline)



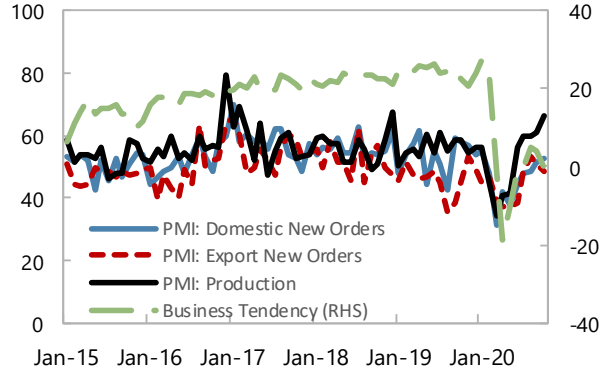
...as consumer confidence remains low despite the rebound in consumption.

Credit Card Consumption by Type and Consumer Confidence
(2002=100)



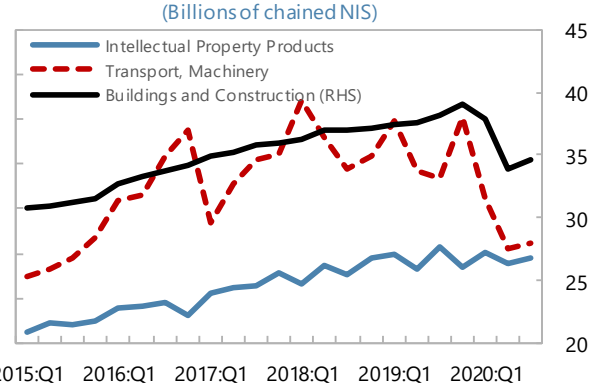
Despite a tentative recovery in business confidence...

PMI and Business Tendency



...investment has plumetted, except in the ICT sector.

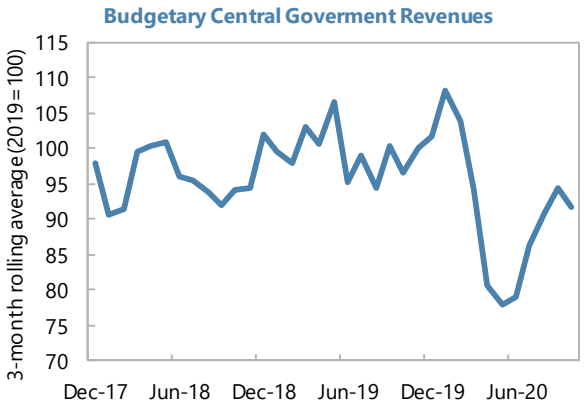
Investment by Type
(Billions of chained NIS)



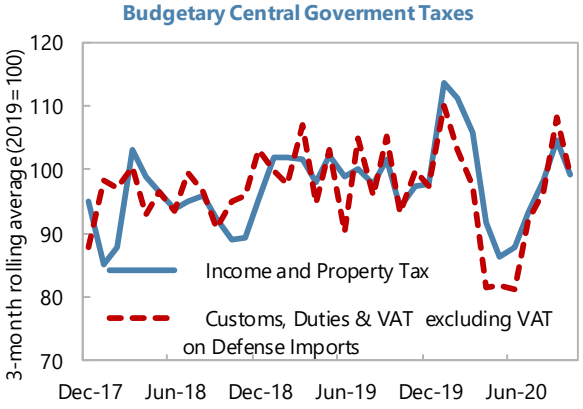
Sources: Bank of Israel; Haver Analytics; IMF, World Economic Outlook; IMF Staff calculations.

Figure 3. Israel: Fiscal Performance

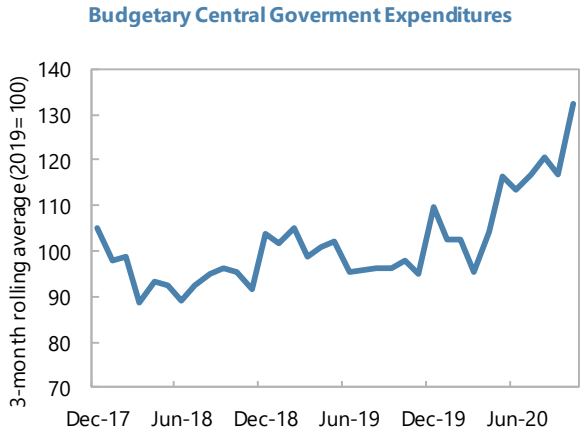
Government revenue has bounced back after a sharp contraction in the spring...



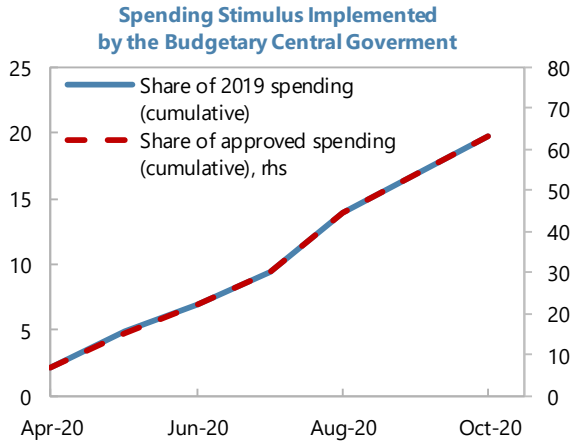
...with direct and indirect taxes following similar patterns.



Spending has increased due to pandemic-related stimulus measures...



...whose implementation has been gradual.



Grants picked up before unemployment benefits.

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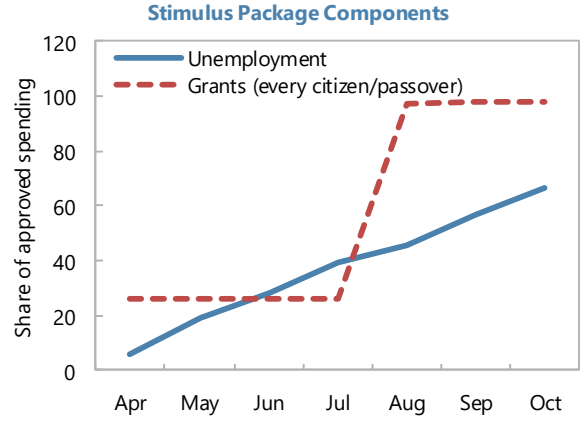
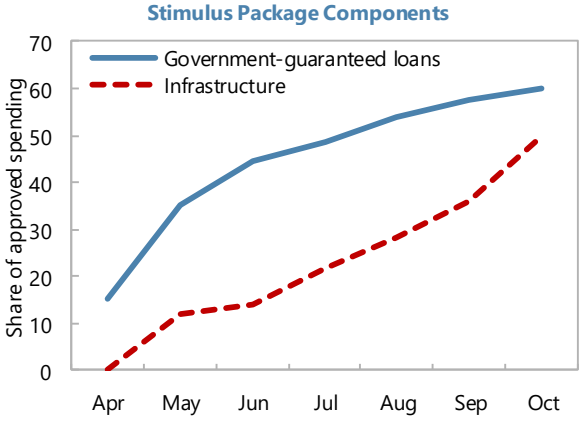


The planned support for companies has been implemented at a slower pace.

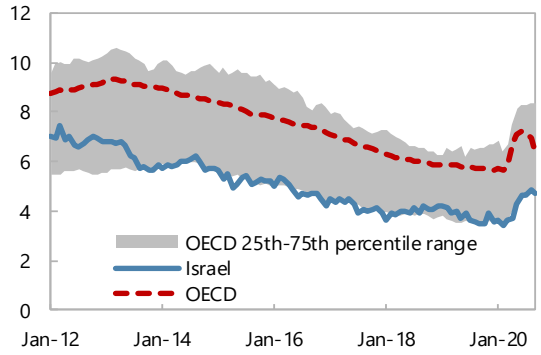


Sources: Ministry of Finance; IMF Staff calculation.

Figure 4. Israel: Labor Market Developments

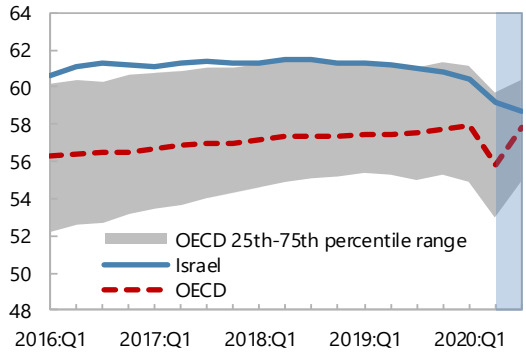
Unemployment started to pick up after the lockdowns, but remains low...

Unemployment
(Percent)



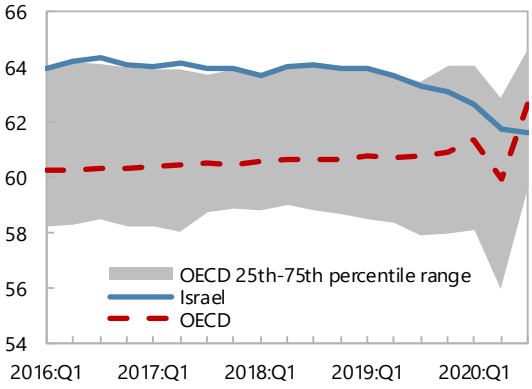
...and employment has declined less than in other advanced countries...

Employment
(Percent)



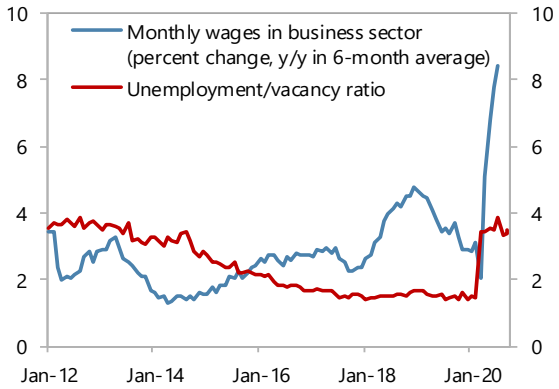
...along with a decline in labor force participation.

Labor Force Participation
(Percent)



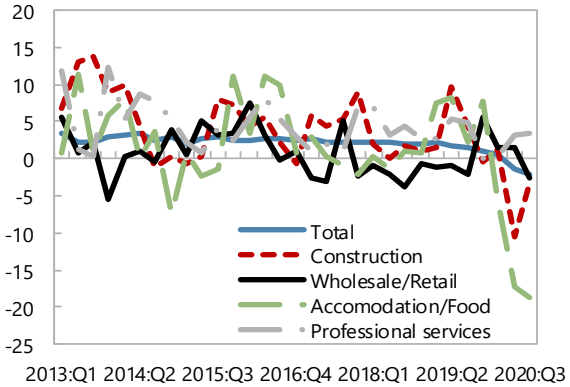
As low-paid workers were furloughed, average wage increased, despite market weakening...

Wages and Labor Market Slack



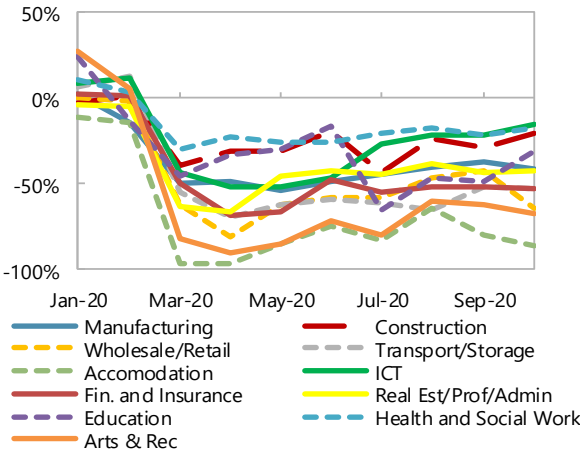
...particularly in accomodation and food services, as well as construction.

Employment by Industries
(Seasonally adjusted, yoy growth, percent)



Job vacancies also dropped across sectors, with the largest decline observed in tourism-related sectors.

Job Vacancy by Industries
(Percent change, yoy)

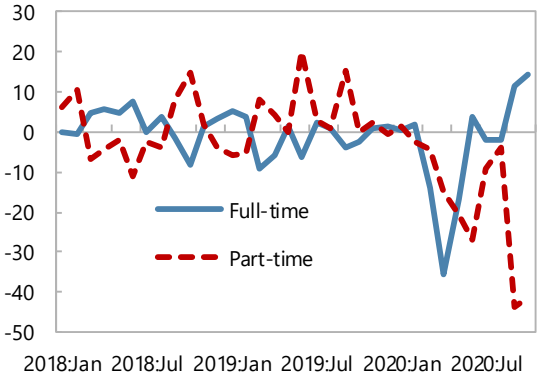


Source: Haver Analytics; IMF Staff calculations.

Figure 5. Israel: Pandemic Impact on the Labor Market

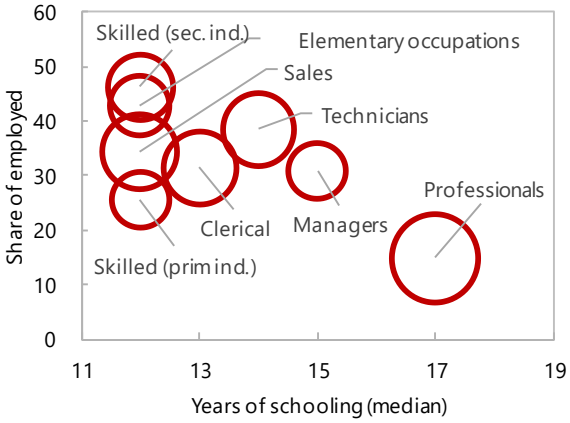
Full time employment recovered faster than part-time...

Contribution to Yearly Employment Growth by Contract Type (Percent)



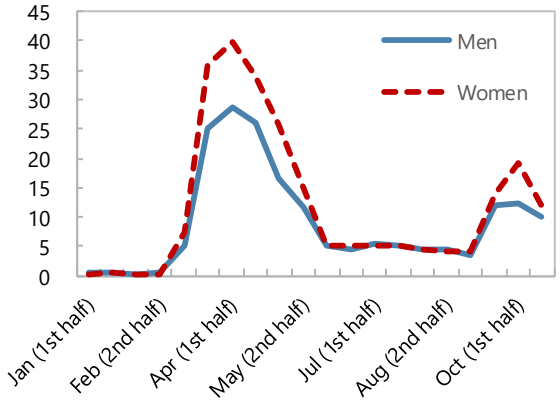
....and the less skilled have been affected more.

Absent from Work due to COVID (August)



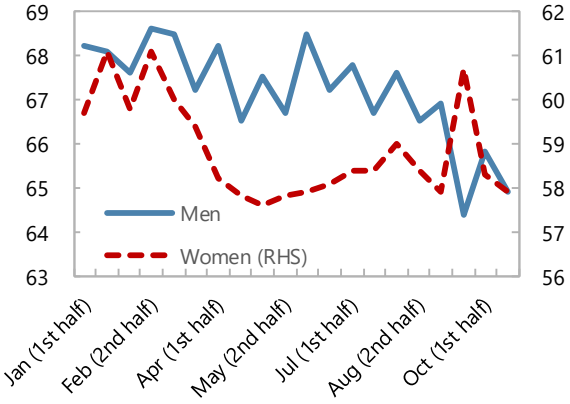
Female workers were more likely to be furloughed....

Absent from Work due to COVID



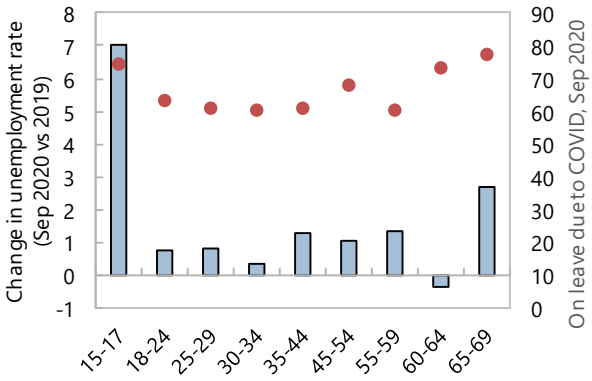
....and leave the labor force, particularly following the first lockdown.

Labor Force Participation



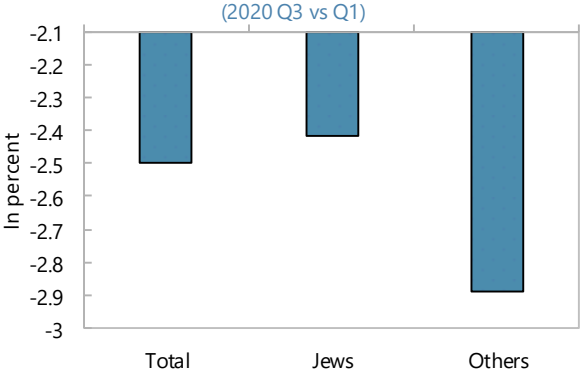
The impact has also been larger for the youth and the elderly...

Unemployment and Furlough



...and partial information suggests a differentiated impact by religious groups.

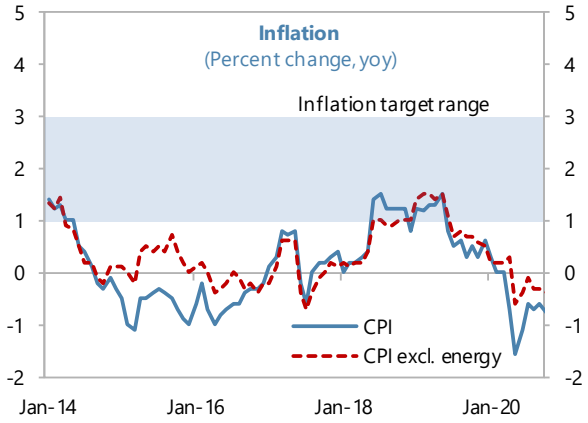
Change in Employment (2020 Q3 vs Q1)



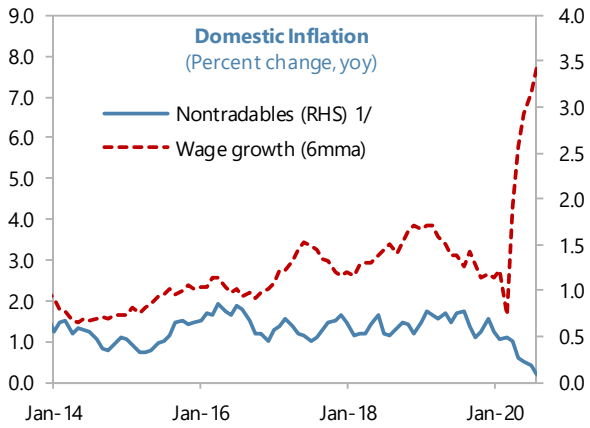
Sources: Central Bureau of Statistics; IMF Staff calculations.

Figure 6. Israel: Inflation and Interest Rate

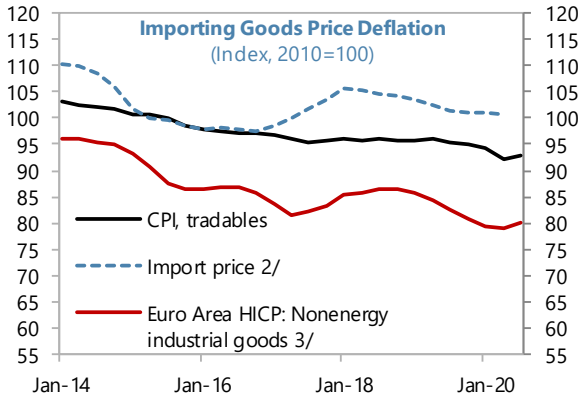
Headline inflation is returning to positive teritory, yet below the target band..



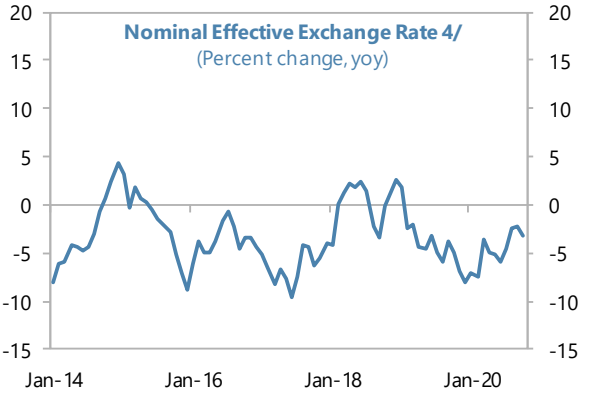
...as nontradable inflation remains low...



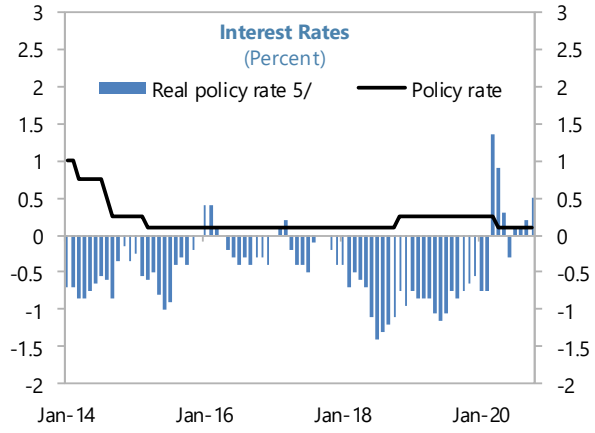
...owing partly to low trading partner inflation...



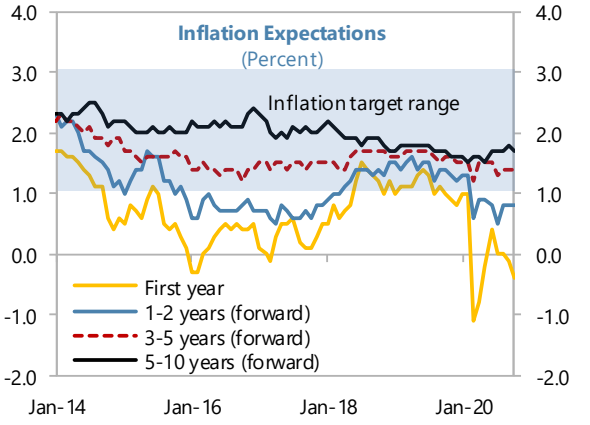
...and shekel appreciation.



Against this backdrop, the BOI has let the policy rate decline near the zero lower bound.



Long-term inflation expectations remain well anchored.

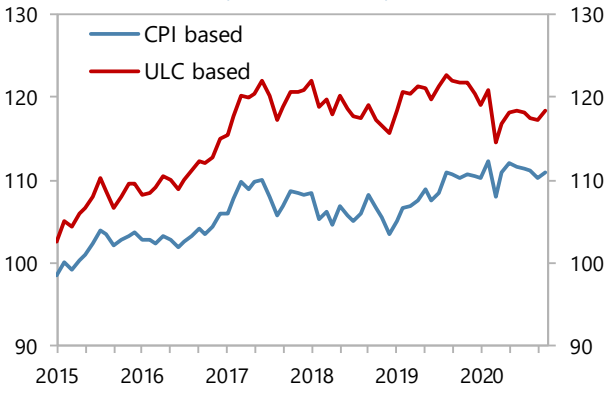


Sources: Haver Analytics; Bank of Israel; IMF, World Economic Outlook; IMF Staff calculations.
1/ Excluding fruit and vegetables, and estimated impact of government measures.
2/ Excluding ships, aircrafts, diamonds, and fuel.
3/ Converted to shekel.
4/ A negative change indicates appreciation of the shekel.
5/ Real policy rate is calculated as the difference between nominal policy rate and one-year ahead inflation expectations.

Figure 7. Israel: Balance of Payments

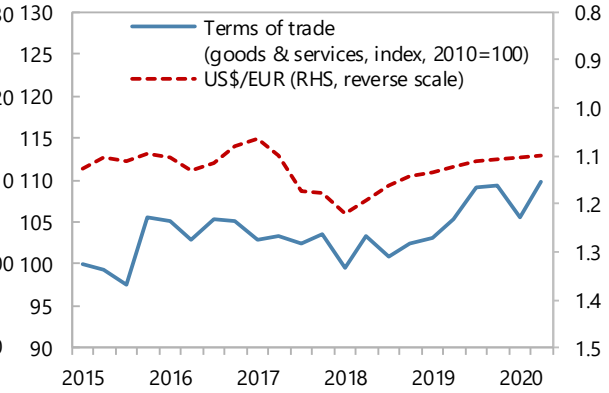
The shekel depreciated in March and quickly bounced back...

Real Effective Exchange Rate
(Index, 2010=100)



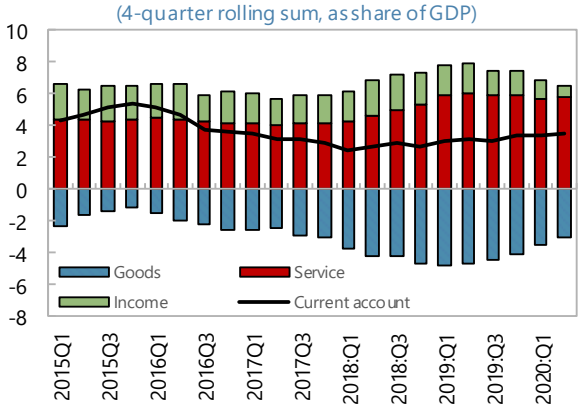
...and terms of trade moved in line...

Terms of Trade and Cross Exchange Rate



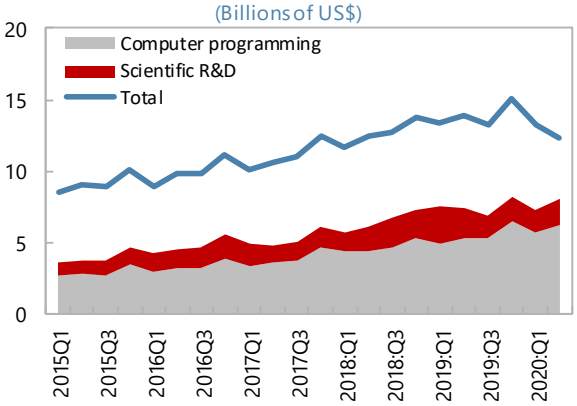
...strengthening the current account, as goods imports plummeted...

Current Account Components
(4-quarter rolling sum, as share of GDP)



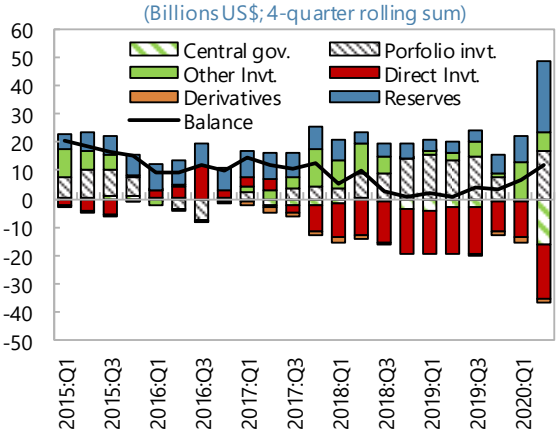
...and service exports remained resilient.

Service Exports
(Billions of US$)



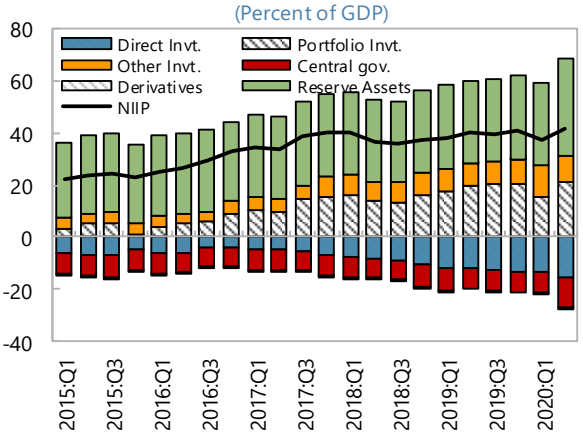
Portfolio inflows improved and reserve accumulation resumed with the strengthening of the Shekel,...

Financial Account Components
(Billions US$; 4-quarter rolling sum)



...supporting a solid net international investment position.

Net International Investment Position
(Percent of GDP)

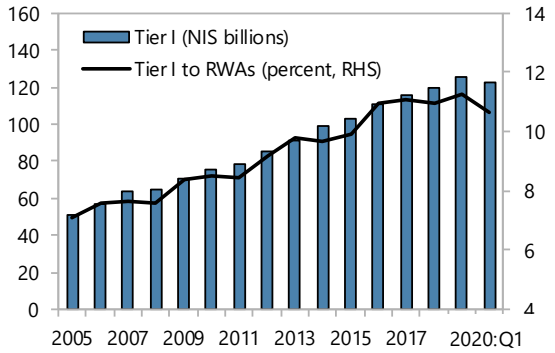


Sources: Bank of Israel; Central Bureau of Statistics; Haver Analytics; IMF Staff calculations.

Figure 8. Israel: Banking Sector Developments

Bank capital has risen, but starting to turn down lately...

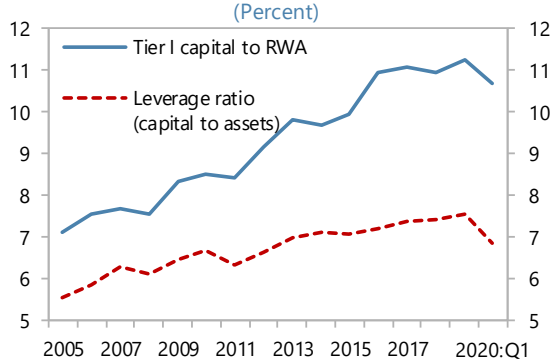
Regulatory Tier 1 Capital



...along with the leverage ratio...

Leverage Ratio

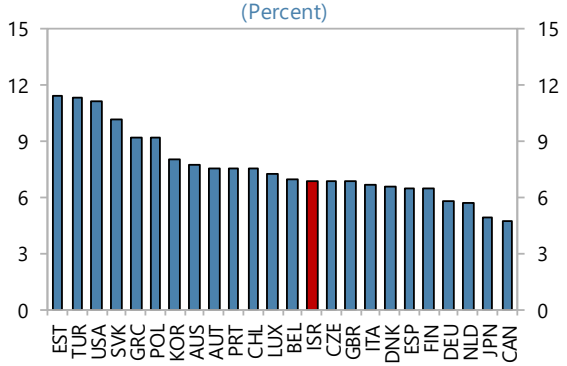
(Percent)



...which is around the median of OECD countries.

Leverage Ratio, 2020Q2 or the latest

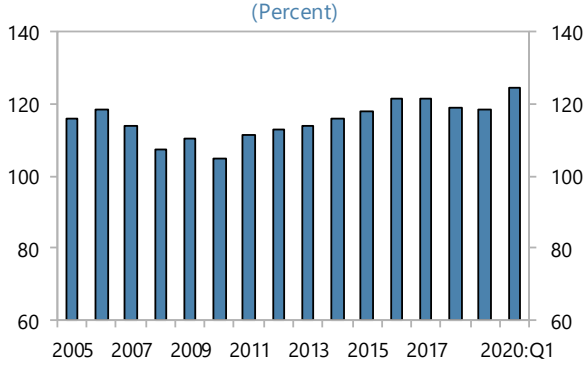
(Percent)



Lending operations have remained fully funded by deposits.

Customer Deposits to Non-Interbank Loans

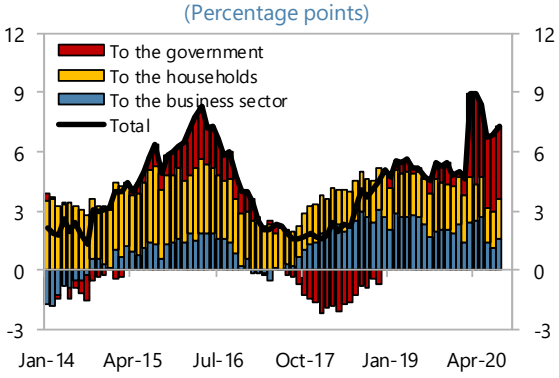
(Percent)



Bank credit to households and businesses continued while funding to government ramped up, also supported by BoI government security purchases.

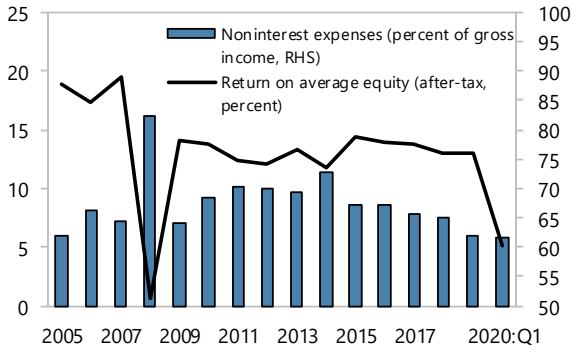
Bank Credit by Sector

(Percentage points)



The efficiency of banks improved, while profitability in 2020 began to be affected by provisioning for shutdowns but remained positive.

Profitability



Sources: IMF, Financial Soundness Indicator Database; Haver Analytics; IMF Staff calculations.

Table 1. Israel: Selected Economic Indicators, 2016–25

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
					Projections					
Real Economy (percent change)										
Real GDP	3.8	3.6	3.5	3.4	-4.0	4.1	5.0	4.6	4.1	3.6
Domestic demand	6.7	3.9	3.4	3.5	-6.8	6.4	5.4	5.0	4.5	4.0
Private consumption	6.4	3.3	3.7	3.8	-10.0	7.3	6.7	6.1	5.2	4.5
Public consumption	4.2	3.5	3.9	2.8	2.3	5.0	3.0	3.0	3.0	3.0
Gross capital formation	10.4	6.0	2.5	3.5	-7.7	5.6	4.9	4.5	4.2	3.7
Gross fixed investment	12.7	4.6	5.1	2.5	-9.2	7.3	4.9	4.4	4.0	3.5
Net exports (contribution to growth)	-2.7	-0.4	0.0	0.0	2.8	-2.1	-0.4	-0.4	-0.4	-0.4
Exports of goods and services	0.8	3.5	6.4	4.0	-1.3	1.9	6.4	5.4	4.9	4.7
Imports of goods and services	10.4	4.8	6.4	4.1	-10.2	9.4	7.9	6.9	6.2	5.8
Potential GDP	3.5	3.4	3.4	3.0	1.8	3.4	3.3	3.2	3.1	3.0
Output gap (percent of potential)	-0.2	0.0	0.1	0.6	-5.2	-4.6	-3.0	-1.7	-0.7	0.0
Unemployment rate (percent)	4.8	4.2	4.0	3.8	4.5	5.9	4.9	4.5	4.2	4.0
CPI (percent change, average)	-0.5	0.2	0.8	0.8	-0.6	0.1	0.5	0.7	0.8	0.8
CPI (percent change, end of period)	-0.2	0.4	0.8	0.6	-0.7	0.5	0.5	0.8	0.8	0.8
Core CPI (percent change, end of period)	0.3	0.7	0.6	0.5	-0.4	0.3	0.3	0.8	0.8	0.8
Saving and investment balance										
Gross national saving (percent of GDP)	24.4	24.6	23.8	24.8	24.7	24.4	24.2	23.9	23.7	23.5
Foreign saving (percent of GDP)	-3.3	-3.1	-2.1	-3.4	-4.0	-3.7	-3.5	-3.3	-3.1	-2.9
Gross capital formation (percent of GDP)	20.6	20.7	21.5	20.9	19.8	20.2	20.2	20.1	20.0	20.0
Money and Interest Rates (percent change)										
M1 (period average)	23.7	13.8	12.7	7.4	22.0	6.0	6.7	6.3	6.0	5.5
M3 (period average)	5.6	5.6	4.0	7.2	20.7	5.2	5.7	5.4	5.0	4.6
Bank of Israel policy rate (percent, end year)	0.1	0.1	0.1	0.3	...	...	...	...	...	...
10-year government bond yield (percent, average)	1.8	2.0	2.0	1.4	...	...	...	...	...	...
Public Finance (percent of GDP)										
Central government										
Revenues and grants	26.3	26.5	25.5	24.7	23.1	24.7	24.7	24.7	24.7	24.7
Total expenditure	28.4	28.4	28.4	28.4	36.5	34.0	31.7	30.0	29.8	29.6
Overall balance	-2.1	-2.0	-2.9	-3.7	-13.2	-9.0	-6.7	-5.0	-4.8	-4.7
General Government										
Overall balance	-1.4	-1.1	-3.6	-3.9	-13.3	-9.7	-6.8	-4.9	-4.5	-4.3
Debt	62.1	60.6	60.9	60.0	73.0	79.1	81.6	82.3	82.8	83.4
Foreign currency external debt	13.1	13.1	14.4	13.3	16.6	16.6	16.6	16.6	16.6	16.6
Balance of Payments (percent of GDP)										
Exports of goods and services	30.0	28.8	29.8	29.3	28.6	29.3	29.8	30.3	30.9	31.6
Imports of goods and services	28.3	27.6	29.2	27.4	24.3	26.2	26.9	27.7	28.5	29.4
Oil imports	0.5	0.6	0.7	0.7	0.4	0.5	0.5	0.5	0.5	0.5
Goods and services balance	1.4	1.1	0.7	1.9	4.2	3.1	2.9	2.6	2.4	2.2
Current account balance	3.3	3.1	2.1	3.4	4.0	3.7	3.5	3.3	3.1	2.9
Foreign reserves (end of period, billions of U.S. dollars)	98.4	113.0	115.3	126.0	161.3	165.6	169.5	173.0	176.6	180.0
Exchange Rate										
NIS per U.S. dollar	3.84	3.60	3.59	3.56	...	...	...	...	...	...
Nominal effective exchange rate (2005=100)	111.27	118.69	118.34	123.22	...	...	...	...	...	...
Real effective exchange rate (2005=100)	103.33	108.15	106.01	108.65	...	...	...	...	...	...

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

Table 2. Israel: Balance of Payments, 2015–25
(In billions of US dollars unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
						Projections					
Current account balance	15.2	10.5	10.8	7.9	13.4	15.7	15.5	15.6	15.6	15.2	15.0
Merchandise	-4.0	-8.4	-10.8	-17.6	-16.2	-8.8	-14.2	-18.3	-21.2	-24.7	-27.6
Exports, f.o.b.	56.5	55.8	57.8	59.3	59.9	58.0	61.3	62.9	65.1	67.7	70.3
Imports, f.o.b.	60.5	64.1	68.5	76.9	76.1	66.9	75.5	81.2	86.3	92.4	97.9
Services	12.6	13.2	14.7	20.1	22.8	25.3	27.2	31.3	33.6	36.4	39.0
Exports	36.4	39.6	43.9	50.6	55.3	52.7	60.5	68.7	76.2	83.8	92.2
Imports	23.8	26.4	29.2	30.5	32.5	27.4	33.3	37.5	42.6	47.4	53.2
Primary income	-2.5	-2.9	-1.8	-0.2	-1.9	-7.8	-5.0	-5.3	-5.1	-5.4	-5.7
Receipts	11.6	11.5	13.2	14.2	15.0	9.7	11.6	12.4	13.5	14.2	14.9
Payments	14.2	14.4	14.1	15.3	16.5	17.4	16.6	17.6	18.6	19.6	20.6
Secondary income	9.1	9.2	7.9	7.7	8.1	7.0	7.5	7.9	8.4	8.8	9.3
Receipts	11.9	12.2	11.6	11.5	12.2	11.6	12.5	13.2	14.0	14.7	15.4
Payments	2.8	3.0	3.8	3.8	4.2	4.7	5.0	5.3	5.6	5.9	6.2
Capital account	2.1	2.2	1.8	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Financial account 1/	7.8	1.1	4.5	-4.7	-3.3	-18.0	9.6	9.7	9.6	9.2	8.3
Direct investment, net	-0.4	2.6	-9.3	-15.4	-10.5	-12.3	-11.6	-11.8	-11.5	-11.2	-11.7
Foreign direct investment abroad	11.0	14.6	7.6	6.1	8.6	8.7	9.6	10.0	10.5	11.1	11.6
Foreign direct investment in Israel	11.3	12.0	16.9	21.5	19.0	21.0	21.2	21.8	22.0	22.2	23.3
Portfolio investment, net	7.1	-1.4	2.4	10.3	6.5	-4.1	8.5	9.6	10.2	10.7	11.0
Financial derivatives, net	-0.3	-0.6	-1.4	0.1	-1.2	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Other investment, net	1.4	0.4	12.8	0.4	1.9	-0.6	13.7	12.9	11.8	10.6	10.0
Change in reserves	7.3	8.5	8.1	5.3	6.4	35.3	7.6	7.6	7.6	7.6	8.2
Errors and omissions	-2.2	-3.1	0.0	-8.9	-11.9	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Current account balance (percent of GDP)	5.1	3.3	3.1	2.1	3.4	4.0	3.7	3.5	3.3	3.1	2.9
Terms of trade (percent change)	10.6	1.4	-3.3	-9.0	3.6	3.2	-1.4	0.1	0.0	0.2	0.2
Gross external debt (percent of GDP)	28.6	27.3	25.5	25.5	26.6	31.8	29.0	27.2	25.9	25.1	24.7
Foreign reserves											
US$ billion	90.6	98.4	113.0	115.3	126.0	161.3	168.9	176.5	184.2	191.8	200.0
Percent of GDP	30.2	30.9	32.0	31.1	31.9	41.6	40.6	40.0	39.5	39.1	38.9
Months of G&S imports	12.0	12.1	12.6	12.7	16.0	17.8	17.1	16.8	16.2	15.6	15.2
GDP (billions of U.S. dollars)	300.1	318.6	352.7	370.5	394.7	387.7	415.9	441.1	466.0	490.3	514.0

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

Table 3. Israel: International Investment Position, 2010–25
(In percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Net Investment	11.6	17.7	21.5	22.3	21.8	22.8	33.1	41.0	36.7	40.9	46.1	47.1	48.3	49.4	50.4	51.3
Direct investment	3.3	2.8	-1.3	-3.0	-3.4	-4.9	-4.0	-7.3	-10.6	-13.3	-16.7	-18.4	-20.0	-21.4	-22.6	-23.9
Portfolio investment	-18.3	-9.7	-3.1	-1.5	-5.2	-5.8	2.6	8.7	8.8	13.4	12.6	13.8	15.2	16.6	17.9	19.2
Financial derivatives	0.0	-0.1	-0.1	0.0	-0.1	-0.2	-0.2	-0.1	-0.4	0.0	-0.2	-0.4	-0.6	-0.8	-1.0	-1.1
Reserve assets	30.3	28.7	29.5	27.9	27.8	30.2	30.9	32.0	31.1	31.9	41.6	40.6	40.0	39.5	39.1	38.9
Other investment	-3.6	-4.0	-3.5	-1.2	2.8	3.4	3.8	7.6	7.7	8.8	8.8	11.5	13.7	15.5	16.9	18.1
Total Assets	110.9	102.2	108.0	107.2	108.0	116.0	117.8	122.9	118.3	126.2	141.8	139.6	139.1	139.2	139.8	140.9
Direct investment	29.0	27.7	28.2	26.6	25.5	28.2	29.7	28.8	28.3	28.4	31.2	31.4	31.9	32.4	33.1	33.8
Portfolio investment	26.6	23.9	29.6	32.6	34.2	38.0	37.4	40.5	38.3	43.4	45.9	44.5	43.9	43.6	43.5	43.6
Reserve assets	30.3	28.7	29.5	27.9	27.8	30.2	30.9	32.0	31.1	31.9	41.6	40.6	40.0	39.5	39.1	38.9
Other assets	25.0	22.0	20.8	20.1	20.5	19.7	20.0	21.7	21.0	22.4	23.3	23.5	24.0	24.5	25.1	25.7
Total Liabilities	99.3	84.5	86.5	84.9	86.1	93.2	84.7	82.0	81.6	85.3	95.7	92.5	90.8	89.8	89.4	89.6
Direct investment	25.7	24.8	29.5	29.6	28.9	33.1	33.7	36.1	38.9	41.8	47.9	49.8	51.9	53.8	55.7	57.7
Portfolio investment	44.9	33.6	32.7	34.1	39.5	43.8	34.8	31.8	29.4	30.0	33.3	30.8	28.8	27.1	25.6	24.3
Other liabilities	28.7	26.0	24.3	21.2	17.8	16.3	16.1	14.1	13.3	13.6	14.5	12.0	10.2	8.9	8.1	7.6

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

Table 4. Israel: Summary of Central Government Operations, 2015–25 1/
(In percent of GDP, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
						Projections					
Revenue and grants	25.7	26.3	26.5	25.5	24.7	23.1	24.7	24.7	24.7	24.7	24.7
On income and profits	11.6	11.7	13.2	12.2	12.0	12.0	12.0	12.0	12.0	12.0	12.0
VAT and customs	10.8	10.8	10.4	10.4	10.1	10.1	10.1	10.1	10.1	10.1	10.1
Fees	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
VAT on defense imports	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Interest	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans from NII	1.4	1.9	1.7	1.8	1.6	0.0	1.6	1.6	1.6	1.6	1.6
Grants 2/	0.7	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.3	0.3	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Expenditure 3/	27.8	28.4	28.4	28.4	28.4	36.5	34.0	31.7	30.0	29.8	29.6
Administrative Departments	4.0	4.0	4.1	4.2	4.3	4.6	4.6	4.6	4.5	4.4	4.4
Social Departments	11.3	12.0	12.5	12.7	12.8	19.7	17.1	14.9	13.5	13.3	13.2
Economic Departments	2.0	2.1	2.3	2.4	2.5	2.7	2.8	2.7	2.7	2.6	2.6
Defense Expenditure 2/	6.0	6.0	5.2	5.1	5.0	5.4	5.4	5.3	5.2	5.2	5.1
Other Expenditures	0.3	0.3	0.3	0.2	0.2	0.4	0.2	0.2	0.2	0.2	0.2
Reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest	2.6	2.5	2.3	2.2	2.1	2.1	2.4	2.5	2.5	2.5	2.5
Repayment of Principal to NII	1.6	1.5	1.6	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Budget deficit	-2.1	-2.1	-2.0	-2.9	-3.7	-13.2	-9.0	-6.7	-5.0	-4.8	-4.7
Unsettled Payment Orders 4/	0.3	0.2	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	2.5	2.3	1.4	2.9	3.7	13.2	9.0	6.7	5.0	4.8	4.7
Foreign (net)	-0.5	0.2	0.7	0.8	0.3	1.1	0.1	0.1	0.1	0.1	0.1
Domestic (net)	2.6	1.8	0.6	1.9	3.3	13.5	8.4	6.0	4.3	4.4	4.5
Loans	6.0	7.2	7.0	6.5	8.8	19.0	1.9	3.3	13.5	-3.7	-2.5
Repayment	-3.4	-5.3	-6.3	-4.6	-5.5	-5.6	-5.7	-5.8	-5.9	-6.0	-6.1
Sale of assets (net)	0.3	0.2	0.1	0.2	0.1	-1.4	0.6	0.6	0.6	0.3	0.1
Memorandum items:											
Structural balance (percent of potential GDP)	-2.0	-2.5	-2.8	-2.9	-3.9	-11.5	-7.7	-6.0	-4.8	-4.8	-4.9
Primary balance (PB)	0.4	0.3	0.3	-0.8	-1.6	-11.3	-6.9	-4.6	-2.8	-2.5	-2.4
Cyclically adjusted PB (percent of potential GDP)	0.4	0.4	0.3	-0.8	-1.7	-9.5	-5.5	-3.7	-2.3	-2.4	-2.4
Deficit limit 3/	3.0	2.9	2.9	2.9	2.9	2.5	2.3	2.0	2.0	1.8	1.8
Real expenditure growth (in percent)	4.2	7.6	3.5	3.8	5.0	23.1	-2.2	-1.9	-0.8	3.4	3.3
Public debt to GDP	63.8	62.1	60.6	60.9	60.0	73.0	79.1	81.6	82.3	82.8	83.4
Nominal GDP (in billions of NIS)	1,167	1,224	1,269	1,330	1,407	1,339	1,409	1,490	1,570	1,649	1,725

Sources: Ministry of Finance; 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.

Table 5. Israel: General Government Operations, 2015–25

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
						Proj.					
	(In billions of NIS, unless otherwise specified)										
Revenue	428.9	447.2	479.5	480.9	496.8	462.8	497.4	526.7	555.5	583.9	611.1
Taxes	301.3	314.9	343.4	339.3	351.0	332.3	353.0	373.2	393.4	413.2	432.4
Taxes on income, profits, and capital gains	117.8	124.6	151.6	139.7	144.9	137.9	145.2	153.5	161.8	170.0	177.9
Taxes on goods and services	143.2	148.6	148.4	154.9	159.8	152.1	160.0	169.2	178.3	187.3	196.0
Taxes on international trade and transactions	2.9	3.3	3.0	2.8	3.0	2.9	3.0	3.2	3.4	3.5	3.7
Taxes n.e.c.	37.5	38.4	40.4	42.0	43.3	39.4	44.7	47.3	49.8	52.3	54.8
Social contributions	68.7	72.6	76.1	79.8	83.5	71.2	82.0	87.5	92.6	97.5	102.2
Grants	12.9	13.5	10.3	10.6	10.4	9.9	10.4	11.0	11.6	12.2	12.8
Other revenue	45.9	46.3	49.7	51.2	51.9	49.4	52.0	55.0	58.0	60.9	63.7
Of which: Interest income	4.6	3.8	3.9	3.9	3.8	3.6	3.8	4.0	4.2	4.4	4.6
Expenditure	441.3	464.8	493.4	528.3	552.2	640.5	634.5	628.4	631.8	657.8	684.4
Expense	445.5	465.4	497.1	525.8	550.1	638.3	632.3	626.1	629.4	655.4	681.8
Compensation of employees	115.5	120.7	127.8	133.7	138.6	146.5	152.0	155.7	157.3	163.6	170.2
Purchases/use of goods and services	100.9	105.6	108.8	116.4	120.0	132.5	137.2	134.3	136.2	141.7	147.3
Interest expense	24.9	26.4	28.2	32.4	31.1	29.9	34.7	37.8	40.5	42.9	44.9
Social benefits	136.7	143.4	155.2	163.3	173.2	209.7	198.9	190.8	196.5	204.4	212.6
Expense n.e.c.	67.6	69.3	77.2	80.0	87.1	119.8	109.5	107.4	98.8	102.8	106.9
Net acquisition of nonfinancial assets	-4.2	-0.6	-3.7	2.5	2.1	2.2	2.3	2.3	2.4	2.5	2.6
Net lending/borrowing	-12.4	-17.6	-13.9	-47.4	-55.4	-177.6	-137.1	-101.7	-76.3	-74.0	-73.3
	(In percent of GDP)										
Revenue	36.8	36.5	37.8	36.2	35.3	34.6	35.3	35.4	35.4	35.4	35.4
Taxes	25.8	25.7	27.1	25.5	24.9	24.8	25.0	25.1	25.1	25.1	25.1
Taxes on income, profits, and capital gains	10.1	10.2	11.9	10.5	10.3	10.3	10.3	10.3	10.3	10.3	10.3
Taxes on goods and services	12.3	12.1	11.7	11.6	11.4	11.4	11.4	11.4	11.4	11.4	11.4
Taxes on international trade and transactions	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Taxes n.e.c.	3.2	3.1	3.2	3.2	3.1	2.9	3.2	3.2	3.2	3.2	3.2
Social contributions	5.9	5.9	6.0	6.0	5.9	5.3	5.8	5.9	5.9	5.9	5.9
Grants	1.1	1.1	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Other revenue	3.9	3.8	3.9	3.8	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Of which: Interest income	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Expenditure	37.8	38.0	38.9	39.7	39.3	47.8	45.0	42.2	40.2	39.9	39.7
Expense	38.2	38.0	39.2	39.5	39.1	47.7	44.9	42.0	40.1	39.7	39.5
Compensation of employees	9.9	9.9	10.1	10.0	9.9	10.9	10.8	10.5	10.0	9.9	9.9
Purchases/use of goods and services	8.6	8.6	8.6	8.8	8.5	9.9	9.7	9.0	8.7	8.6	8.5
Interest expense	2.1	2.2	2.2	2.4	2.2	2.2	2.5	2.5	2.6	2.6	2.6
Social benefits	11.7	11.7	12.2	12.3	12.3	15.7	14.1	12.8	12.5	12.4	12.3
Expense n.e.c.	5.8	5.7	6.1	6.0	6.2	8.9	7.8	7.2	6.3	6.2	6.2
Net acquisition of nonfinancial assets	-0.4	-0.1	-0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Net lending/borrowing	-1.1	-1.4	-1.1	-3.6	-3.9	-13.3	-9.7	-6.8	-4.9	-4.5	-4.3

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

Table 6. Israel: Financial Soundness Indicators, Banks, 2013–2020:Q1
(End=period, in percentage points)

	2013	2014	2015	2016	2017	2018	2019	2020Q1
Capital Adequacy								
Regulatory capital to risk-weighted assets 1/	14.8	14.3	14.0	14.7	14.5	14.2	14.6	14.0
Regulatory Tier I capital to risk-weighted assets 1/	9.8	9.7	9.9	10.9	11.1	10.9	11.3	10.7
Capital as percent of assets (leverage ratio)	7.0	7.1	7.1	7.2	7.4	7.4	7.6	6.9
Asset quality and exposure								
Nonperforming loans to total gross loans	2.9	2.2	1.8	1.6	1.3	1.2	1.4	1.4
Nonperforming loans net of loan-loss provisions to capital	8.9	6.1	3.4	2.2	0.8	0.4	1.1	0.1
Large exposures as percent of regulatory capital	357.9	345.5	349.6	321.4	312.2	323.3	329.6	...
Earnings and profitability								
Return on average assets (before tax)	0.9	0.8	1.0	1.0	1.0	1.0	1.0	0.4
Return on average equity (before tax)	13.3	11.8	14.4	13.9	13.8	13.0	13.0	5.2
Interest margins to gross income	59.1	58.4	56.5	58.6	61.7	64.7	66.4	69.1
Trading and fee income to gross income	6.2	6.8	6.3	5.3	5.2	4.9	4.6	...
Noninterest expenses to gross income	69.3	72.7	67.1	67.1	65.5	64.9	61.8	61.5
Personnel expenses to noninterest expenses	59.6	59.1	59.3	58.0	57.8	52.5	53.4	54.0
Liquidity								
Liquid assets as percent of total assets	14.8	16.5	21.0	24.5	24.1	22.3	23.3	23.8
Liquid assets as percent of short-term liabilities	26.4	28.6	110.8	135.3	124.8	128.0	125.3	133.2
Customer deposits as a percent of total (non-interbank) loans	113.9	115.8	117.8	121.6	121.5	118.9	118.6	124.5
Foreign exchange risk								
Net foreign exchange open position to capital	-55.7	-55.2	-61.1	-65.6	-55.4	-56.9	-54.4	-63.8
Foreign currency-denominated loans as percent of total loans	13.1	13.2	12.4	11.4	10.3	11.2	10.0	11.9
Foreign currency-denominated liabilities as percent of total liabilities	26.8	29.2	26.9	25.9	23.3	24.7	23.2	25.7

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

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

Annex I. External Sector Assessment

Overall Assessment: *The external position in 2020 was moderately stronger than the level implied by medium-term fundamentals and desirable policies.* The current account (CA) balance is projected to have improved in 2020, against the backdrop of a sharp decline in overall trade, especially imports. This assessment—while supported by the strength of the net international investment position and international reserves—is subject to unprecedented uncertainty around the impact of the pandemic and is based on incomplete information of the state of the economy in 2020. It is also qualified by the limited extent to which the model captures Israel's country-specific *factors.*

Potential Policy Responses: The policy focus should be on saving lives and providing sufficient fiscal and monetary support to households and businesses in the near term to face the economic and social impact of the pandemic. This, along with structural measures to strengthen the resilience of the economy, including much needed public investment spending, should aim to minimize medium- and long-term scarring and prevent potential accumulation of imbalances. Strengthening the social safety net would also improve the allocation of resources and reduce large precautionary savings. As inflation trends toward the target band, the BoI should cease FX intervention in managing inflation expectations and limit its use to addressing disorderly market conditions.

Foreign Assets and Liabilities: Position and Trajectory

1. Background. The NIIP is projected to have increased from 41 percent of GDP in 2019 to 46 percent of GDP in 2020, supported by a stronger rise in gross assets than in gross liabilities. More than half of foreign liabilities are FDI, and their share is projected to remain high over the medium term. Gross external debt is projected to increase to 32 percent of GDP, mainly due to foreign bond issuances by the government in the amount of $19 billion. New government debt was issued at very long maturities (above 10 years), lengthening the average maturity of the government's external debt to 17 years.

2. Assessment. The NIIP does not represent a major risk, due to the high share of FDI and long-term government debt in foreign liabilities. Foreign assets, including international reserves at41 percent of GDP, exceed liabilities and provide a very large buffer.

2020 projections (% GDP)	NIIP: 46.1	Gross Assets: 141.8	Debt Assets: 76.5	Gross Liab.: 95.7	Debt Liab.: 31.8

Current Account

3. Background. The current account balance is projected to increase from 3.4 percent in 2019 to 4.0 percent of GDP in 2020 in the face of a sharp contraction in overall trade. In the first nine months of 2020, exports fell by 3 percent yoy and imports by 13 percent, reflecting global and domestic collapse in demand due to the pandemic, fall in oil prices, and suspension of travel. Sustained exports of high-tech sectors supported the increase in Israel's current account. Over the

medium term, the CA surplus is projected to decline below 3 percent of GDP, with the pandemic shock on trade gradually dissipating and imports recovering to pre-pandemic levels.

4. Assessment. The EBA CA analysis suggests that the cyclically adjusted 2020 CA balance is above the level warranted by fundamentals and appropriate policies by 1.3 percent of GDP, with a policy gap of 0.4 percent of GDP. The cyclically adjusted CA balance includes a multilaterally consistent adjustment for the output gap and terms of trade (0.6 percent), and COVID-related decline in oil imports and net tourism exports (summing to 1.1 percent). The current account norm includes an adjustment for geopolitical uncertainty.[1] Other country-specific factors not reflected in the CA norm potentially also play a role in Israel's high savings rate, including its high level of transfer and grant inflows and mandatory pension contributions (2017 and 2018 Article IV Staff Reports).[2]

Text Table. Israel: Model Estimates for 2020 (Percent of GDP)

	CA model	REER level	REER index
CA-Actual	**4.04**		
Cyclical Contributions	1.72		
EBA model results	0.63		
Oil adjustment	0.64		
Tourism adjustment	0.45		
Additional temporary/statistical factors	0.0		
Adjusted CA	**2.32**		
CA Norm (from model) 1/	**0.20**		
Adjustments to the norm	.80		
Adjusted CA Norm	**1.00**		
CA Gap	**1.32**	**-5.7**	**-2.6**
o/w Policy gap	0.45		
Elasticity	-0.23	-0.23	-0.23
REER Gap	**-5.74**	**23.8**	**10.7**

1/ Cyclically adjusted, including multilateral consistency adjustments.

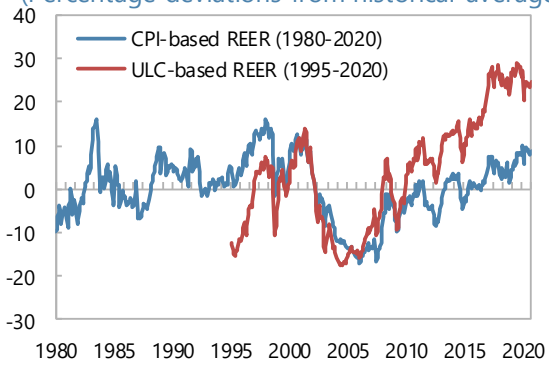
[1] This adjustment is derived from the EBA-lite model—estimated without Israel in the sample—which suggests that the impact of uncertainty related to potential armed conflict would increase Israel's current account balance by about 0.8 percent of GDP in 2020.

[2] A pension law enacted in 2008, which requires mandatory pension contributions to fully fund Israel's defined contribution (DC) pension system, has increased private savings from 15.3 percent of disposable income prior to 2008 to 20.3 percent in 2019 after full transition to the new contribution rates. While the cross-country evidence of a permanent impact of DC pension reforms on the savings rate remains inconclusive, previous staff assessments (2017 Article IV Staff Report) suggested a significant adjustment to the CA norm estimated on the basis of the 2015 EBA CA model.

Real Exchange Rate

5. Background. Both the CPI-based and ULC-based REERs have appreciated significantly in the last decade—by 9 percent and 20 percent, respectively. Despite fluctuations at the onset of the pandemic, the CPI-based REER continued to appreciate by 0.6 percent yoy in the first ten months, mostly driven by a 2.7-percent nominal appreciation of the shekel against the currency basket. The ULC-based REER depreciated somewhat, with lower ULC in Israel outweighing the nominal appreciation.

Real Effective Exchange Rates
(Percentage deviations from historical average)



Source: IMF, INS Database.

6. Assessment. There is a large variation in the estimates of the REER gap provided by different models. The REER-index and REER-level models point to an overvaluation of 10.7 and 23.8 percent, respectively, reflecting the continuing appreciation of the CPI-based REER.[3] However, the implied CA gap—which forms the basis of the bottom-line assessment—suggests an undervaluation of 5.7 percent.

Capital and Financial Accounts: Flows and Policy Measures

7. Background. Net capital inflows in the amount of $10.8 billion took place in 2020H1—substantially larger than the $0.5 billion in 2019H1. This is partly driven by an upsurge of inward FDI ($15.8 billion) and the government's foreign bond issuance. Net portfolio, financial derivatives, and other investment flows were smaller in magnitude, with flows mostly offsetting between Q1 and Q2.

8. Assessment. Risks remain limited. The competitiveness of Israel's high-tech sectors has remained attractive for foreign direct investors even during the pandemic. Capital outflow risks are low due to low external indebtedness of the private sector, a resilient banking system, and long maturity of government debt.

FX Intervention and Reserves Level

9. Background. Net international reserves rose to $ 166.9 billion (. 43.1 percent of GDP, 18 months of imports) billion by November 2020 from $126.0 billion (32 percent of GDP) at end-2019. The increase was mainly driven by the government's foreign bond issuances and the BoI's FX purchases, which have averaged $1.5 billion per month in 2020.

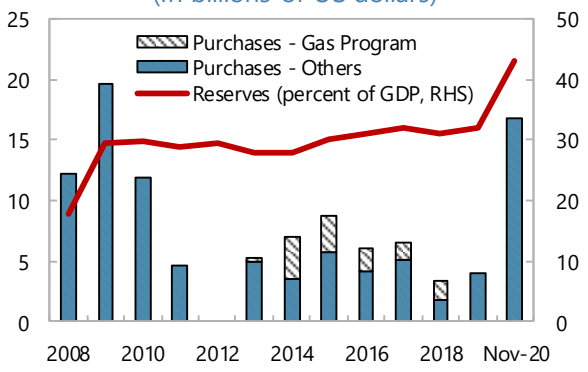
10. Assessment. Israel's level of international reserves is large and exceeds the benchmark reserve adequacy metrics by more than fivefold for months of imports and 20 percent of broad money. Large net international reserves—and other buffers—are justified in Israel in view of the significant geopolitical risks that the country faces. Since the onset of the pandemic, the BOI's

[3] The REER-level model is estimated without Israel in the sample and apply the coefficients for Israel data. This makes it difficult to assess the goodness of fit on Israeli data and weakens the robustness of the results.

intervention has helped prevent a very sharp inflation undershooting from de-anchoring medium-term inflation expectations and sustain the positive impact of the package of monetary easing measures on financial markets and financial stability. Going forward, as inflation trends toward the target band, foreign exchange intervention should cease to serve as a tool to manage inflation expectations and remain a tool to prevent disorderly market conditions.

Foreign Reserves and FX Intervention

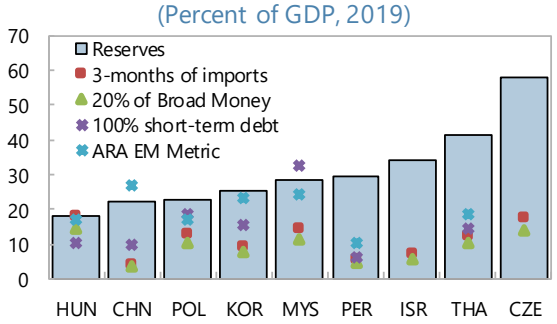
(In billions of US dollars)



Source: Bank of Israel.

Indicators of Reserve Adequacy 1/

(Percent of GDP, 2019)

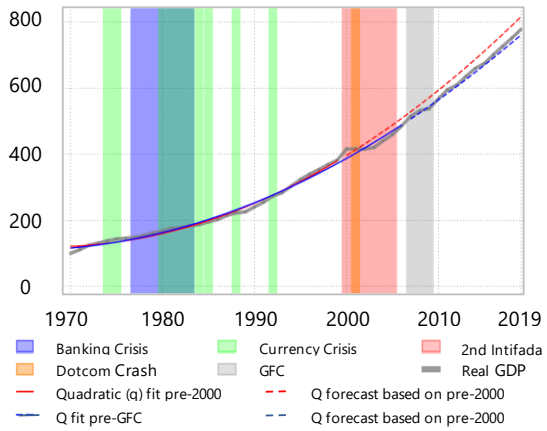


Sources: IMF, World Economic Outlook; IMF Staff calculations.
1/ Comparator countries have similar tolerance for external risks based on indicators for economic flexibility, market maturity, and market access. Israel's reserves as of September 2020.

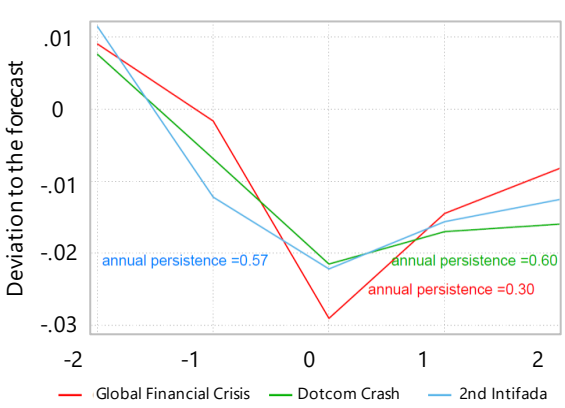
Annex II. Scarring Scenarios

The COVID-19 pandemic has brought unprecedented uncertainty to Israel's economy. The deterioration in economic activity in 2020 indicates significant downside risk to near-term growth. Although Israel has weathered well most crises in recent history, its persistently subdued growth during the most severe crisis (2000–2005) could imply growth remaining below pre-COVID trend throughout the medium-term. Supply shocks from unemployment, corporate balance sheet impairment, and productivity slowdown and demand shocks from precautionary saving motives could leave persistent scarring to potential growth.

1. Historically, Israel's economy has shown resilience to shocks. The banking and currency crises that took place in the past affected growth only moderately and temporarily. During the Global Financial Crisis (GFC), output fell by 1.3 percent below its pre-GFC projection and swiftly returned to the pre-GFC trend after 2009, demonstrating the economy's renewed resilience.



Sources: IMF, World Economic Outlook; Haver Analytics; IMF Staff calculations.

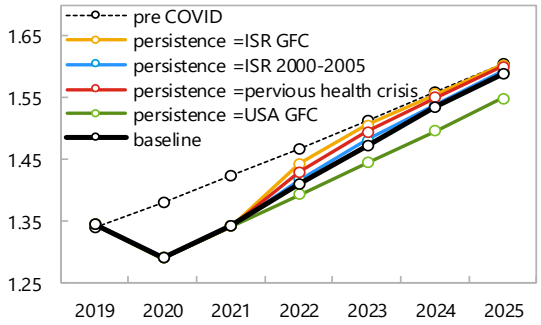


Sources: IMF, World Economic Outlook; Haver Analytics; IMF Staff calculations.

2. The most severe crisis in Israel's recent history was caused by the joint occurrence of the Dotcom bubble burst and the Second Intifada in 2000–5. Compared to pre-crisis growth forecasts, real output declined by 4.3 percent in 2001–5 and took years to return to its pre-crisis path. The large and persistent damage to the economy—7.3 percent contraction compared with an early-2000 WEO projection—was about equally attributed to the Dotcom crisis and the Second Intifada.[1] The impact of these crises was long-lasting with annual persistence of 0.6—double that of the GFC.

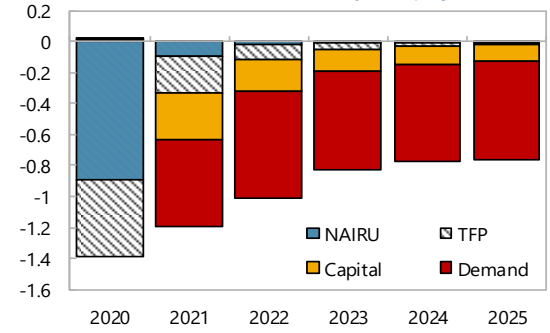
[1] The shocks are measured by the deviations from the 2000 Spring WEO forecast. To decompose the two shocks, we use other OECD countries' Dotcom Crisis shocks to estimate that of Israel and attribute the residual to the Second Intifada. We include the share of the IT sector in the economy as one explanatory variable for the Dotcom shock, accounting for the larger share of the ICT sector in Israel than in other OECD countries.

Real Output Under Different Scenarios
(Trillions, constant price)



Sources: IMF Staff calculations.

Shocks to Potential Real GDP
(Deviation of baseline from Jan. 2020 Projection)



Sources: IMF Staff calculations.

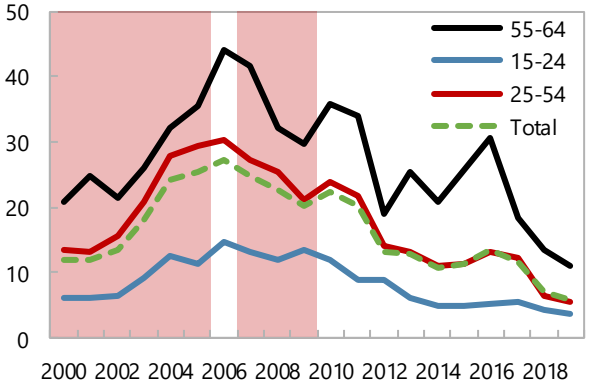
3. Based on different scenarios of the persistence of the shocks, the medium-term scarring resulting from the COVID-19 crisis is likely to be in a 0.3–4.2 percent range relative to the pre-COVID trend. In the baseline projection—where the annual persistence of the COVID-19 shock ranges between 0.6 and 0.8, output would remain around 1 percent below its pre-COVID level by 2025. In a worse scenario where the COVID-19 shock follows that of the GFC in the United States (0.9 annual persistence), output will be 4.2 percent below the pre-COVID path by 2025. If COVID-19 resembles previous health crises with persistence around 0.45 at annual frequency,[2] the medium-term scaring would be less than 0.3 percent. However, previous health crises were localized, allowing rapid economic recovery on the back of favorable external conditions, whereas the COVID-19 pandemic—severely affecting global growth and trade—could be more persistent.

4. The COVID-19 shock could hinder potential growth. Based on the G20MOD model projections,[3] the negative supply shocks—from lockdown-induced unemployment, investment fatigue, and productivity slowdown—would reduce the near-term potential output and quickly dissipate.[4] However, the demand shock—stemming from precautionary saving motives—would have protracted impact on medium-term growth capacity.

[2] Nan Li and Mattia Coppo. 2020, "Severe Epidemics in Modern History: Growth, Debt and Civil Unrest". International Monetary Fund.
[3] Andrle, Michal, Patrick Blagrave, Pedro Espaillat, Keiko Honjo, Ben Hunt, Mika Kortelainen, René Lalonde, Douglas Laxton, Eleonora Mavroeidi, Dirk Muir, Susanna Mursula, and Stephen Snudden, 2015, "The flexible system of global models–FSGM". International Monetary Fund.
[4] We consider the output loss due to *de jure* lockdown measures as supply shock and the residual as demand shock. The decomposition shows that the contraction in 2020 is equally attributed to supply and demand.

5. Labor market hysteresis is likely to emerge. The leave-without-pay program has kept workers from being dismissed since the virus outbreak, but unemployment has risen. Historical evidence[5] shows that high unemployment tends to reduce labor market fluidity and prolong unemployment duration, due to both dwindling labor demand and resource reallocation. For instance, the share of long-term unemployed more than doubled during the 2000–5 crisis and increased post-GFC in Israel. Low-skilled workers in contact-intensive sectors may face greater challenges in restoring employment during and after the COVID-19 crisis.

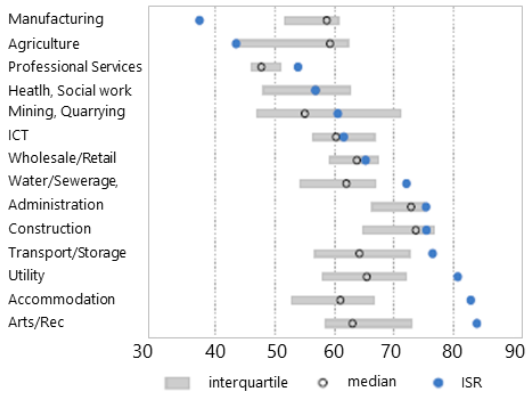
Israel: Long-Term Unemployment
(As share of total unemployment, by age group)



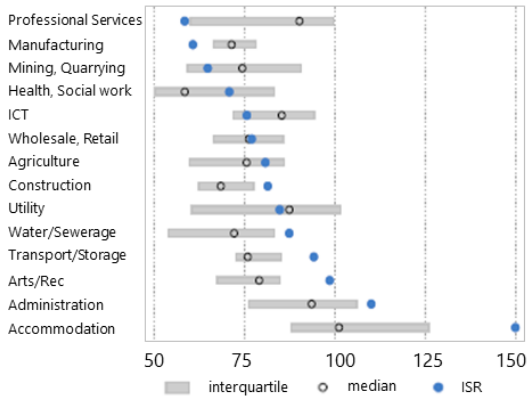
Sources: OECD; IMF Staff calculations.
Note: Shaded areas indicate the 2000-5 crisis and the GFC.

6. Financial weakness in the hard-hit sectors may aggravate the COVID-19 shock. Corporate balance sheets in transportation, accommodation and food services, and arts and entertainment in Israel showed greater signs of weakness prior to the pandemic than corporate balance sheets in these sectors in other European countries. The leverage (share of liabilities to assets) ratio surpassed the European median by 30 percent in accommodation and food services and arts and entertainment and by 20 percent in transportation. Liquidity—measured by the share of current liabilities to current asset—was lower than the European median by 50 percent in accommodation and food services and by 25 percent in arts and entertainment and transportation. These pre-existing vulnerabilities would increase the likelihood of liquidity shortage and bankruptcy, causing investment fatigue. Based on the historical relationship between the increase in firms' financial leverage ratio and the decrease in investment,[6] the financial deterioration associated with COVID-19 could

Liability to Asset



Current Liability to Current Asset



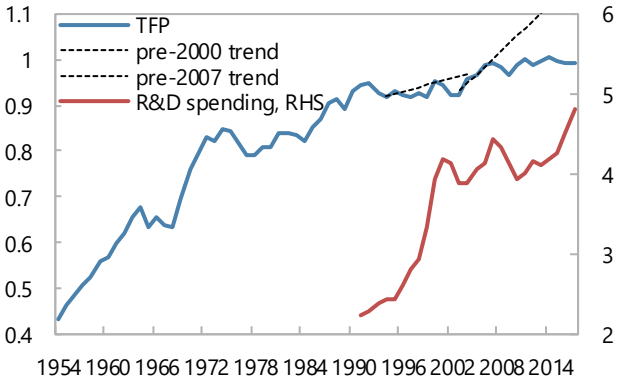
Sources: Bank for the Accounts of Companies Harmonized database, Central Bureau of Statistics.
Notes: Balance sheet information is as of 2016, the latest available for ISR. Countries included in BACH are AUT, BEL, CZE, DEU, DNK, ESP, FRA, HRV, ITA, LUX, POL, PRT, SVK.

[5] See, for instance, Aaronson, Mazumder, and Schechter (2010) and Bonthuis, Jarvis, and Vanhala (2013).
[6] Calligaris, Sara, Lilas Demmou, Dennis Dlugosch, and Guido Franco. 2020. "Insolvency and debt overhang following the COVID-19 outbreak: assessment of risks and policy responses", OECD.

lead to investment declining by 0.8-2.7 percent as a share of total fixed assets in the hard-hit sectors.

7. Health crises are usually associated with productivity decline. Containment measures during the COVID-19 crisis could disrupt global value chains and hinder technological diffusion. Uncertainties around the economic recovery could discourage R&D investment. Fatalities associated with the disease could erode human capital, and working from home may hamper knowledge sharing. Israel's pre-pandemic labor productivity was 24 percent lower than the OECD average (BoI, 2019). Productivity growth may also lose momentum after the crisis, as this happened after the 2000–5 crisis and the GFC partly due to lower R&D spending. Historical evidence shows that health crises entail significant and protracted loss in labor productivity. In Israel, the COVID-19 crisis could result in a contemporaneous productivity loss of about 1 percent and a cumulative loss of about 4 percent in the medium term.

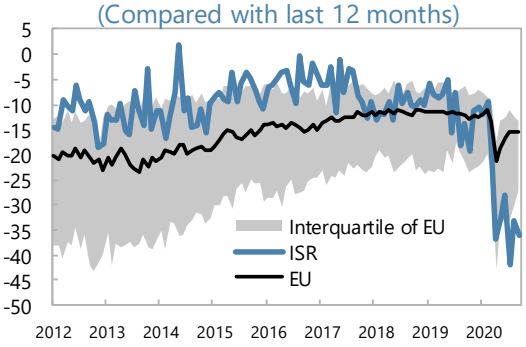
Total Factor Productivity and R&D Spending
(TFP=1 for 2011; R&D spending as share of GDP)



Sources: OECD; Penn World Table.

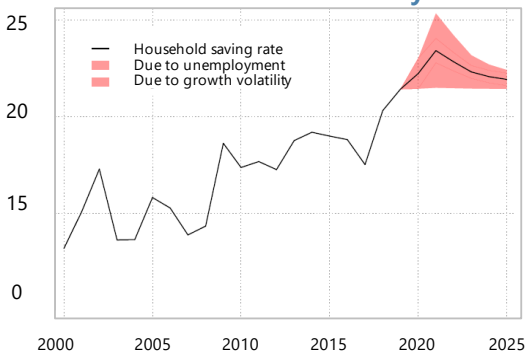
8. Heightened uncertainty associated with the pandemic could intensify precautionary savings, resulting in sluggish demand recovery. Uncertainty tends to incentivize precautionary saving to buffer against the higher likelihood of adverse outcomes. As a result of COVID-19, the likelihood that Israeli households make major purchases in the next 12 months has declined by more than 30 percentage points since the beginning of 2020. The estimated relationships between

Intension to Make Major Purchases in the Next 12 Months
(Compared with last 12 months)



Sources: Eurostat; Central Bureau of Statistics.

Precautionary Savings due to the COVID-19 Uncertainty



Sources: Central Bureau of Statistics; IMF Staff calculations.
Note: Growth volatility is from a GARCH(1,1) estimation.

household savings and several measures of uncertainty in a panel of advanced economies[7] suggest that the increase in unemployment—a proxy for labor income uncertainty—and growth volatility could raise household savings from 21.4 percent of disposable income to 23.4 percent and significantly discourage private consumption.

[7] Mody, Ashoka, Franziska Ohnsorge, and Damiano Sandri. 2012. "Precautionary savings in the great recession." IMF Economic Review 60, no. 1: 114-138.

Annex III. Withdrawing Fiscal Stimulus: When and How Fast?

The Israeli authorities responded to the global pandemic with a significant fiscal stimulus in 2020. Staff's model-based analysis suggests that the envisaged fiscal policy response in 2021 would be broadly adequate, but additional stimulus may be needed, particularly if downside risks materialize. This analysis is sensitive to the degree of persistence of the pandemic, the size of possible economic scarring, and the likely fiscal multiplier. This suggests that the fiscal stimulus should focus on programs with high impact on aggregate demand.

1. The large fiscal policy response to the impact of the global pandemic brings to light the tradeoff between economic stability and debt sustainability. While the immediate objective is to pursue countercyclical policy to support the economy, ensuring debt sustainability and mitigating the potential impact of higher public debt levels on government borrowing costs has also emerged as a concern. Striking a balance between the two is particularly challenging when facing an economic shock as large as that caused by COVID-19.

2. The Israeli authorities provided a large fiscal stimulus to address the pandemic. Staff's baseline projections estimate a deterioration of the primary fiscal balance of about 7 percent of GDP in 2020, and an output gap of about 5.2 percent of potential GDP. With the finalization of the 2021 budget, the key issue is what should be the fiscal stance in 2021. There is significant uncertainty about the size of potential GDP and the output gap in 2021 and still high likelihood of large adverse future shocks associated with the pandemic and other risks to the outlook. This makes the trade-off between stimulus and preserving fiscal space particularly relevant.

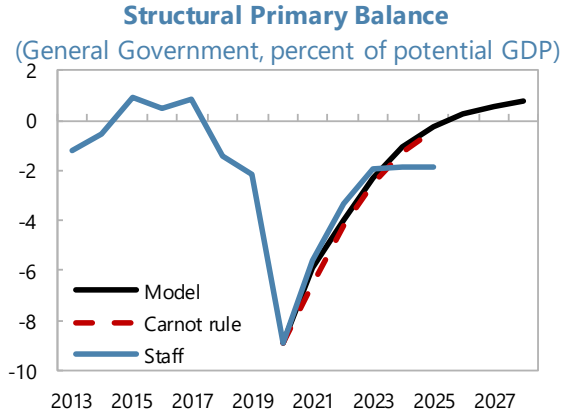
3. To assess these trade-offs, we calibrate Fournier's buffer-stock model for the Israeli economy[1]. Fournier's (2019) model—inspired by the buffer-stock model of the consumer (Deaton, 1991)[2] —gauges the fiscal stance by balancing the need to stabilize the economy through fiscal policy with the risk of losing government market access. The state of the economy is summarized by the structural primary balance, the public debt level, and the output gap. The government chooses a change in the structural primary balance that is sufficient to close the output gap and avoid negative gaps that might have a feedback to potential output (a hysteresis effect). Higher debt levels, however, increase the government risk premium and the risk of losing market access. Moreover, the model assumes that the fiscal stance is decided one year ahead to reflect lags in the implementation of fiscal policy.

4. The model baseline suggests the need for more prolonged fiscal support than envisaged under staff's baseline forecast. Since the goal is to assess the pace at which the fiscal

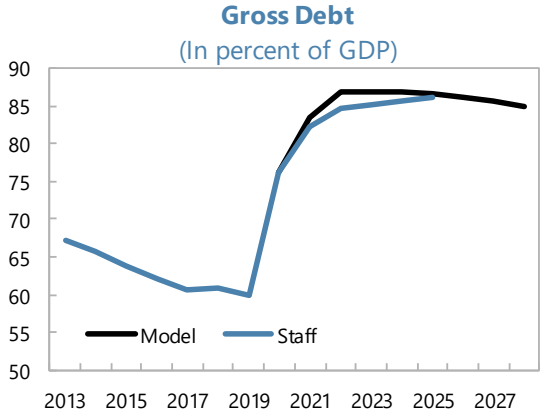
[1] See Fournier, Jean Marc (2019), "A Buffer Stock Model for the Government: Balancing Stability and Sustainability", IMF Working Paper 19/159. Relative to Fournier (2019), key differences in the calibration include a lower debt level threshold, less persistent shocks in the long run, and no hysteresis parameter in the model's baseline case.

[2] See Deaton, Angus S. 1991. "Saving and Liquidity Constraints." Econometrica 59(5): 1221-48.

stimulus should be withdrawn, calibration starts in 2021. The model's baseline suggests a slightly smaller stimulus withdrawal in 2021—by about 0.3 percent of GDP—which helps the economy close the output gap faster, but at the cost of higher debt. The model also suggests the need for a larger fiscal consolidation in the long run than staff's baseline projection. This is broadly consistent with staff's advice of pursuing an adjustment of 2–2½ percent of GDP once growth is on a strong



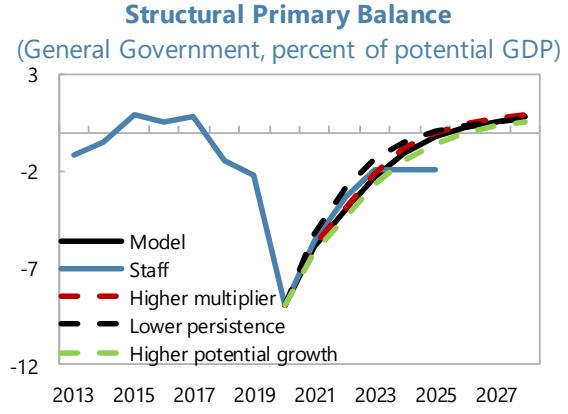
Source: IMF Staff calculations based on the Buffer-stock model of the Government (IMF WP 159/19).



Source: IMF Staff calculations based on the Buffer-stock model of the Government (IMF WP 159/19).

footing.[3] While the more aggressive countercyclical policy entails a larger increase in debt than under the staff forecast, the strong medium-term adjustment puts debt on a declining path.

5. The model baseline results are similar to those of a "Carnot" rule. The rule[4] of thumb is akin to a Taylor rule but the two objectives are fiscal sustainability and economic stabilization. We calculate a simplified version in which the rule targets an underlying fiscal effort equivalent to a quarter of the sum of the primary gap[5] and the output gap. The Carnot rule suggests a smaller stimulus withdrawal in 2021, but a similar stance afterwards.



Source: IMF Staff calculations based on the Buffer-stock model of the Government (IMF WP 159/19).

6. This normative baseline is underpinned by assumptions that are subject to significant uncertainty. Lower potential growth would entail less room for countercyclical policy, while lower interest rates would provide more room. A more effective fiscal policy—yielding larger fiscal

[3] Staff's baseline assumes full withdrawal of the pandemic-related stimulus—in the medium term—such that the structural deficit returns to its 2019 level. However, it does not include the recommended adjustment of about 2 percent of GDP to bring the debt to GDP ratio back to a declining trend.

[4] See Nicolas Carnot, 2014, "Evaluating Fiscal Policy: A Rule of Thumb", European Economy, Economic Papers 526.

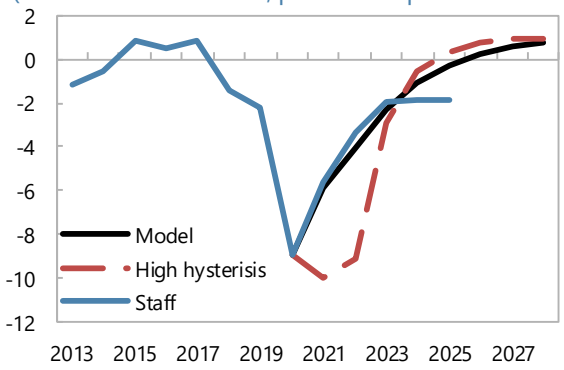
[5] The primary gap is calculated relative to the primary balance needed to reach a debt-to-GDP ratio of 60 percent in the long run.

multipliers—would reduce the size of the needed stimulus—helping preserve fiscal space. Lowering the persistence of the shock—which could be achieved with medical advances in vaccine adoption and distribution and improvement in treatment therapies—would also reduce the need for fiscal stimulus.

7. High scaring would call for a stronger countercyclical policy during downturns. The model baseline assumes no scarring. A high hysteresis scenario would imply a permanent decline in potential output during downturns, leading to a need for more aggressive stimulus—at the cost of a larger impact on debt—to close the output gap faster and limit such scarring. It would also entail a faster pace of adjustment afterwards. While the strong recovery following the second lockdown in Israel is encouraging, it is too early to rule out a more permanent damage to potential output.

Structural Primary Balance

(General Government, percent of potential GDP)



Source: IMF Staff calculations based on the Buffer-stock model of the Government (IMF WP 159/19).

8. Fiscal policy should respond flexibly to the ongoing circumstances. Uncertainty about the parameters seem to have some modest impact on the desirable pace of consolidation. The largest uncertainty likely arises from the plausible persistence of the pandemic and the degree of possible economic scarring. Policy makers will need to be ready to assess these developments and make appropriate adjustments to fiscal policies. Planning for an appropriate contingency reserve in the 2021 budget would be a good step towards ensuring a prompt response to downside risks.

Annex IV. Public DSA

The pandemic resulted in an unprecedented contraction of the Israeli economy despite a large fiscal stimulus to ameliorate the impact. As a result, debt to GDP and gross financing needs increased sharply, as in other advanced economies, significantly increasing vulnerabilities. While fiscal policy should remain supportive of the economy, once the recovery is on a firm ground, fiscal consolidation would be needed to rebuild fiscal buffers. Returning to pre-crisis debt ratios is projected to be a very long process.

1. Under the staff's baseline scenario, the government debt to GDP ratio is projected to reach 87 percent of GDP. Gross financing needs would increase to about 20 percent of GDP (about 10 percent of GDP higher than the pre-crisis level). The baseline assumes the 2020 fiscal stimulus is gradually withdrawn such that the structural deficit approaches pre-crisis levels.

- Real GDP is projected to decline by about 4 percent in 2020, but growth is strong afterwards (4–5 percent), closing the output gap. Nonetheless, the projection envisages that scarring will lead to a loss in the GDP level of about 0.9 percent by 2025.

- CPI Inflation is projected to remain close to zero in the near term, and gradually converge towards the lower end of the target range.

- The general government primary deficit is projected to increase by 9 percentage points of GDP in 2020, and to decline by 7½ in 2021–22 as the stimulus is withdrawn. The baseline primary deficit is somewhat higher than pre-crisis largely due to spending pressures.

- Non-debt creating financing is assumed to be about 0.3–0.4 percent of GDP per year, which is a conservative assumption given historical outturns.

- Risks related to short-term and foreign currency debt remain low. A 2019 increase in T-bill issuance seeks to improve cash management, with similar placements assumed in the future. Foreign currency-denominated debt—at 16.5 percent of total government debt—is placed at long maturities (about 24 years on average during 2020), with amortizations projected at about 2½ percent of GDP per year in 2021–2025.

- Risks associated with pandemic-related government guaranteed programs are also low and amount to about 0.4 percent of GDP.

- The effective interest rate is projected to decline, reflecting an accommodative monetary policy in Israel and globally in the medium term and the smaller share of private placements with pension funds.[1]

[1] The high interest rates reflect a long-standing arrangement between the government and institutional investors guaranteeing a stable return of approximately four percent in real terms to benefit contributors to mandatory private pension schemes. About 30 percent of domestic debt falls into this category and is held by institutional investors (mostly pension and insurance funds) as non-tradable bonds.

2. A range of common stress tests indicate that debt sustainability may become at risks, which could be mitigated with consolidation measures over the medium term. These shocks would place debt above 90 percent of GDP with an increasing trend. To place debt to GDP on a sustained gradual downward trajectory, an adjustment of about 2 percent of GDP would be needed in the medium-term.

- **Growth shock**. Lower real GDP (by one standard deviation for two years starting in 2021) would stabilize debt at around 90 percent of GDP, with the resulting worsening of the primary balance contributing to some 1½ percent in debt creating flows. Gross financing needs would decline at a slightly slower pace than in the baseline.

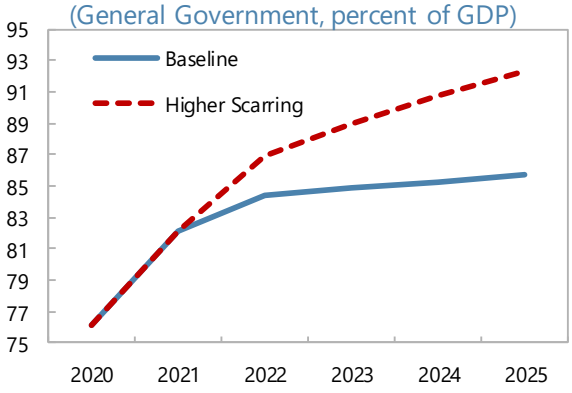
- **Interest rate shock**. A geopolitical shock or tighter global financing conditions could push up borrowing costs by 200 basis points. Debt will increase to about 89½ percent of GDP in the medium term, with debt on an increasing trend. Gross financing needs would be slightly higher than in the baseline.

- **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 around 97¼ percent of GDP, with debt on an increasing trend. Gross financing needs would peak at 22 percent of GDP in 2021 but would later decline at a similar pace as in the baseline.

- **Consolidation scenario.** This scenario illustrates the impact of a 2 percent structural fiscal adjustment in 2022–23 (1 percent each year). Debt would decline to about 80 percent by 2025 (compared to 83 percent in the baseline). The sensitivity to the timing of the adjustment is modest, particularly if one considers that multipliers are likely higher when the output gap is larger. The scenario makes evident that fully rebuilding fiscal buffers is an effort that would likely exceed this timeframe.

3. The risks associated with the pandemic are more significant. The common battery of stress tests does not adequately reflect the level of uncertainty and risks associated with the pandemic. There are significant risks to the baseline with regard to the path of the recovery and the level of scarring, not to mention the policy response. If the persistence of the shock is larger than envisaged, as in the US GFC shock (see Annex II), the GDP loss could be about 4.2 percent by 2025. In such a scenario, debt to GDP would be about 3½ percent of GDP higher by 2025, with the primary deficit about 1¼ percentage points higher than the debt stabilizing primary balance.[2] However, the proposed adjustment of 2 percent of GDP over the medium-term would mitigate risks to the debt dynamics even under such a severe scarring scenario.

Impact of Scarring on Government Debt
(General Government, percent of GDP)



Sources: IMF Staff calculations.

[2] The debt stabilizing primary balance would be about ¼ percent points higher than in the baseline scenario.

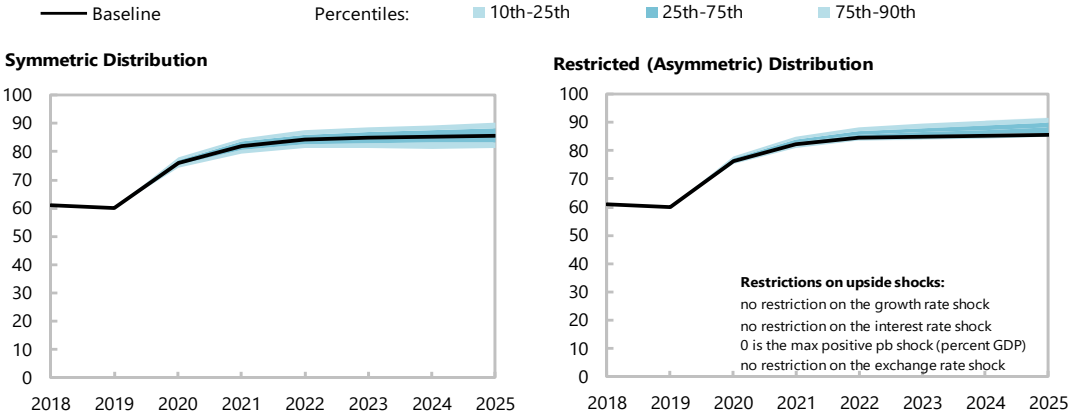
Appendix IV. Figure 1. Israel: Public DSA Risk Assessment

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

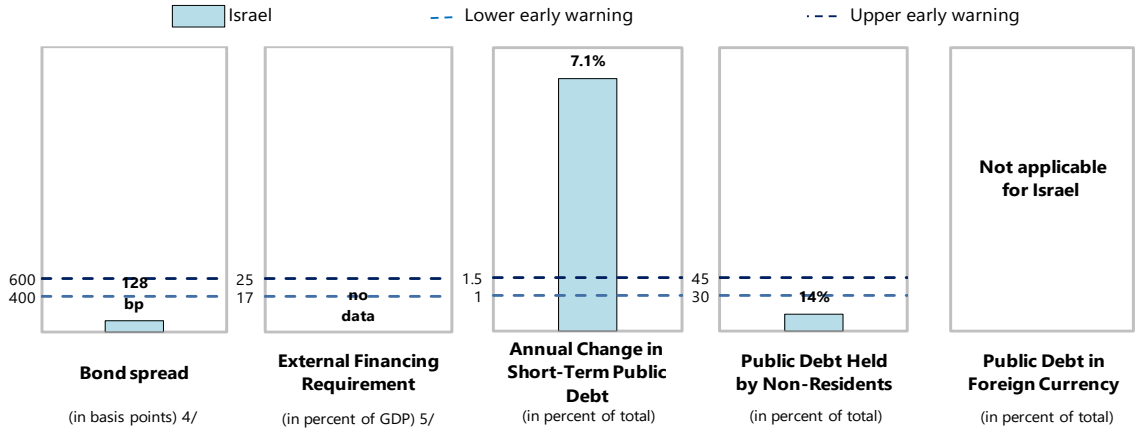
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2019)



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, 20-Mar-20 through 18-Jun-20.

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.

Appendix IV, Figure 2. Israel: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

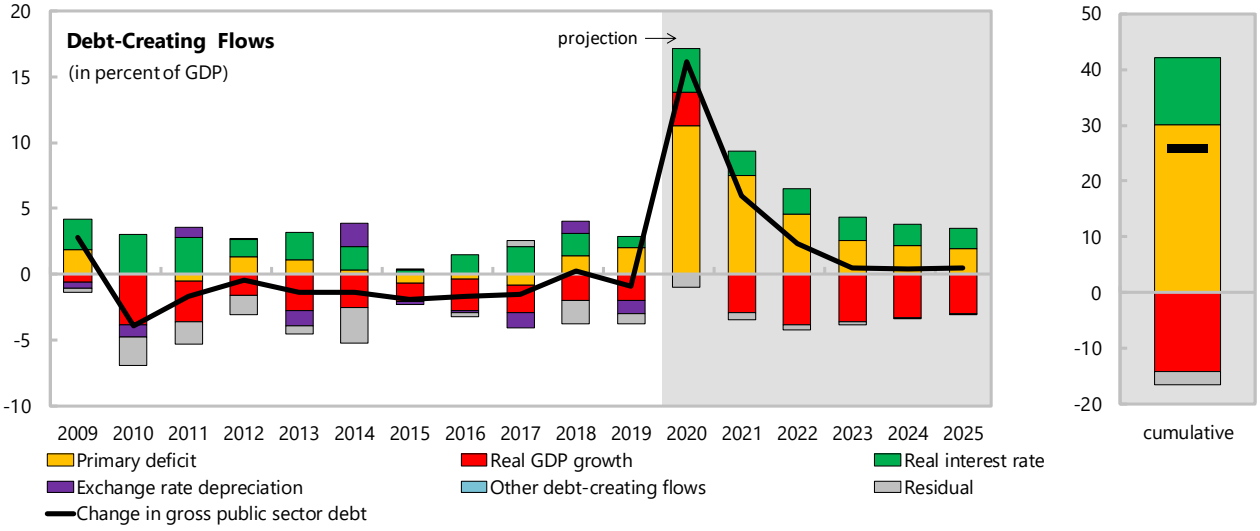
	Actual			Projections					
	2009-2017 [2/]	2018	2019	2020	2021	2022	2023	2024	2025
Nominal gross public debt	66.9	60.9	60.0	76.1	82.1	84.4	84.9	85.3	85.7
Public gross financing needs	10.2	10.8	10.8	18.7	20.0	17.0	15.0	13.1	12.1
Net public debt									
Real GDP growth (in percent)	3.5	3.5	3.4	-4.0	4.1	5.0	4.6	4.1	3.6
Inflation (GDP deflator, in percent)	2.0	1.3	2.2	-0.8	1.1	0.7	0.8	0.9	0.9
Nominal GDP growth (in percent)	5.6	4.8	5.8	-4.8	5.2	5.7	5.4	5.0	4.6
Effective interest rate (in percent) [4/]	5.1	4.2	3.8	4.5	3.7	3.3	3.1	3.0	2.9

As of June 18, 2020

Sovereign Spreads		
EMBIG (bp) 3/		113
5Y CDS (bp)		56
Ratings	Foreign	Local
Moody's	A1	A1
S&Ps	AA-	AA-
Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2009-2017	2018	2019	2020	2021	2022	2023	2024	2025	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.2	0.3	-0.9	16.2	6.0	2.3	0.5	0.4	0.4	25.8	
Identified debt-creating flows	-0.3	2.0	-0.2	17.2	6.5	2.7	0.7	0.5	0.5	28.0	
Primary deficit	0.2	1.4	2.0	11.3	7.5	4.6	2.5	2.2	1.9	30.0	-1.4
Primary (noninterest) revenue and grants	36.1	35.9	35.0	34.3	35.0	35.1	35.1	35.1	35.1	209.8	
Primary (noninterest) expenditure	36.4	37.3	37.0	45.6	42.6	39.6	37.7	37.3	37.1	239.8	
Automatic debt dynamics [5/]	-0.5	0.6	-2.1	5.9	-1.1	-1.9	-1.8	-1.7	-1.4	-2.0	
Interest rate/growth differential [6/]	-0.3	-0.3	-1.1	5.9	-1.1	-1.9	-1.8	-1.7	-1.4	-2.0	
Of which: real interest rate	1.9	1.7	0.9	3.4	1.9	2.0	1.8	1.6	1.5	12.2	
Of which: real GDP growth	-2.3	-2.0	-2.0	2.5	-2.9	-3.9	-3.7	-3.3	-3.0	-14.2	
Exchange rate depreciation [7/]	-0.2	0.9	-1.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	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/]	-1.0	-1.8	-0.7	-1.0	-0.5	-0.3	-0.2	-0.1	0.0	-2.2	



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).

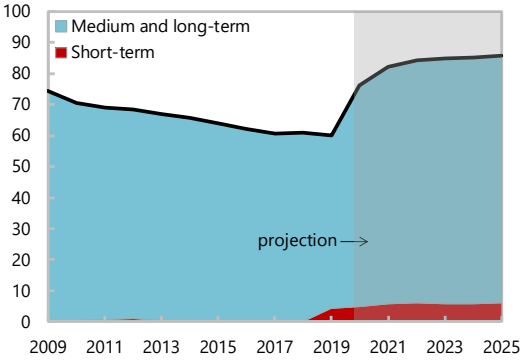
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

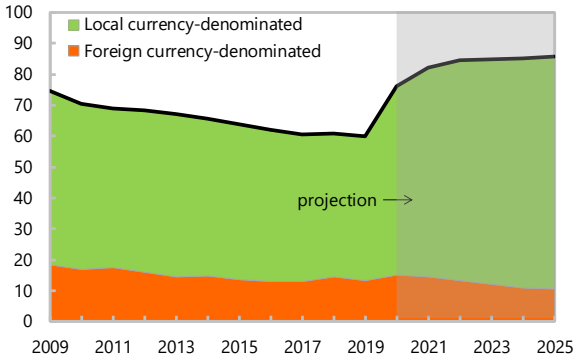
Appendix IV Figure 3. Israel: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

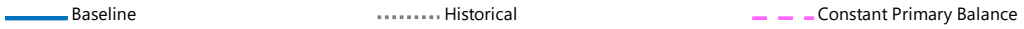
By Maturity
(in percent of GDP)



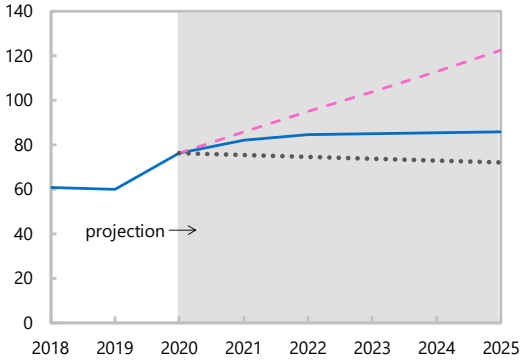
By Currency
(in percent of GDP)



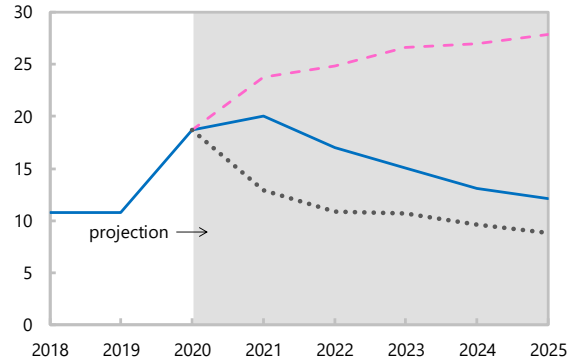
Alternative Scenarios



Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



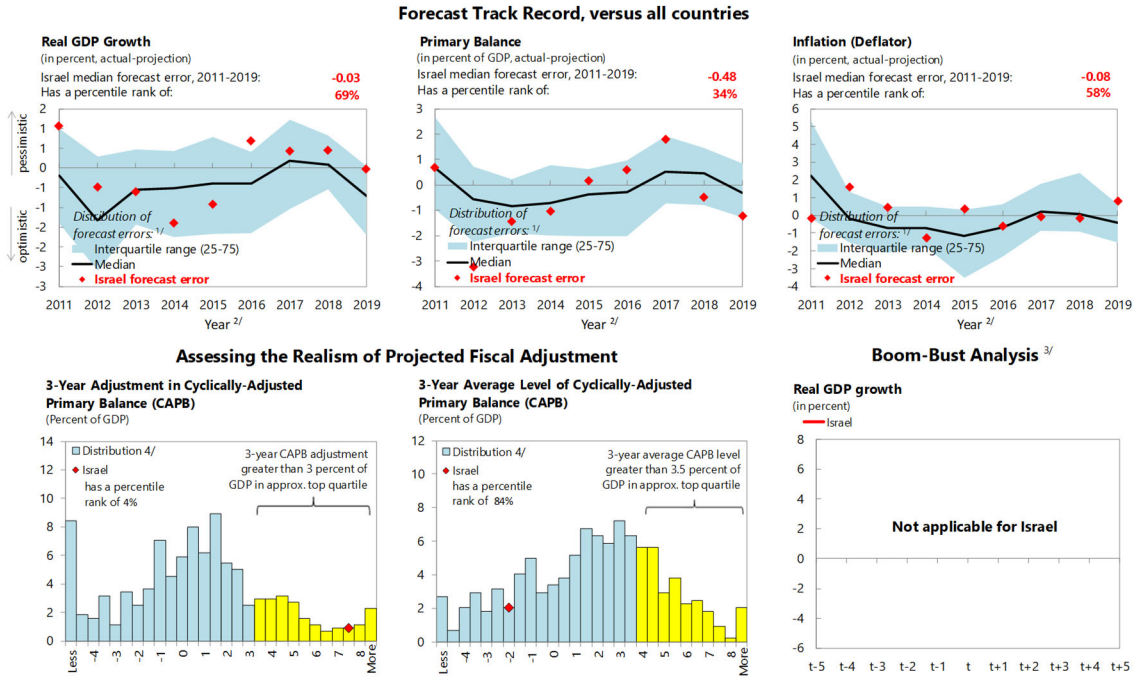
Underlying Assumptions
(in percent)

Baseline Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	-4.0	4.1	5.0	4.6	4.1	3.6
Inflation	-0.8	1.1	0.7	0.8	0.9	0.9
Primary Balance	-11.3	-7.5	-4.6	-2.5	-2.2	-1.9
Effective interest rate	4.5	3.7	3.3	3.1	3.0	2.9
Constant Primary Balance Scenario						
Real GDP growth	-4.0	4.1	5.0	4.6	4.1	3.6
Inflation	-0.8	1.1	0.7	0.8	0.9	0.9
Primary Balance	-11.3	-11.3	-11.3	-11.3	-11.3	-11.3
Effective interest rate	4.5	3.7	3.2	2.9	2.8	2.7

Historical Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	-4.0	3.8	3.8	3.8	3.8	3.8
Inflation	-0.8	1.1	0.7	0.8	0.9	0.9
Primary Balance	-11.3	-0.4	-0.4	-0.4	-0.4	-0.4
Effective interest rate	4.5	3.7	3.5	3.3	3.2	3.0

Source: IMF Staff Calculations.

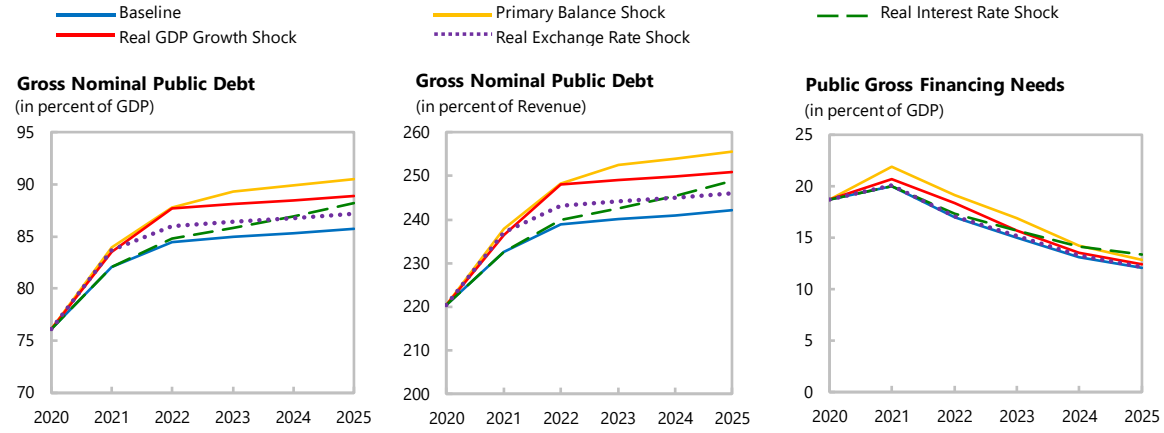
Appendix IV. Figure 4. Israel: Public DSA – Realism of Baseline Assumptions



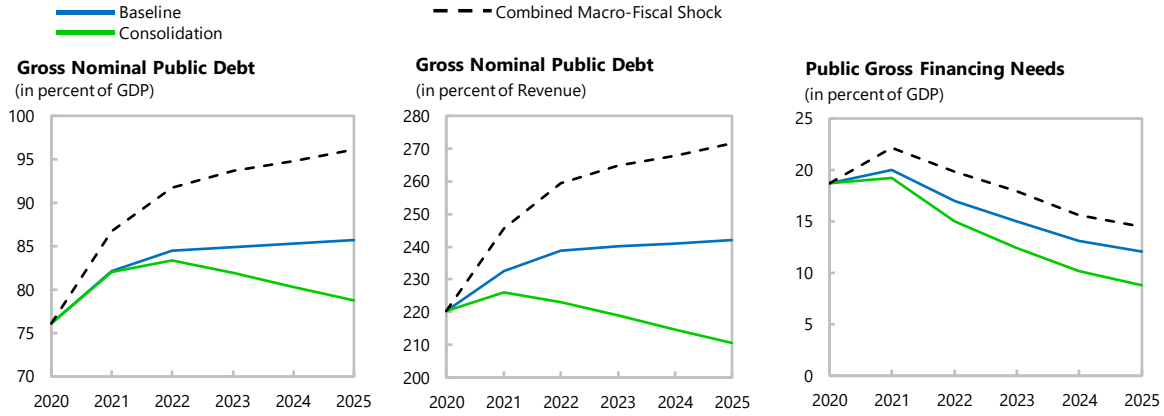
Source : IMF Staff calculations.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Israel, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Appendix IV. Figure 5. Israel: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2020	2021	2022	2023	2024	2025
Real GDP growth	-4.0	4.1	5.0	4.6	4.1	3.6
Inflation	-0.8	1.1	0.7	0.8	0.9	0.9
Primary balance	-11.3	-9.4	-6.0	-3.6	-2.4	-2.0
Effective interest rate	4.5	3.7	3.4	3.2	3.1	3.0
Real Interest Rate Shock						
Real GDP growth	-4.0	4.1	5.0	4.6	4.1	3.6
Inflation	-0.8	1.1	0.7	0.8	0.9	0.9
Primary balance	-11.3	-7.5	-4.6	-2.5	-2.2	-1.9
Effective interest rate	4.5	3.7	3.8	3.8	3.8	3.9
Combined Shock						
Real GDP growth	-4.0	3.1	4.0	4.6	4.1	3.6
Inflation	-0.8	0.9	0.5	0.8	0.9	0.9
Primary balance	-11.3	-9.4	-6.0	-3.6	-2.4	-2.0
Effective interest rate	4.5	3.8	3.7	3.7	3.8	3.8

Real GDP Growth Shock	2020	2021	2022	2023	2024	2025
Real GDP growth	-4.0	3.1	4.0	4.6	4.1	3.6
Inflation	-0.8	0.9	0.5	0.8	0.9	0.9
Primary balance	-11.3	-8.0	-5.5	-2.5	-2.2	-1.9
Effective interest rate	4.5	3.7	3.3	3.1	3.0	2.9
Real Exchange Rate Shock						
Real GDP growth	-4.0	4.1	5.0	4.6	4.1	3.6
Inflation	-0.8	1.5	0.7	0.8	0.9	0.9
Primary balance	-11.3	-7.5	-4.6	-2.5	-2.2	-1.9
Effective interest rate	4.5	3.8	3.3	3.1	3.0	2.8
Consolidation Shock						
Real GDP growth	-4.0	3.1	4.0	4.6	4.1	3.6
Inflation	-0.8	0.9	0.5	0.8	0.9	0.9
Primary balance	-11.3	-6.5	-2.6	-0.5	-0.2	0.1
Effective interest rate	4.5	3.7	3.3	3.1	3.0	2.9

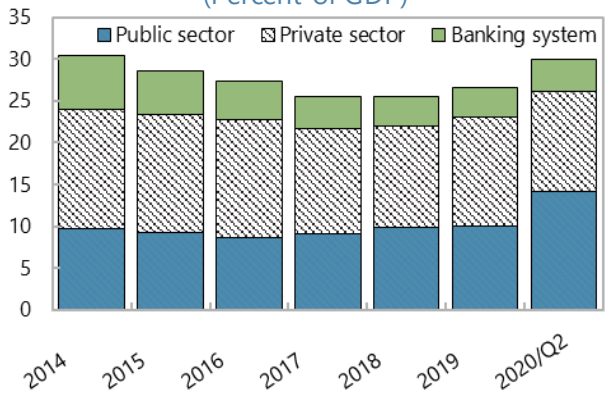
Source: IMF Staff calculations.

Annex V. External DSA

Gross external debt is projected to increase from 27 percent of GDP in 2019 to 32 percent in 2020 and resume its downward trend in 2021. Its dynamic is robust to most shocks.

1. Israel's external debt has been on a broadly declining trend in recent years. External debt—at 26.6 percent in 2019—has dropped by 2 percentage points since 2015. General government external debt remained stable around 9.5 percent of GDP, while private sector and banks' external debt fell by a total of 4 percentage points of GDP. External debt is projected to have increased to 31.8 percent of GDP at end-2020 (Table 1), mainly driven by the large GDP contraction due to the COVID-19 crisis and the associated government financing needs.

Gross External Debt
(Percent of GDP)



Sources: Bank of Israel.

2. Gross external debt and gross external financing needs are projected to gradually decline in the medium term. Under the baseline scenario, external debt would fall below 25 percent of GDP in 2025, reflecting higher output as the economy recovers from the pandemic, smaller government borrowing needs, and favorable debt dynamics given low interest rates. Gross external financing needs are projected to remain comfortably low. After a temporary increase in 2020, they are projected to fall to their pre-pandemic level under 7 percent of GDP by 2024.

3. The risk associated with short-term external debt is low. The share of short-term debt is 36 percent at end-June 2020 and is fully covered by Israel's abundant international reserves (4 times of short-term debt). External assets of the public, private, and banking sectors exceed their external liabilities.

4. External debt sustainability is robust to most shocks. Standard interest rate, growth, and current account shocks would not overturn its projected downward path. External debt is more sensitive to a real depreciation shock: a 30 percent depreciation in 2020 would increase external debt by 11 percent of GDP, but more than half of the increase would dissipate in the medium term.

Table 1. Israel: External Debt Sustainability Framework, 2015–2025

(in percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2015	2016	2017	2018	2019			2020	2021	2022	2023	2024	2025	Debt-stabilizing non-interest current account 6/
Baseline: External debt	28.6	27.3	25.5	25.5	26.6			**31.8**	**29.0**	**27.2**	**25.9**	**25.1**	**24.7**	**-1.8**
Change in external debt	-1.7	-1.3	-1.8	-0.1	1.1			5.2	-2.7	-1.9	-1.3	-0.7	-0.4	
Identified external debt-creating flows (4+8+9)	-5.7	-5.3	-8.3	-5.3	-6.8			-4.9	-6.5	-6.4	-5.9	-5.4	-5.1	
Current account deficit, excluding interest payments	-5.9	-4.1	-3.9	-2.8	-4.1			-4.8	-4.5	-4.2	-4.0	-3.7	-3.5	
Deficit in balance of goods and services	-2.9	-1.4	-1.1	-0.7	-1.9			-4.2	-3.1	-2.9	-2.6	-2.4	-2.2	
Exports	31.0	29.7	28.7	29.7	29.2			28.6	29.3	29.8	30.3	30.9	31.6	
Imports	28.1	28.3	27.6	29.0	27.3			24.3	26.2	26.9	27.7	28.5	29.4	
Net non-debt creating capital inflows (negative)	-1.6	-0.3	-2.6	-1.9	-1.8			-1.9	-1.6	-1.5	-1.4	-1.3	-1.3	
Automatic debt dynamics 1/	1.8	-0.9	-1.8	-0.6	-0.9			1.9	-0.5	-0.7	-0.5	-0.4	-0.3	
Contribution from nominal interest rate	0.8	0.8	0.8	0.6	0.7			0.8	0.7	0.7	0.6	0.6	0.6	
Contribution from real GDP growth	-0.7	-1.0	-0.9	-0.8	-0.8			1.1	-1.2	-1.4	-1.2	-1.0	-0.9	
Contribution from price and exchange rate changes 2/	1.7	-0.6	-1.8	-0.4	-0.7			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	4.0	4.0	6.5	5.2	7.9			10.1	3.8	4.6	4.6	4.6	4.7	
External debt-to-exports ratio (in percent)	92.5	92.2	89.0	85.8	91.1			111.2	99.1	91.0	85.3	81.3	78.2	
Gross external financing need (in billions of US dollars) 4/	24.5	24.5	24.4	30.9	26.3			34.9	30.2	31.3	33.7	32.2	29.7	
in percent of GDP	8.2	7.7	6.9	8.3	6.7	10-Year	10-Year	9.0	7.3	7.1	7.2	6.6	5.8	
Scenario with key variables at their historical averages 5/								**31.8**	**30.0**	**28.3**	**26.7**	**25.0**	**23.5**	**-2.5**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	2.2	3.8	3.6	3.5	3.4	3.8	1.0	-4.0	4.1	5.0	4.6	4.1	3.6	
GDP deflator in US dollars (change in percent)	-5.3	2.2	6.9	1.5	3.0	2.9	4.7	2.3	3.1	1.0	1.0	1.1	1.1	
Nominal external interest rate (in percent)	2.7	2.9	3.3	2.6	2.8	2.8	0.3	2.9	2.5	2.5	2.5	2.6	2.6	
Growth of exports (US dollar terms, in percent)	-6.6	1.8	7.1	8.5	4.8	5.5	7.2	-3.9	10.0	8.0	7.3	7.3	7.2	
Growth of imports (US dollar terms, in percent)	-11.1	7.0	8.1	10.2	0.2	5.7	9.9	-12.4	15.4	9.0	8.7	8.4	8.1	
Current account balance, excluding interest payments	5.9	4.1	3.9	2.8	4.1	3.8	1.3	4.8	4.5	4.2	4.0	3.7	3.5	
Net non-debt creating capital inflows	1.6	0.3	2.6	1.9	1.8	1.6	1.3	1.9	1.6	1.5	1.4	1.3	1.3	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

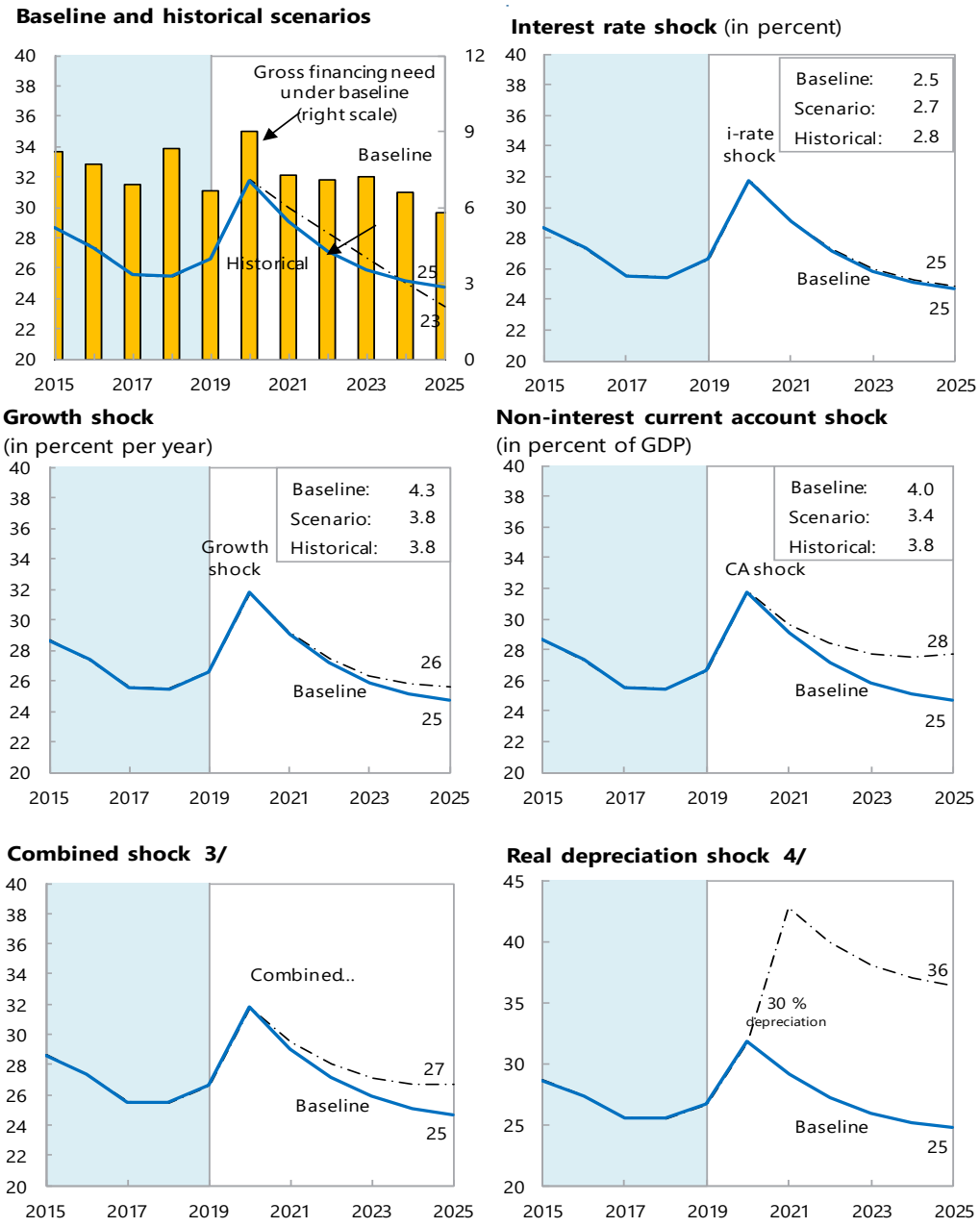
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2021.

INTERNATIONAL MONETARY FUND

ISRAEL

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 22, 2020

Prepared By European Department

CONTENTS

FUND RELATIONS

(As of November 30, 2020)

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)	1,471.92	76.63
Reserve Tranche Position	448.99	23.37
Lending to the Fund		
New Arrangements to Borrow	16.37	…

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	883.39	100.00
Holdings	873.08	98.83

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				
	2020	2021	2022	2023	2024
Principal					
Charges/Interest	0.00	0.02	0.03	0.03	0.03
Total	0.00	0.02	0.03	0.03	0.03

[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" and the *de facto* exchange rate arrangement is classified as "floating".

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.

Article IV Consultation:

The last Article IV consultation was concluded on April 30, 2018. 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:

Conforming the commitments under the Oslo Accords, the Fund has been providing policy advice and technical assistance (TA) to the Palestinian Authority (PA) since 1994, and presently has a 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 27, 2018. The Fund has also provided TA for capacity development, 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 income tax reform, macroeconomic forecasting, 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:

The office of the IMF Resident Representative for the WBG was established in July 1995.

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 annual data on the overall annual fiscal balance submitted by the Central Bureau of Statistics (CBS covers all the General Government units) are compiled according to the *GFSM2014* methodology. This follows the implementation of the accrual basis of recording for the interest expense series. Quarterly data for the consolidated budgetary central government and social security fund submitted by the CBS are accrual-based and broadly follow the *GFSM2014* 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. In-year monthly reports on central government operations—compiled by the MOF on a cash basis—cover only the main aggregates of budgetary government accounts and net accounts of the social security fund, not broken down by components.	
Monetary Statistics: Monthly monetary and financial statistics in IMF's Standardized Reporting Format (SRF) for the central bank, other deposit takers, and other financial corporations are reported to the IMF. Israel reports data on some key series and indicators of the Financial Access Survey (FAS), including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).	
Financial sector surveillance: Data on financial soundness indicators (FSIs) are compiled and reported to IMF on a quarterly basis and cover deposit takers, other financial corporations, nonfinancial corporations and households.	
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. Country participates in Coordinated Direct Investment Survey and in Coordinated Portfolio Investment Survey.	
II. Data Standards and Quality	
Participant in the Special Data Dissemination System (SDDS) since April 1996, and in full	Data ROSC published on March 24, 2006.

observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars.	
III. Reporting to STA (Optional)	
Data are regularly reported for publication in the *Government Finance Statistics Yearbook* and in the *IFS*.	

Table 1. Israel: Common Indicators Required for Surveillance
(As November 30, 2020)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
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]	Oct-20	Nov-20	M	M	M
Reserve/Base Money	Oct-20	Nov-20	M	M	M
Broad Money	Oct-20	Nov-20	M	M	M
Central Bank Balance Sheet	Oct-20	Nov-20	M	M	M
Consolidated Balance Sheet of the Banking System	Jun-20	Sep-20	M	M	M
Interest Rates[2]	Same day	Same day	D	D	D
Consumer Price Index	Oct-20	Nov-20	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2019	Nov-20	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Oct-20	Nov-20	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2-20	Sep-20	Q	Q	Q
External Current Account Balance	Q2-20	Sep-20	Q	Q	Q
Exports and Imports of Goods and Services	Q2-20	Sep-20	Q	Q	Q
GDP/GNP	Q2-20	Sep-20	Q	Q	Q
Gross External Debt	Q2-20	Sep-20	Q	Q	Q
International Investment Position[6]	Q2-20	Sep-20	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).

Statement by the Staff Representative on Israel
January 19, 2021

This statement provides information that has become available since the staff report was issued to the Executive Board on December 22, 2020. The thrust of the staff appraisal remains unchanged.

1. Parliament was dissolved on December 23 after the coalition government failed to agree on a budget for 2020, triggering parliamentary elections in March. PM Netanyahu is the head of the interim caretaker government. Political fragmentation has risen, posing risks of a stalemate in establishing a governing coalition. Nonetheless, the general course of economic policies is unlikely to change.

2. With potentially significant delays in the adoption of the 2021 budget, parliament approved government spending to mitigate the fiscal contraction that would otherwise occur. This includes NIS 72 billion (about 5 percent of GDP) in pandemic-related spending in line with the authorities' 2021 plans. Legal amendments also allow an increase in the 2021 government spending allocation—which is based on the 2019 budget—in line with population growth rather than with inflation. The approved general government expenditures are about ½ percent of GDP lower than previously projected, which could result in a slightly tighter fiscal stance than implied by the baseline in the event that a 2021 budget is not adopted.

3. Political uncertainty and the race between the spread of the COVID-19 virus and vaccine distribution have widened the risks to the economic outlook. The sharp rise in new COVID-19 cases in December and early-January necessitated imposing a third nation-wide lockdown, which together with political instability ahead of the elections could exacerbate precautionary behavior and drag growth. On the upside, since end-December, Israel has rolled out a swift vaccination campaign, administering more than 1.8 million doses to around 20 percent of the population as of January 10, 2021. Should vaccination pace and effectiveness be sustained, Israel may reach herd immunity in 2021Q2, significantly boosting confidence and recovery prospects. Medium-term risks have also widened, with rapid vaccine distribution limiting economic scarring, while political uncertainty puts reform progress in jeopardy.

Statement by Mr. Anthony De Lannoy, Alternate Excutive Director and Mr. Shay Tsur, Senior Advisor to the Executive Director on Israel
January 19, 2021

On behalf of the Israeli authorities, we thank the mission team for an excellent report and the candid, constructive, and friendly dialogue. We appreciate the efforts made by the team to conduct a complete and effective mission under the challenging circumstances of COVID-19 and the virtual environment that it has created. The authorities agree with the vast majority of the analysis and recommendations in the report. We would like to offer the following updates and comments:

Recent Developments

The COVID-19 crisis has emerged following continued growth, low debt to GDP ratio, and an improvement in inequality indicators in Israel. The health crisis led to an economic crisis of unprecedented intensity, but at the same time, the economic developments over the course of the year repeatedly illustrated the resilience of the Israeli economy. In the two times that the restrictions on supply were lifted following lockdowns, economic activity has risen quickly and sharply. Some businesses succeeded in aligning the features of their activity with the new situation, with the high-tech service industry notably well placed, as reflected in the continued growth of services exports. Nevertheless, the severe adverse impact has been felt by employees in industries characterized by low productivity and wages.

Israel has experienced a fast recovery of its economic activity in November and December following the exit from the second lockdown. The broad unemployment rate (including employees on unpaid leave) reached about 23% during the second lockdown and declined to about 12.7% in the first half of December. Nevertheless, the authorities are concerned by the fact that unemployment has failed to reduce below that level and are ready to mitigate this challenge with its supportive policy.

While morbidity reemerged and the government has decided on a third lockdown, the vaccine campaign in Israel is a source of growing optimism. The campaign began earlier than expected, and to date, the vaccination pace in Israel is the highest in international perspective: already at the beginning of January 2021, 20% of the population have been vaccinated.

On the political front, the Israeli parliament dissolved without approving a budget for 2021 and the country is heading to its fourth election campaign in the past two years. Nevertheless, the parliament approved an amendment to the law that expands the budget for 2021 to match population growth and to preserve the current support for health and social needs that emerge from the COVID-19 crisis. The government has also approved a program to target 2 billion Shekels to businesses that experienced a sharp reduction in their income. The authorities believe that given these additions, the current planned funding is adequate to mitigate the baseline scenario.

Outlook and Risks

We broadly agree with staff about the outlook and the risks but at the same time, we believe that growth will be faster than staff projects, based on the fast recoveries from previous lockdowns and the remarkable vaccine campaign. The Bank of Israel (BOI) has published optimistic and pessimistic scenarios but assesses that given the rapid pace of inoculations, the optimistic scenario is significantly

more likely to materialize. This scenario assumes a process of rapid inoculation of the population that lasts until May 2021, and no government restrictions with a significant positive impact on economic activity beyond May 2021. GDP is expected to expand in this case by 6.3% percent in 2021 and by 5.8% in 2022. While staff assumes, similar to the BOI, that restrictions will fade during 2021 as vaccine coverage expands and therapies improve, their growth outlook is more pessimistic with 4.1% in 2021 and 5% in 2022, resembling the BOI pessimistic scenario, which assumes a more prolonged inoculation process lasting until June 2022, and GDP growth of 3.5% in 2021 and 6% in 2022.

Fiscal Policy

The health crisis led to a determined response from the government. We appreciate staff's view that the volume of fiscal support has been adequate. This support has been possible thanks to the prolonged reduction of public debt, up to 60% of GDP prior to the crisis. The political situation undoubtedly created challenges but despite that, the government provided extensive assistance to the unemployed, to businesses that were adversely impacted, and to the health system's response. Furthermore, the Ministry of Finance (MOF) has been publishing a monthly report on the government's programs, to allow important planning and policy analysis.

The lack of an orderly government budget for 2021 and the need to rely on an interim budget, weigh on the government's ability to operate. Nevertheless, the MOF succeeded during 2020 to support the economy efficiently. The approvals of ad-hoc budget expansions for 2021 indicate that this support will also be available in 2021.

Staff's baseline projection for debt is more pessimistic compared to the authorities' projections. The Israeli authorities believe that the fast recoveries from previous lockdowns, the promising vaccination campaign, and the long-lasting fiscal responsibility imply a better prospect. Nevertheless, the structural deficit that has been burdening fiscal stance already before the pandemic is a source of concern that should be addressed. As for the way to achieve fiscal consolidation, and referring to staff's notes on tax policy, the Israeli authorities note that the top PIT rates in Israel are relatively high, and they emphasize the government's objective of returning and preserving IP as a tool to enhance recovery.

Monetary Policy and Inflation

To face the COVID-19 initial shock to the financial markets, the BOI acted rapidly by supplying liquidity to the economy in shekels and foreign currency. As staff well noted, this policy was successful and mitigated the pressures on exchange rates, bond yields, and corporate spreads. Following this timely emergency support, the BOI ensured that the credit market is well supporting the needs of all borrower types in the economy—households, businesses, and the government. The BOI has eased the Monetary policy using various tools, including several programs to ensure that credit continued to flow towards small businesses as well.

Inflation in Israel was low even before the crisis, and the sharp decline in demand led to an additional decline in inflation. The BOI assesses that within several months, the year-over-year inflation rate will return to positive and that it will continue to increase gradually towards the lower bound of the target range. Throughout the crisis, the expectations for medium- and long-term inflation have remained anchored within the inflation range target.

After remaining relatively stable since April, the shekel began to strengthen at the beginning of October. This trend accelerated in November and December, resulting in 6.5% and 3.3% appreciation of the shekel against the dollar and an aggregate of trade-currencies respectively. While the appreciation is partly generated by spillovers from the extraordinarily accommodative monetary policy in other advanced economies, it is difficult to determine the extent to which it reflects fundamental developments. The IMF's REER-index and REER-level models point to an overvaluation of 10%-20%, but the implied CA gap suggests an undervaluation of 5.7%. As staff well notes, the results of the CA models are subject to unprecedented uncertainty around the impact of the pandemic. We agree with staff about the role that factors that are not reflected in the CA norm might play, and we would like to emphasize here Israel's high savings rate, including its high level of transfers and grant inflows, mandatory pension contributions, and gas exports. Given this uncertainty, the BOI has decided that at these unusual times of negative inflation and an unprecedented crisis, it should act to soften the ongoing appreciation, as consistent with the overall expansionary monetary policy.

The Financial Sector

The BOI took, within the framework of the Banking Supervision Department's authority, a broad range of steps to ensure the banks' continued ability to extend credit to the economy. Staff rightly reports that the BOI also eased macroprudential and supervisory requirements, and several specific important steps. It should be also noted that on December 2020, the BOI announced that on January 17th, 2021, the restriction on the part of mortgage loans indexed to the policy rate interest rate will be two-third of the loan instead of one-third, to reduce the mortgage burden on households.

As staff reports, the BOI's sensitivity tests show that Israeli banks would stay stable even under the most severe scenarios. It should also be noted that the stability of the entire financial system has been closely monitored, by the Financial Stability Committee headed by the BOI and established in November 2018, and by the Capital Markets, Insurance and Savings Authority (CMISA) among others.

Macro-Structural Policies

We appreciate the in-depth analysis by staff on policies needed to mitigate long-term scarring and improve the resilience of the economy. We share staff's views and believe that this crisis should not be wasted. While the crisis has been causing human and economic suffering, it has already resulted in some promising developments: the urgent need to assist employees has created useful databases to deploy ALMPs that promote reskilling and upskilling during the recovery; and maintaining vital economic and social activities during the crisis led to increasing digitalization capacity, including in the wholesale sector and the educational system.

The government has been taking several steps in recent years to increase productivity in the long run. For instance, it increased the expenditure on education and improved affirmative action; and markedly shifted infrastructure investment from roads to mass transportation. In August 2019, the BOI published a vast report with various recommendations to deploy more policies to enhance productivity growth. A cautious consolidation policy will hopefully create the budgetary space that is needed to finance some of these policies in the next years.