INTERNATIONAL MONETARY FUND

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ISRAEL

2013 ARTICLE IV CONSULTATION

February 2014

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 2013 Article IV consultation with Israel, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 10, 2014, following discussions that ended on December 16, 2013, 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 January 24, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of February 10, 2014 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its February 10, 2014 consideration of the staff report that concluded the Article IV consultation with Israel.
- A **Statement by the Executive Director** for Israel.

The following documents have been or will be separately released.

Selected Issues Paper

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

ISRAEL

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

January 24, 2014

KEY ISSUES

Context. The economy is growing at a moderate pace. Abstracting from the impact of new large-scale natural gas production, GDP growth is estimated to have moderated to about 2½ percent in 2013, owing in large part to weak investment and exports. Some pick up is expected in 2014, but the underlying momentum is weaker than before. Despite notable progress, Israel's public debt (68 percent of GDP) remains high, while continued house price increases pose risks of a boom-bust cycle in the housing market.

Policy priorities. The key policy challenge is to maintain near-term growth at potential, while preventing the build-up of imbalances, strengthening resilience to shocks, and ensuring long-term sustainability.

Monetary policy. Given the still uncertain external environment and headwinds to growth from an appreciation of the shekel and planned fiscal tightening, monetary policy should remain accommodative for now. Macroprudential policy measures should be further tightened to minimize the risk of a boom-bust cycle in the housing market. If growth prospects improve more than expected, the policy stance should be gradually normalized.

Fiscal policy. Bold fiscal consolidation measures embedded in the 2013–14 Budget are welcome, but further adjustment will be required for 2015 and beyond to anchor sustainability, along with a strengthening of fiscal institutions.

Financial stability. The financial system remains relatively sound. In line with the recommendations of the 2012 FSAP Update, a Financial Stability Committee needs to be established, with a clear focus on macroprudential policies in normal times. Legal reforms aimed at strengthening the framework for bank resolution should be legislated as soon as practicable.

Structural reforms. Further action is required to improve the business climate and boost competition in the non-tradable sector. In addition, it will be important to enhance the participation of rapidly growing Israeli-Arab and Ultra-Orthodox Jewish (Haredi) populations in the labor force to bolster the economy's long-term potential and to reduce poverty and inequality.

Approved By
Philip Gerson and Vivek Arora

The 2013 Article IV discussions were held in Jerusalem and Tel Aviv during December 4–16, 2013. The team comprised Mr. Srinivasan (Head, EUR), Mr. Bakker, Mr. Ishi, Ms. Osorio Buitron (all EUR), Ms. Bova, and Mr. Josephs (all FAD). Ms. Denis and Ms. Jung (both EUR) contributed from headquarters. Mr. Friedman (OED) attended most meetings, while Mr. Snel (OED) attended the concluding meeting. The mission met with Finance Minister Lapid, Bank of Israel Governor Flug, representatives of the Price Minister's Office, other senior officials, the chairman of the Knesset Finance Committee, academics, head of the trade union, and private sector representatives.

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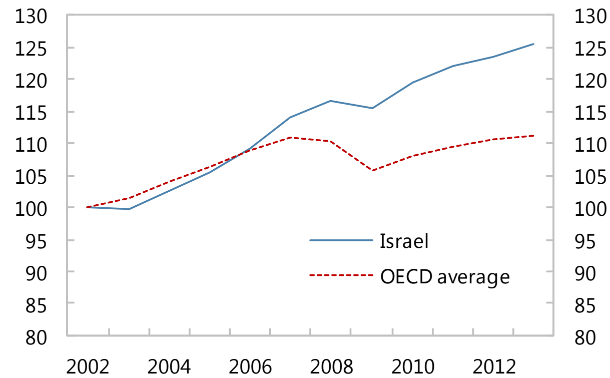
CONTEXT

The Israeli economy has weathered the global crisis remarkably well

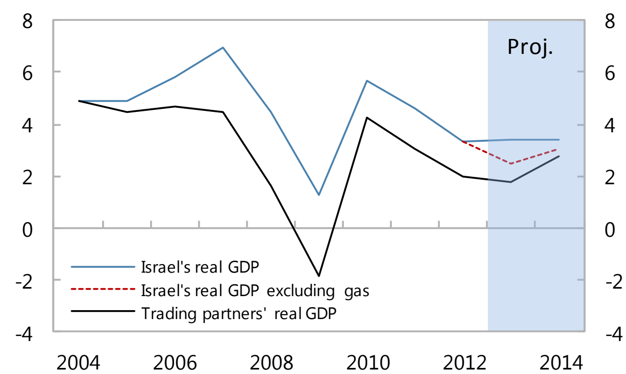
1. Israel has been exposed to a series of shocks, including the global crisis and heightened geopolitical tensions in the Middle East. Nevertheless, GDP growth has averaged 4 percent over the past 5 years, compared with 0.7 percent on average for OECD countries (Figures 1, 2 and Table 1). The overall living standards continue to improve gradually, with per capita real GDP growing more rapidly than in other OECD countries. The economy's resilience has been underpinned by solid economic fundamentals, including large foreign reserves, a dynamic high-tech export sector, and the absence of economy-wide deleveraging pressures. Over the past year, stock market indices have gradually risen, while credit spreads of Israeli sovereign and banks remain stable (Figure 3).

Per Capita Real GDP Growth
(Index, 2002=100; in local currency units)



Source: IMF World Economic Outlook.

Israel: Real GDP and Global Demand
(Y/Y percent change)



Source: IMF World Economic Outlook.

The economy, however, faces significant challenges

2. Growth momentum is slowing. Exports, at 40 percent of GDP and comprising largely of high-technology products, such as electronics, pharmaceuticals, and communications, have been under pressure, reflecting weakness in the global economy and a sharp appreciation of the shekel. A rapid increase in house prices, notably in the context of a cooling economy, poses risks of a boom-bust cycle in the housing market, while notwithstanding notable progress, public debt remains high. Alongside, there is concern that unless large employment and productivity gaps, particularly between the general Jewish and the Israeli-Arab and Ultra-Orthodox Jewish (Haredi) populations, are addressed, growth potential would slow significantly in the long-run.

Traction of Fund policy advice

3. Economic policy has been broadly in line with past Fund advice. Consistent with Fund recommendations in the 2012 Article IV consultations, the BoI has continued to maintain an accommodative monetary policy stance to support growth, while tightening macroprudential policy to contain house price inflation. Progress has been made in following through most of the 2012

FSAP Update recommendations, while steps have also been taken to address long-standing structural problems, notably pertaining to the low participation of Haredi and Arab-Israeli populations in the labor force. The main deviations from Fund advice have centered on the fiscal policy stance and issues pertaining to the financial sector architecture. In particular, the budget outturn underperformed in 2012, reflecting both revenue shortfalls and expenditure overruns, while the establishment of a Financial Stability Committee (FSC), a key FSAP recommendation, is yet to materialize.

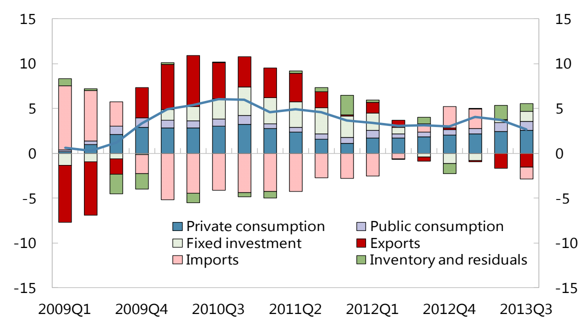
THE STATE OF THE ECONOMY AND THE OUTLOOK

The Israeli economy is growing at a moderate pace

4. Following a strong expansion in 2010–11, real GDP growth moderated to 3½ percent in 2012 and 2013. As a result, the positive output gap has dissipated. Excluding the impact of natural gas, growth was more moderate, at about 2½ percent in 2013.[1]

Contributions to Annual Real GDP Growth

(Percent, two quarter moving average)

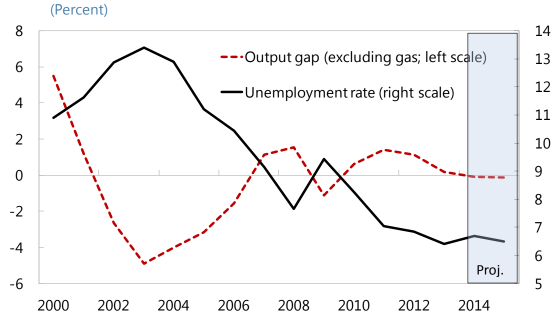


Source: Haver Analytics.

5. Inflation remains subdued. Headline CPI inflation, underlying inflation (CPI excluding energy price), and market-based inflation expectations have all remained at around the mid-point of the 1–3 percent target range (Figure 4). Notwithstanding tax and food price increases, soft domestic demand, coupled with the appreciation of the shekel and deregulation (e.g. cellular telecom industry), has contained inflationary pressures. Unemployment remains low at about 6 percent, but wage pressures remain contained.

Output Gap and Unemployment Rates

(Percent)



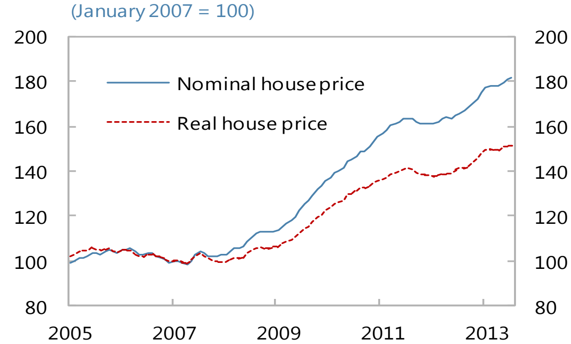
Source: Fund staff estimates.

1/ Percent of potential output (estimated by HP filtering).

6. House prices have, however, risen sharply. The low interest rate environment and a search for yield have boosted the demand for housing, even as chronic shortages of planned land and delays in the process of obtaining building permits have constrained supply. As a result, house prices have sky-rocketed (an increase of 80 percent in nominal terms since 2007).

House Price Indices

(January 2007 = 100)



Sources: Central Bureau of Statistics.

[1] Natural gas production at Tamar came on stream in the second quarter of 2013.

7. The external position remains strong (Tables 2-3). Foreign reserves have risen to $82 billion (192 percent of short-term external debt), and the surplus on the net international investment position is high at about 22 percent of GDP. The US government guarantee program for Israeli sovereign bonds was extended to 2016 in July 2012, providing additional assurance ($3.8 billion of the total of $9 billion is untapped). The shekel has appreciated sharply, up some 12 percent in real effective terms over the past 15 months.

Foreign Reserves
(End period)

	2009	2010	2011	2012	2013
In billions of US dollars	60.6	70.9	74.9	75.9	81.8
In percent of short-term external debt	143.5	127.2	146.9	172.9	191.9
In percent of total external debt	64.9	65.8	71.1	78.3	86.2
In months of imports of goods and services	9.4	9.1	9.7	9.9	10.5
In percent of broad money	53.7	57.0	58.7	53.7	52.5

Sources: Haver Analytics.

Growth momentum is expected to remain moderate

8. Staff expects growth (excluding the contribution of gas) to increase to 3 percent in 2014, reflecting some recovery in investment. However, growth momentum is expected to remain moderate, as planned fiscal tightening and shekel appreciation would weigh on the economy and offset, in part, the pick-up in demand in Israeli trading partners. In the baseline scenario, the output gap (excluding the impact of gas production) is expected to widen slightly, unemployment to edge up to just above 6½ percent, and inflation to remain within the 1–3 percent target range.

9. Beyond 2014, growth over the medium term is projected at around 3½ percent annually (excluding the impact of gas production), much lower than the annual average of 4¼ percent over the past 10 years. This reflects, in part, an anticipated reduction in labor force growth (as baby boomers are reaching retirement ages).

Israel: Short-term Projections, 2012–14
(Percent change from the previous period, SAAR; unless otherwise indicated)

	2012		2013				2014		2012	2013	2014
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2		Staff	Staff
					Staff est.		Staff proj.			est.	proj.
GDP	4.2	3.6	2.4	4.7	2.0	3.5	3.7	3.9	3.4	3.4	3.4
Private consumption	1.4	3.7	4.6	6.0	5.2	4.0	2.0	2.0	3.2	4.2	3.2
Public consumption	-1.2	8.8	-1.3	8.1	5.0	6.0	1.0	1.0	3.2	3.6	3.0
Gross capital formation	-0.8	-4.3	-11.5	13.9	33.5	4.2	1.6	1.6	6.3	3.2	4.3
Net exports 1/	0.1	0.6	0.6	-0.6	-2.8	0.5	0.5	0.5	-0.5	-0.5	0.0
Exports of goods and services	-12.8	-5.4	10.3	-1.3	-21.9	9.0	4.0	7.0	0.9	-2.3	2.2
Imports of goods and services	-13.7	-12.2	3.4	6.2	9.7	2.6	-2.0	0.2	2.3	-1.0	2.1
CPI (end period, NSA, year on year)	2.1	1.6	1.3	2.0	1.3	1.8	1.1	1.5	1.6	1.8	2.0
Output gap (percent of potential)	…	…	…	…	…	…	…	…	0.6	0.2	0.1
Memorandum items:											
Tamar gas											
Contribution to GDP growth	…	…	…	…	…	…	…	…	…	0.8	0.3
GDP growth excluding gas	…	…	…	…	…	…	…	…	…	2.5	3.1
Output gap excl. gas (percent of potential)	…	…	…	…	…	…	…	…	…	0.2	-0.1

Source: Haver Analytics; IMF staff estimates and projections.

1/ Contributions of GDP growth.

Risks to the outlook are mainly to the downside

10. Israel is a small open economy, with its exports divided roughly evenly among the US, Europe, and emerging Asia. Financial links to the rest of the world through the banking channel are limited, but Israel does receive a significant amount of FDI inflows, notably from the US and Europe. Indeed, following a dip in 2009, FDI inflows have surged and remain the dominant component of the capital account. By contrast, portfolio inflows, which rose rapidly in 2010, have since then declined sharply in magnitude—owing to a narrowing of interest rate differentials and the removal of tax exemption on capital gains for foreign investors—but remain volatile (Annex I).

- Externally, the main downside risks pertain to a protracted period of sluggish growth in Europe and the United States and growth disappointments in emerging economies (Annex II). Given the limited financial links to the rest of the world, relatively strong macroeconomic fundamentals, and the predominance of stable FDI inflows, risks related to volatility in global financial markets, are less of a concern for Israel. In this context, an exit from unconventional monetary policies in major advanced economies may actually alleviate appreciation pressures on the shekel and pose upside risks to growth prospects.[2]

- Domestic risks include a further weakening of the competitiveness of the tradable sector, a correction in the housing market, with attendant implications for the fiscal position and the financial sector, and the reemergence of regional geopolitical tensions, which would bear upon sentiment. Risks to the upside could arise from faster-than-expected recovery in Israel's major trading partners and larger than anticipated spillovers from the natural gas sector.

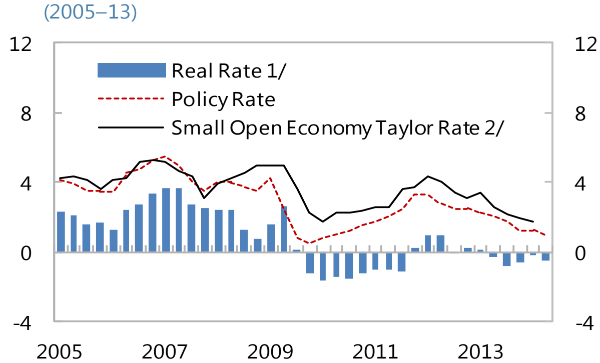
POLICY CHALLENGES

11. Given the still uncertain external environment, the key policy challenge is to maintain near-term growth at potential, while preventing the build-up of imbalances, strengthening resilience to shocks, and vigorously pursuing structural reforms to ensure long-term sustainability.

A. Monetary and Exchange Rate Policies

With headwinds to growth emanating from an appreciation of the shekel and fiscal tightening, monetary policy should be on hold for now, lest the overall macroeconomic policy stance becomes overly tight. Macroprudential policy measures should be further tightened to minimize the risk of a boom-bust cycle in the housing market.

Monetary Policy Stance
(2005–13)



Sources: Bank of Israel; and IMF staff calculations.
1/ Policy Rate - Market based expected inflation rate
2/ As defined in the BOI Annual Report 2012 (Chapter 3).

[2] Israel was relatively resilient to the market turmoil in mid-2013. While non-resident portfolio investment flows in Israel turned negative, this was more than offset by large FDI inflows, notably in the high-tech sector, leading to currency appreciation pressures (see Annex 1).

12. Monetary policy has been accommodative. Since October 2011, the BoI has lowered in several steps the policy rate to 1 percent. At the same time, the BoI has introduced, since 2009, various types of macroprudential measures to address the risks emanating from rapid house price increases. This includes “indirect” measures, such as capital surcharges and additional provisioning, aimed at reducing banks’ incentives to extend mortgage loans. These measures have contributed to strengthening the resilience of the financial system, but have not been particularly successful in containing house price inflation. In response, the BoI has more recently put in place “direct” measures, such as loan-to-value (LTV) and debt-service-to-income (DTI) limits. While it is too early to assess the effectiveness of such measures, they appear to have reduced speculative behavior and the volume of housing transactions. If given sufficient time to play out, these measures are expected to curtail house price inflation.[3]

Monetary policy faces a delicate balance in the current context

13. On the one hand, the absence of inflationary pressures and the uncertain external outlook would suggest maintaining the current accommodative monetary policy stance. On the other hand, however, house price increases have been rampant and may suggest the need for policy tightening (Figure 5).[4] There is also a concern that fiscal slippages, which have been a common occurrence in Israel, could contribute to overly accommodative macroeconomic policies and lead to higher inflation down the road.

Monetary policy should, on balance, remain on hold in the near-term, but the BoI should respond nimbly to changes in the economic environment

14. Given the drag on growth from an appreciation of the shekel and planned fiscal tightening (see section B), as well as the still uncertain external environment, monetary policy should be on hold for now. The strong appreciation of the shekel, in particular, has hurt competitiveness, causing sluggish export growth and a protracted decline in manufacturing production. If house prices continue to rise, “direct” macroprudential measures should be further tightened (e.g. by making the limits on LTVs and DTI more stringent). At the same time, consideration should also be given to a tightening of property taxation, notably by raising temporarily the property purchase tax for non-primary residences. Most importantly, concerted efforts should be made toward alleviating supply-side constraints, including by expediting the implementation of the Housing Committee’s recommendations.[5]

15. If global growth prospects improve sharply or domestic demand strengthens appreciably, including because the fiscal stance turns out to be more expansionary than expected, or if appreciation pressures on the shekel ease, including because of policy tightening in major advanced economies, the monetary policy stance should be gradually normalized.

[3] See Annex III and Selected Issues Chapter 1.

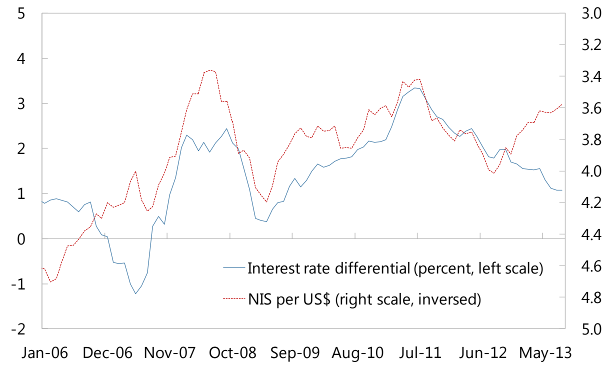
[4] Staff analysis suggests that house prices in Israel are about 25 percent above their long-term fundamental value.

[5] The committee’s key recommendation include: reforming the planning process to expedite the supply of planned land and the issuance of building permits, and introducing a compensation scheme to accelerate the evacuation of land currently used for agricultural purposes.

The exchange rate and the current account appear to be broadly consistent with macroeconomic fundamentals

16. The shekel has appreciated sharply over the past year, despite a narrowing of the interest rate differential. This can be attributed to promising prospects of large-scale natural gas production and strong FDI inflows, including from foreign purchases of Israeli start-ups in the high-tech sector. At the same time, depreciation pressures that would typically arise from capital outflows, owing to investment abroad by Israeli pension and insurance companies, have been limited because of active hedging operations by these firms.

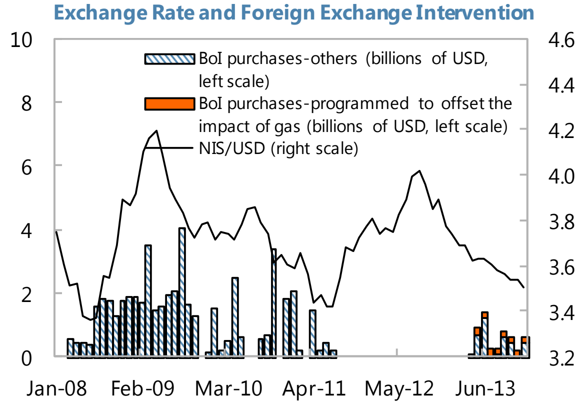
Israel-US Interest Rate Differentials and Foreign Exchange Rates



Sources: IMF' Information Notice System; and IMF staff calcualations.

17. Various model estimates (CGER-type and EBA) suggest no obvious sign of exchange rate misalignment, but the appreciation of the shekel has adversely affected the tradable sector (Annex I). The mix of tight fiscal and accommodative monetary policy, combined with structural reforms to boost productivity, should help reduce appreciation pressures on the exchange rate and improve competitiveness associated with a stronger shekel. In this context, a new foreign currency purchase program that the BoI introduced in May 2013 to offset the impact of natural gas production on the foreign exchange market should help mitigate the risk of a Dutch disease, until the proposed Sovereign Wealth Fund is set up (expected in 2018). In the interest of transparency, however, the programmed intervention should be pre-announced and well-communicated. Finally, in the event of disorderly movements in the exchange rate (for instance, from euphoria pertaining to natural gas discovery, as witnessed in June 2013), exchange rate policy should be attuned to mitigating the risk of an exchange rate overshoot.

Exchange Rate and Foreign Exchange Intervention



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

B. Fiscal Policy: Strengthening Buffers and Credibility

Bold fiscal consolidation measures embedded in the 2013–14 Budget are welcome, but further adjustment will be required for 2015 and beyond to anchor sustainability, along with a strengthening of fiscal institutions.

Israel is back on a fiscal consolidation path

18. Fiscal consolidation stalled in 2012, with the deficit expanding to 4 percent of GDP, well above the initial target of 2 percent (Tables 4 and 5). In mid-2012, recognizing the risk of a further widening of the deficit, the government announced some fiscal consolidation measures (such as raising the VAT rate from 16 to 17 percent) but could not agree on a budget for 2013. As a result, elections were brought forward to early 2013.

19. Following the election, the new government announced an ambitious fiscal consolidation program. The 2013–14 budget included large discretionary consolidation measures totaling 2¾ percent of GDP, with the aim of reducing the deficit to 3 percent of GDP in 2014, which is both broadly appropriate and realistic and lays the ground for further consolidation over the medium-term.[6]

- Revenue measures include: (i) raising the VAT rate from 17 percent to 18 percent; (ii) increasing the excise tax on tobacco and beer; (iii) introducing environmental taxes; (iv) increasing personal income (a measure that was subsequently rolled back) and corporate taxes (including a 2 percent surtax on the wealthiest); and (v) one-time corporate tax amnesty for companies subject to tax exemptions under an investment law ("trapped profits" collections).

- On the expenditure side, measures include: (i) freezing previously planned public sector wage hikes; (ii) cutting the defense budget; (iii) reducing child allowances and education expenditure (including for religious study); and (iv) postponing infrastructure projects.

20. Budget implementation in 2013 has been better than expected. Revenues have been higher than forecast due largely to one-off measures and a rebound in the stock market. Expenditures have been lower-than-expected due to tight spending controls. Overall, the deficit outturn for 2013 is expected to be 3.5 percent of GDP, about ¾ percentage point below the target.

2013–14 Budget Revenue Measures

	2013		2014	
	Billions of NIS	Percent of GDP	Billions of NIS	Percent of GDP
Announced prior to 2013				
VAT from 16 to 17 percent	3.5	0.3	...	...
Income taxes	4.0	0.4	-3.1	-0.3
Customs, excises and wealth	0.8	0.1	0.5	0.0
Others	-0.2	0.0	-0.5	0.0
Total	8.1	0.8	-3.0	-0.3
2013-2014 Budget				
VAT to 18%	2.3	0.2	2.3	0.2
Excise	0.7	0.1	0.4	0.0
Luxury tax	0.0	0.0	0.1	0.0
Income tax	...	...	3.9	0.3
Company tax	...	...	1.0	0.1
Others	0.2	0.0	1.2	0.1
Total	3.3	0.3	8.9	0.8

Source: Israeli Authorities.

2013–14 Budget Expenditure Measures

	2013		2014	
	Billions of NIS	Percent of GDP	Billions of NIS	Percent of GDP
Wage bill freeze	0.5	0.0	1.0	0.1
Defense budget	...	...	3.0	0.3
Child allowances	...	...	2.7	0.2
Postponing agreed wage hike	...	...	1.0	0.1
Education	...	...	2.0	0.2
Postponing infrastructure projects	...	...	2.0	0.2
Yeshiva (religious study)	...	...	0.5	0.0
Reducing other specific items	...	...	2.5	0.2
Flat cuts across all ministries	...	...	1.4	0.1
Others	...	...	3.2	0.3
Total	0.5	0.0	19.2	1.7

Source: Israeli Authorities.

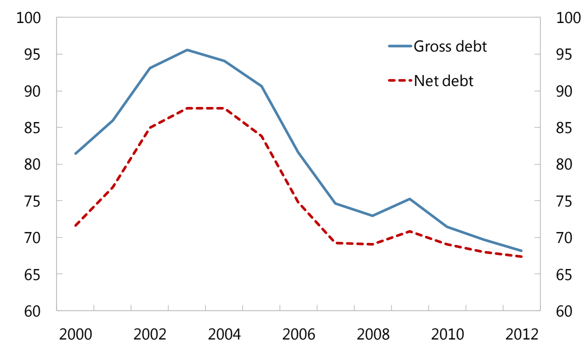
[6] Without these measures, the deficit was projected to further widen to 5¾ percent of GDP in 2014. As currently projected, the fiscal adjustment would amount to a cumulative of 1¼ percentage points of GDP over 2013–14. Assuming a multiplier in the range of 0.5–0.8 (based on BoI estimates), the adverse impact on growth would be around ¾–1 percentage points of GDP.

21. Risks to the fiscal outlook for 2014 are tilted to the downside. Revenue could be lower than expected, especially if there is a correction in the housing market or planned measures are not fully implemented. After the 2013–14 Budget was approved, the projection for interest expense was lowered due to lower-than-assumed interest rates, and in response the government rolled-back the planned increase in personal income tax for 2014. The two changes are intended to be deficit neutral, but will lead to a structural revenue loss. Moreover, spending pressures could arise, a concern mostly pertaining to defense spending. In this context, strict adherence to the expenditure ceiling and announced tax revenue measures is imperative to ensure the credibility of the fiscal framework. Nevertheless, if growth underperforms, automatic stabilizers should be allowed to operate fully, and the deficit target relaxed.

For 2015 and beyond, additional consolidation efforts will be necessary

22. Public debt has declined from over 95 percent of GDP a decade ago to a still high 68 percent in 2012. The projected fiscal deficit of 3.5 percent in 2013 is also high, especially given that the output gap is close to zero and that revenues have benefited from large one-off measures. The authorities are committed to gradually reducing the deficit target from 3 percent in 2014 to 1.5 percent of GDP in 2019, a path that would help reduce debt to about 60 percent of GDP. Delivering this path of deficit and debt reduction is important for ensuring long-term fiscal sustainability, although an even more ambitious path of deficit reduction is warranted to provide a greater buffer against shocks, including a sharp correction in the housing market.

General Government Debt
(Percent of GDP)



Source: Israel Central Bureau of Statistics.

23. To achieve the deficit targets, additional adjustment will be needed from 2015 onwards. This will require both reducing expenditure growth by modifying the expenditure rule and introducing additional revenue measures. Importantly, given the low levels of non-interest civilian expenditures in Israel, relying solely on reducing expenditure growth would compromise long-term growth and sustainability.[7]

- Expenditure on priority items that boost the economy's productive capacity and reduce the social gap—such as on education, job training, employment services, and infrastructure—should be protected. Large unfunded expenditure commitments should be avoided, while annual budgets should provide sufficient contingent reserves in anticipation of shocks.

[7] Most recently, the government has submitted to the Cabinet a revised expenditure rule, aimed at reducing expenditure growth. Consistent with staff recommendations, it is intended that lower expenditure growth will be complemented by revenue measures to meet the deficit and debt targets. Also see debt sustainability analysis in Annex IV.

- On the revenue side, additional measures should be less distortionary and aim at: (i) broadening the tax base, including by eliminating tax exemptions (e.g. for advanced study funds and the VAT exemptions on fruit and vegetables, on tourist services, and in the resort town of Eilat); (ii) further increasing indirect taxes (e.g. VAT); and (iii) introducing new taxes that reduce externalities (such as a congestion or a pollution tax) or inequality (such as raising the property tax).

And a comprehensive review of budgetary and fiscal institutions is imperative

24. Given the history of repeated and significant slippages in meeting fiscal deficit targets, a comprehensive review of current fiscal institutions is needed.

- Importantly, the current fiscal rules should be developed to have a more clearly defined debt objective, a better link between this objective and the deficit and expenditure targets, and to allow for more flexibility to deal with shocks.[8]
- In addition, the fiscal rules should be embedded within a fully-fleshed out medium-term fiscal and expenditure framework—including a multi-year overall expenditure ceiling and expenditure allocations to line ministries—multi-year revenue and fiscal forecasts, and an analysis of the risks to the fiscal outlook. This would enhance the credibility of the framework and promote fiscal discipline, transparency, and accountability.
- Finally, building on the role currently played by the BoI and following the development of a medium-term fiscal framework, consideration should be given to establishing an independent and stand-alone fiscal council, both as a disciplining mechanism and to evaluate the consistency of overall fiscal policies with the fiscal rules.[9]

C. Financial Sector Policy: How Best to Safeguard Financial Sector Stability?

The financial system remains relatively sound. A Financial Stability Committee (FSC) needs to be established, with the BoI taking the lead role, and a new bank resolution framework should be legislated as soon as practicable.

The financial system remains relatively resilient

25. Israel's banking system is domestically oriented, and its soundness is underpinned by strong and intrusive supervision (Tables 6-8).

- Banks have limited exposure to the global financial system and focus on traditional retail business, with limited engagement in investment banking activity. In the housing market,

[8] See Selected Issues Chapter II.

[9] See Selected Issues Chapter III.

historically low mortgage losses, a limited buy-to-let market, and open-ended personal liability, all curtail risks of major credit losses.

- Banks have gradually increased capital ratios, largely through retained earnings, consistent with the BoI's new capital regulation which requires all banks to meet the core Tier 1 capital ratio of 9 percent by 2015. The capital ratios at the two largest banks must reach 10 percent by 2017 (under the Basel III capital definition). Banks' core Tier 1 capital ratios range between 8½ and 9¾ percent, which is relatively low compared with many large banks in other advanced economies. However, this reflects the conservative use of risk weights. Moreover, Israeli banks' leverage ratios (equity to capital ratios) are relatively high.

- Banks' operations are fully deposit-funded, with the loan-to-deposit ratio well below 100 percent. In January 2013, the BoI strengthened liquidity regulations, requiring banks to adhere to new Basel III-type minimum liquidity coverage ratios, monitor net stable funding ratios, and strengthen the governance of liquidity management.

26. Against this backdrop, the BoI's recent stress tests suggest that even under severe global crisis scenarios—which assume an impact more severe than what Israel experienced during the 2008 crisis—all banks would be able to maintain a 6 percent core Tier 1 capital ratio.[10] These results validate the broadly reassuring assessment provided by the 2012 FSAP Update.

Summary of Performance of Israel Five Major Banks
(In percent; unless otherwise indicated)

	Bank Leumi			Bank Hapoalim			Israel Discount Bank			Mizrahi Tefahot Bank			First International Bank		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Capital															
Total capital to RWAs 1/	15.0	14.3	14.9	13.9	14.1	15.7	13.3	14.1	14.3	14.0	13.4	13.4	12.4	13.1	14.9
Tier 1 capital to RWA	8.4	8.1	8.6	8.9	8.7	9.7	8.2	8.8	9.3	7.9	7.8	8.6	8.0	8.5	9.7
Equity to total assets	7.1	6.4	6.6	7.0	6.7	7.1	5.8	5.3	5.9	5.4	5.1	5.4	5.7	5.8	6.2
Asset quality															
NPLs to gross loans 2/	4.7	3.7	3.8	3.9	3.7	3.9	4.9	4.9	5.0	2.7	2.5	2.5	2.7	3.1	2.8
Earning and profitability															
Return on equity	10.3	8.3	3.8	10.4	12.0	10.1	7.0	8.2	7.1	11.8	14.6	13.1	8.0	8.5	9.5
Non interest income to operating expenses	…	50.1	52.5	…	59.7	62.1	…	50.3	55.9	…	56.6	56.5	…	49.4	55.4
Liquidity															
Average duration of assets to duration of liabilities	115.2	104.8	120.0	76.1	91.2	111.2	163.5	146.6	148.8	88.5	99.3	110.2	150.0	133.3	145.0
Deposits to loans	111.4	115.8	120.0	103.9	104.0	108.9	116.3	131.8	129.2	99.1	100.0	99.9	126.3	125.3	124.3

Sources: Banks' annual reports.

1/ Risk weight assets under Basel II standardized approaches.
2/ Problematic credit risk as a percentage of total creidt risk.

[10] Under the most severe stress scenario, GDP is assumed to contract for four consecutive quarters (-4 percent growth annually), unemployment to rise to 12 percent, and house prices to fall a cumulative of 15 percent. Banks' ROE would fall sharply from around 8 percent to -1 percent, but all banks would be able to maintain the capital ratio of above 6 percent.

But tail risks to financial stability remain, and continuous efforts to further bolster the resilience of the system to shocks are imperative

27. The concentration of loans continues to pose a risk to banks. Banks' lending to mortgage markets and commercial real estate amounts to 40 percent of their total assets. To reduce concentration risks, the BoI has appropriately lowered regulatory exposure limits and has strengthened credit risk management. Nevertheless, stress-testing of banking sector exposures to large highly-leveraged corporates—in particular, holding companies and real estate and construction firms—should continue to be carried out periodically.

28. If interest rates were to increase, households with floating-rate mortgages would be hit hard. The BoI's stress test suggests that with a 20 percent drop in house prices and a sharp increase in unemployment, many mortgage borrowers, especially those with high DTI and LTV ratios and with floating-rate mortgages, would default on their loans. But overall, the impact on banks would be limited because of collateral and open-ended personal liabilities. However, a housing market shock could lead to a prolonged economic recession, which, taking into account adverse feedback effects, could indirectly hurt banks' asset quality and profitability. It is therefore important that risk diagnoses and assessments from a macroprudential policy perspective are carried out on an ongoing basis, taking into account macro-financial feedback loops.

29. The banking supervisor is considering introducing the Internal Ratings-Based approach, with a view to incentivizing banks to strengthen their risk management capacity. This is appropriate. Where risks are difficult to assess, regulatory floors should be set on risk weights or on loss given default estimates.

30. Corporate lending by non-bank institutions (insurance, pension, and provident funds) has increased sharply in recent years (about 40 percent growth in 2012). Although the level of such lending is still low (less than 10 percent of bank loans), a sharp increase could give a cause for concern. The Goldschmidt Committee (which is currently reviewing regulatory standards for non-bank institutional lending activity) has recently made preliminary recommendations, including a tightening of corporate governance and a strengthening of transparency. As soon as the committee finalizes its report, regulations should be strengthened accordingly.

31. In the insurance area, a Multilateral Memorandum of Understanding with the International Association of Insurance Supervisors was signed recently. This will facilitate international cooperation and information exchange in insurance supervision.

Progress needs to be expedited in addressing some key issues identified by the FSAP Update[11]

32. The authorities have instituted regular meetings of the three supervisory agencies—the BoI, the Capital Markets, Insurance, and Savings Division (CMISD) of the MoF, and Israel Securities

[11] See Annex V.

Authority (ISA) —and the MoF, including to share information, harmonize regulatory practices, and analyze potential systemic risk factors.

33. Consistent with the FSAP recommendations, the authorities are considering formalizing this practice by establishing a Financial Stability Committee(FSC). However, views differ on elements of the FSC's mandate, governance structure, and organizational framework, including most importantly on whether the FSC should focus solely on macroprudential policies in normal times or also be in charge of crisis management, and who should chair such a committee (the Governor of the BoI, the Minister of Finance, or both as co-chairs). Staff discussed two options that are currently under consideration.

- **Option 1**. The FSC will focus on macroprudential policies for normal times. The BoI would play the leading role, with the Governor serving as the Chairperson. The governance structure of the FSC would be carefully designed, with a view to ensuring its independence and effectiveness in carrying out its mandate (namely, information collection, risk identification, and decision making), while maintaining the autonomy of the financial regulators. The inclusion of non-executive committee members may also be considered. At the same time, consideration would be given to establishing a separate crisis management committee, focusing on crisis preparedness and management, with the MoF playing the leading role.

- **Option 2**. The FSC shall have two functions, macroprudential policies in normal times and crisis management when necessary. The Minister of Finance would chair the FSC, although a compromise solution could involve both the Minister and the BoI Governor serving as co-chairs of the Committee. The decision making process would recognize the differences between normal times, where the BoI Governor would play the leading role, and crisis time operations, where the Minister of Finance would take the lead role. The membership of the committee could be expanded to include other important government agencies (such as the Prime Minister Office), but would exclude non-executive members, as the committee may need to share and deal with confidential information during crisis times.

34. Staff favors the first option. There is clearly no one-size fit-all model for all countries. But as a general principle, to ensure the effectiveness of the FSC, institutional arrangements need to support a policymaker's ability and willingness to act, by setting clear mandates, assuring operational independence, and requiring accountability and transparency. In this regard, Option 2 may risk undermining the effectiveness of the FSC's macroprudential function in normal times, mainly because many government agencies (which may not have particular expertise in supervision) might be involved, political independence could be compromised, democratic accountability could be weakened by the exclusion of non-executive members, and because there is no easy way to clearly differentiate normal versus crisis times, thus creating governance and accountability problems.[12]

[12] See Selected Issues Chapter IV.

35. Legal reforms to strengthen the BoI's toolkit for early intervention and resolution, while clarifying the policy for emergency liquidity assistance and protecting the bank from quasi-fiscal activity, should proceed apace. Progress has been made in preparing a draft law with technical assistance from the Fund. All remaining issues need to be addressed expeditiously, with the aim of submission of the draft law to the Knesset as soon as practicable.

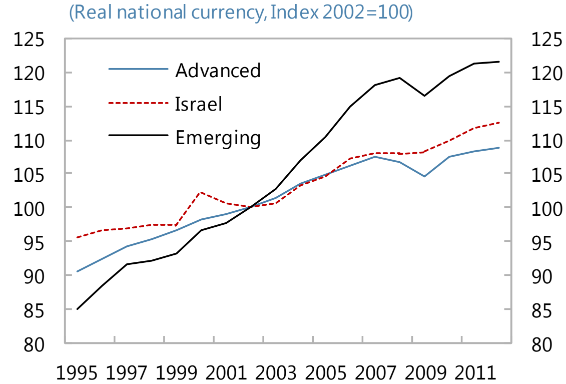
D. Structural Policy: Promoting Longer-term Sustainable and Inclusive Growth

Further action is required to improve the business climate and boost competition in the non-tradable sector. In addition, it will be important to enhance the participation of rapidly growing Haredi and Israeli-Arab populations in economic activity to bolster the economy's long-term potential and to reduce poverty and inequality.

There is room to improve Israel's business environment

36. To secure strong, balanced and sustainable growth, further action will be required to improve the business environment. In particular, it would be important to tackle the weaknesses identified by the World Bank's Doing Business Survey, including in the areas of "property registration," "construction permits," and "contract enforcement." Efforts should also continue to address infrastructure gaps, notably pertaining to railroad, port, and air transport facilities. Alongside, as the Committee on Increasing Competitiveness recommended in 2012, competition in the non-tradable sectors should be enhanced.

Labor Productivity
(Real national currency, Index 2002=100)

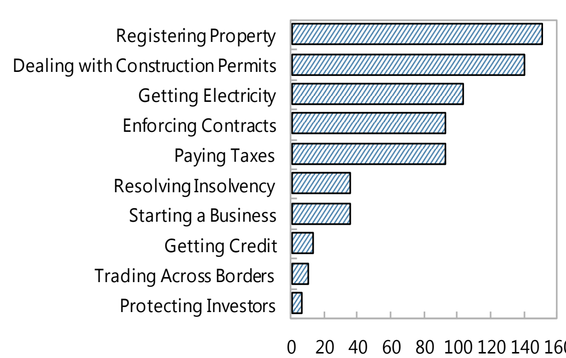


Sources: OECD and IMF staff calculations.

Another cause of concern is high poverty among rapidly growing groups

37. Despite rapid growth, the poverty rate in Israel (near 20 percent) remains among the highest in OECD countries. Much of this high poverty incidence is accounted for by Haredi and Arab-Israeli communities. Going forward, given Israel's demographic profile—in 20 years, the population of these two groups is projected to exceed 40 percent of the total population—their integration into the labor force will be essential not only to improve their welfare, but also to boost labor productivity and the long-run growth potential of the Israeli economy as a whole.[13]

World Bank Doing Business Index. 2014
(Ranking out of 189 economies)



Source: World Bank's Doing Business Database.

[13] The recent analysis by BoI staff suggests that unless demographic and educational problems are appropriately addressed, Israel's long-term growth potential would be reduced by about 1–1½ percentage points of GDP.

38. These are structural problems. Many Arab-Israeli communities live in underdeveloped rural and remote areas (thus raising the costs of supplying labor). In addition, many of Haredi and Arab-Israeli children follow different education systems with fewer years of formal schooling (thus lowering human capital acquisition) and do not participate in military or civic services (thus isolating them from the social networks that facilitate employment opportunities).[14]

39. To address these problems, a number of initiatives are under way, including the expansion of Haredi units in the defense forces and the opening of public employment centers in Arab-Israeli towns. In response, preliminary evidence suggests that participation of these populations in the labor force is rising, albeit slowly. To achieve inclusive growth, more forceful and concerted action by all stakeholders is needed, especially in the areas of education (including access to higher education and enforcement of core curriculum), rural infrastructure and transportation, enforcement of labor laws, and national service arrangements. Private initiatives should also include enhancing the efficient use of talents across all different populations to fully reap Israel's productivity potential.

THE AUTHORITIES' VIEWS

40. The authorities broadly concurred with staff assessment of economic developments, risks and the contours of the policy response. They agreed that given the moderation in growth momentum and the still uncertain external environment, the key policy challenge is to support near-term growth, while preserving long-term sustainability. Some difference of views and issues of emphasis were, however, elaborated.

Monetary policy and house prices

41. On monetary policy, the BoI acknowledged a dilemma. On the one hand, the sharp appreciation of the shekel had weakened the performance of the tradable sector and was seen as a drag on growth. The shekel was considered to be moderately overvalued. On the other hand, it was recognized that the low interest rate environment could fuel further house price increases. It was, however, argued that that the probability of a sharp house price correction is low, given that the supply of houses is limited. The BoI was of the view that, on balance, monetary policy should remain accommodative in the near-term, but if this, in turn, led to further house prices increases, it would be inclined to seek greater recourse to macroprudential measures that directly restrict the size and risk of mortgages. The BoI also underscored that alleviating supply constraints is the key to cooling the housing market on a durable basis.

Fiscal policy

42. The authorities noted that the stance of fiscal policy needed to be framed by judgments concerning debt sustainability and long-term growth, underscoring that reducing public debt over the medium-term would remain one of the top policy priorities. The authorities noted that although

[14] See Israel 2012 Article IV Consultation Selected Issues, Chapter I, for more detailed discussions.

the level of civilian expenditures in Israel is relatively small compared with other countries in the OECD, economic "outcomes" associated with such spending are high, as evidenced by low mortality and high life expectancy. In addition, it was argued that there remains further scope for improving government efficiency and reducing administrative spending without lowering social and welfare spending. Accordingly, the MoF indicated that fiscal adjustments needed over the medium-term to put debt on a firmly downward path should come mainly from expenditure cuts, while revenue raising efforts should be focused largely on broadening the tax base rather than on raising tax rates.

43. On the fiscal rule, although all options were on the table, the MoF did not see the case for introducing an explicit debt target, as it was felt that such a target could be subject to frequent revisions, including because of growth shocks, and would thus not provide a credible fiscal anchor. Instead, it was argued that laying out the medium-term deficit target would be sufficient to ensure public confidence in fiscal policy. In this context, the authorities agreed with the importance of further developing a comprehensive medium-term fiscal and expenditure framework.

44. The authorities were not fully convinced with the merits of establishing a fiscal council. It was argued that the key priority should be to strengthen capacity within the MoF. In addition, while the authorities acknowledged the limits of the BoI's role in serving as a shadow fiscal council, they argued that there were significant advantages to the current practice and establishing a new institution would be costly.

Financial sector and structural policies

45. On functions and modalities of an FSC, the BoI broadly agreed with staff's preferred option of the committee focusing on macroprudential policies in normal times, with the BoI playing the leading role and its chairmanship assigned to the Governor, and establishing a separate crisis management committee. The MoF is, however, opposed to this option and favors the establishment of a single committee (responsible for both macroprudential policy making in normal times and crisis management when necessary) to ensure a smooth coordination and transition from normal to crisis times. It was argued that the Minister of Finance should chair this committee, given his overall responsibility for macroeconomic stability.

46. On the structural front, the authorities agreed on the need for more concerted efforts aimed at integrating Arab-Israeli and Haredi communities in economic activity.

STAFF APPRAISAL

47. The Israeli economy is growing at a moderate pace. Inflation and inflation expectations are squarely within the 1–3 percent target band, and unemployment is low. The external position is strong, while Israeli financial markets have remained relatively calm.

48. But the country faces significant challenges. Israel's public debt and the fiscal deficit remain high; house price inflation poses risks of a boom-bust cycle; the appreciation of the shekel raises competitiveness concerns; and the medium-term growth potential is likely to be lower than in the past.

49. The key challenge is to pursue an appropriate policy mix to ensure strong and sustainable growth, while preventing the build-up of imbalances and strengthening the resilience to shocks.

50. With inflation firmly anchored within the target range and growth momentum at risk from a strengthening of the shekel and a drag from fiscal tightening, as well as from the still uncertain external environment, monetary policy should remain on hold for now. Risks of rapid house price inflation should be addressed with a further tightening of "direct" macroprudential measures. The BoI should, however, respond nimbly to changes in the economic environment.

51. The government's commitment to fiscal discipline is welcome, but the risk of fiscal slippages should be minimized by a firm adherence to the expenditure ceiling and announced revenue measures to meet the deficit target for 2014. For 2015 and beyond, efforts on both expenditure and revenue fronts will be required to put public debt firmly on a downward trend, while preserving long-term growth and sustainability. A further strengthening of the fiscal framework is warranted, including by embedding the current fiscal rules within a fully-fledged medium-term fiscal and expenditure framework. Consideration should also be given to establishing an independent fiscal council.

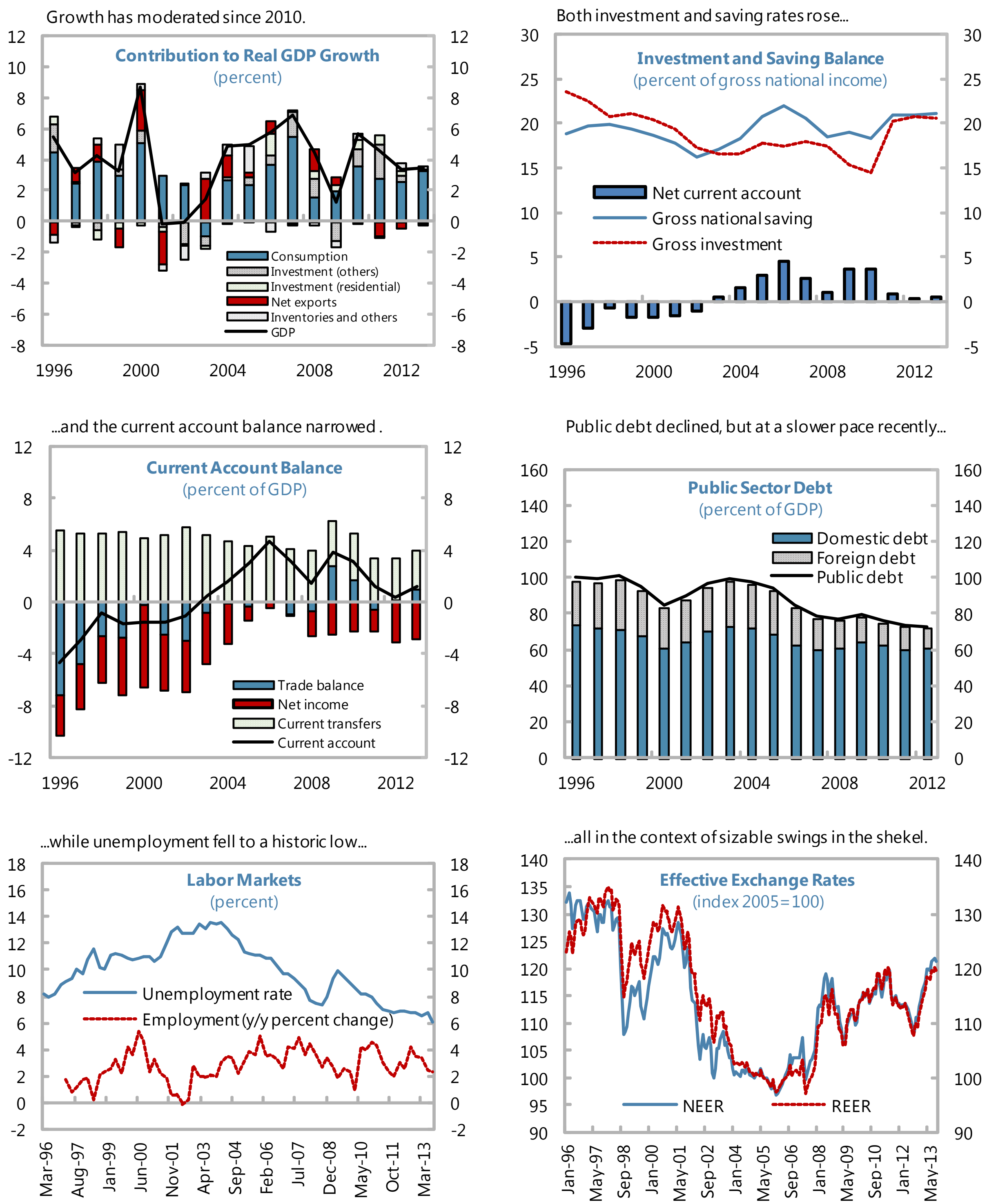
52. The macroeconomic policy mix (accommodative monetary and tight fiscal), combined with structural reforms to boost productivity, will help alleviate shekel appreciation pressures and boost the competitiveness of the tradable sector. To reduce the risk of a Dutch disease, arising from capital inflows associated with gas production, there is merit in pursuing a pre-announced and well-communicated program of intervention to offset the impact of natural gas on the external accounts. This could be complemented by discretionary intervention aimed at stemming exchange rate volatility.

53. Ongoing initiatives to strength financial sector resilience are welcome. However, progress needs to be expedited in addressing some key issues identified by the FSAP Update. In particular, efforts to establish an FSC need to be intensified, with a clear focus on macroprudential policies in normal times and with the BoI in the lead. At the same time, consideration should be given to establishing a separate Crisis Management Committee, focusing on crisis preparedness and management, with the MoF playing the leading role. The draft bank resolution law should be submitted to the Knesset as soon as practicable.

54. To ensure strong, sustainable and balanced growth, more concerted action is required to improve the business climate and boost competition, especially in the non-tradable sector. In addition, given Israel's demographic profile, addressing low labor participation rates of Haredi and Israeli-Arab communities is important to bolster the economy's productive capacity and long-term growth, as well as to reduce poverty and inequality.

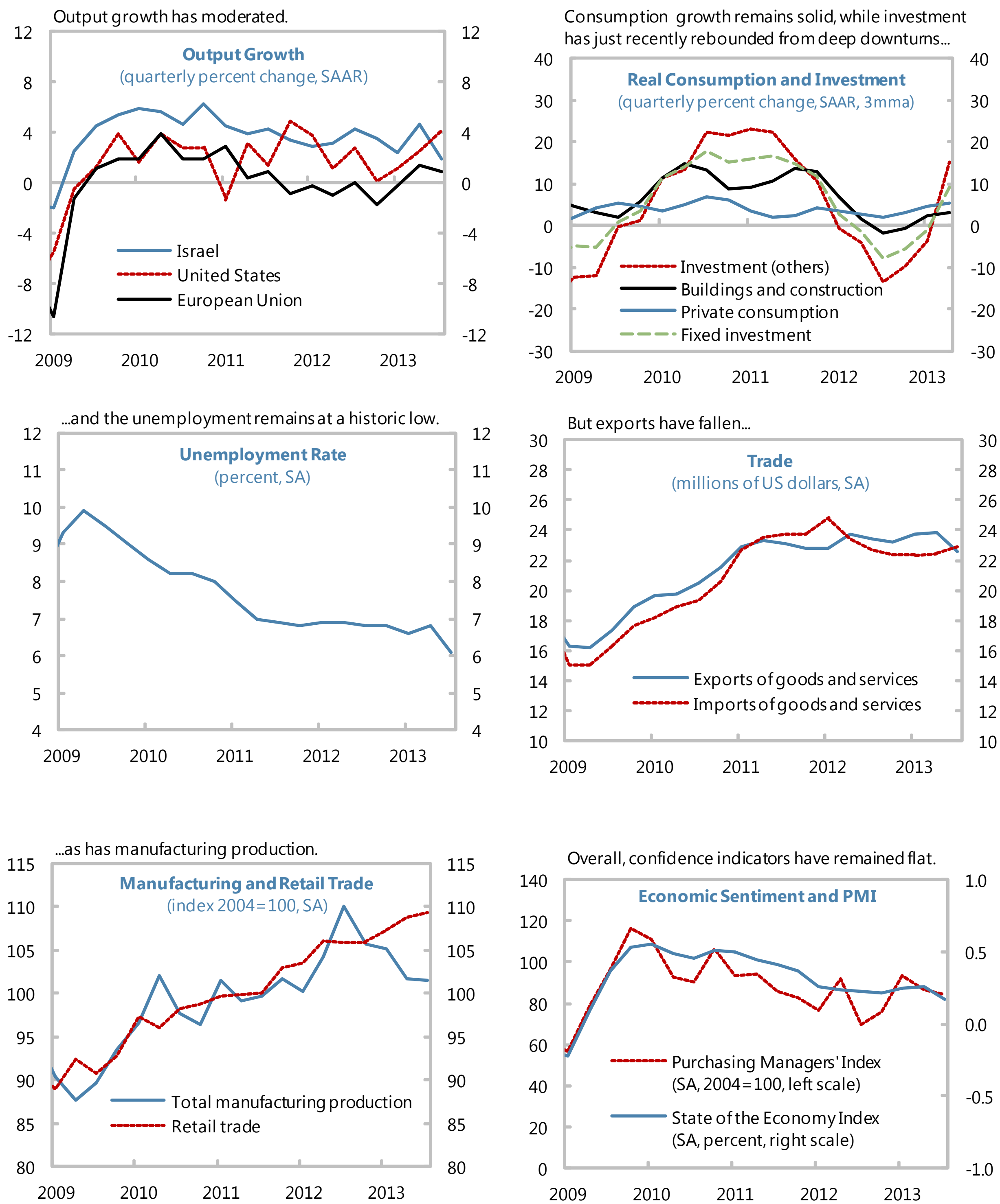
55. It is recommended that the next Article IV consultation with Israel be held on a standard 12-month cycle.

Figure 1. Israel: The Long View, 1996–2013



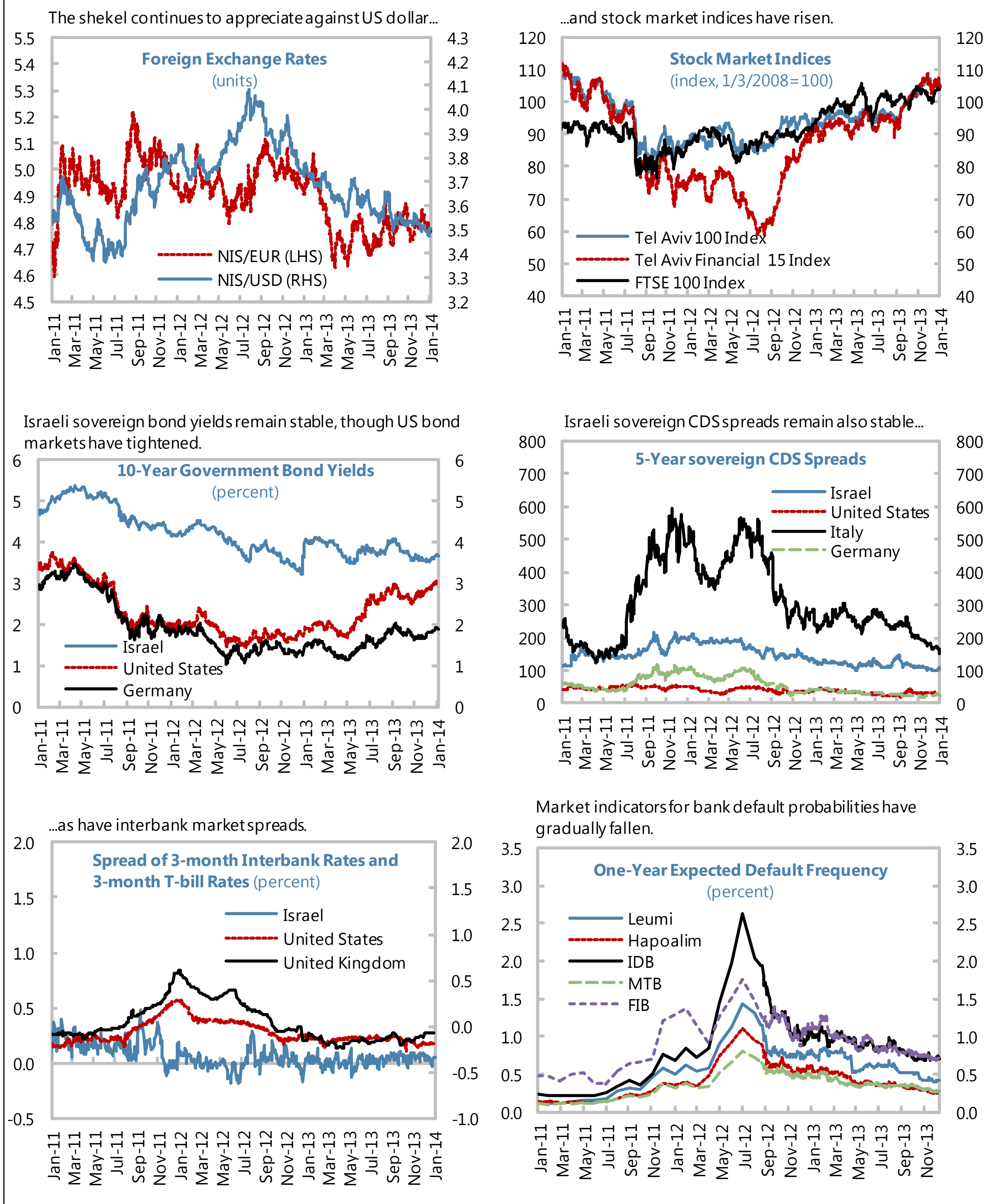
Sources: Bank of Israel; Central Bureau of Statistics; Information Notice System; and IMF staff calculations.

Figure 2. Israel: Recent Economic Developments, 2009–13



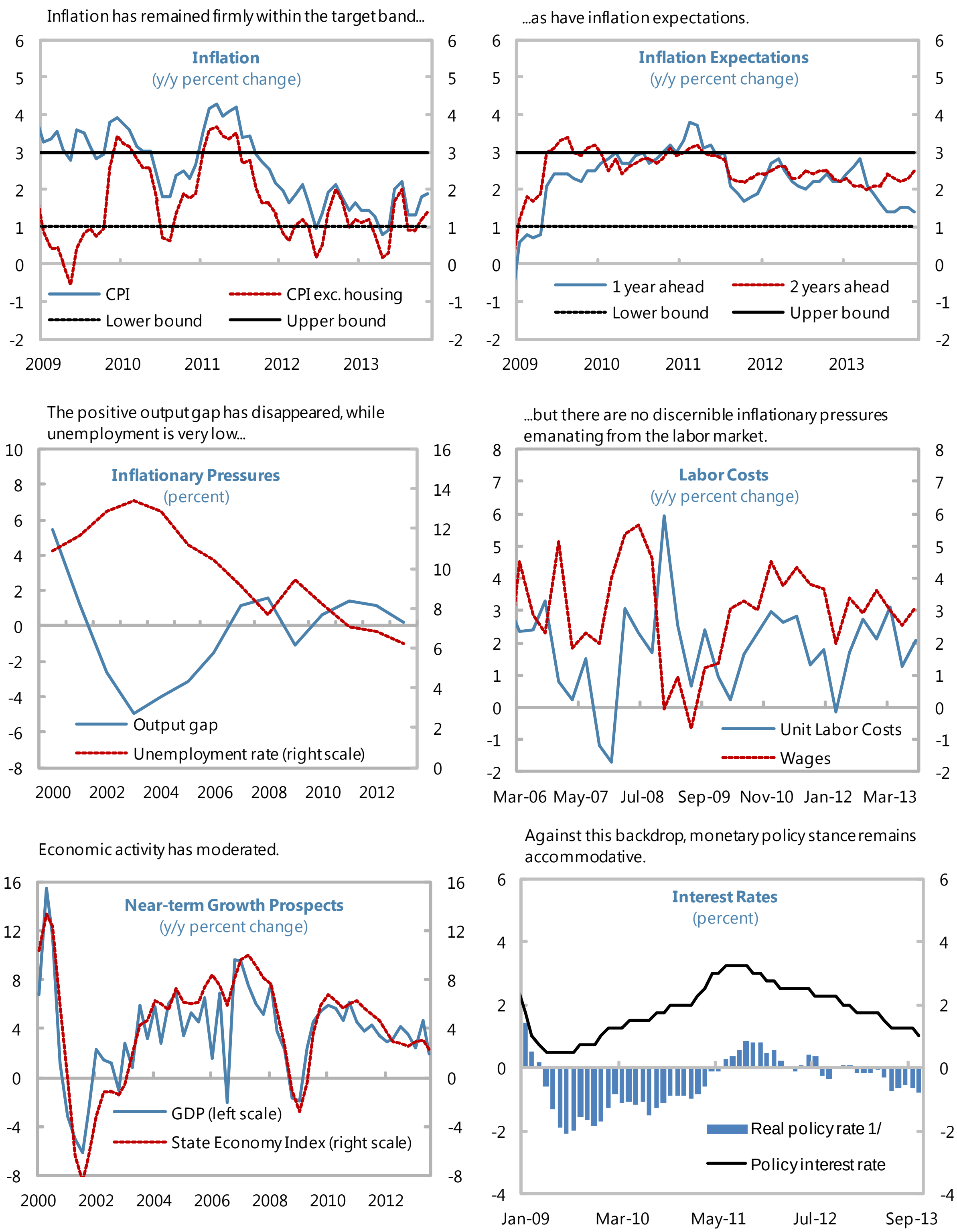
Sources: Bank Hapoalim/Israeli Purchasing and Logistics Managers Association; Bureau of Economic Analysis; Central Bureau of Statistics; and Statistical Office of the European Communities.

Figure 3. Israel: Selected Financial Indicators, 2011–14



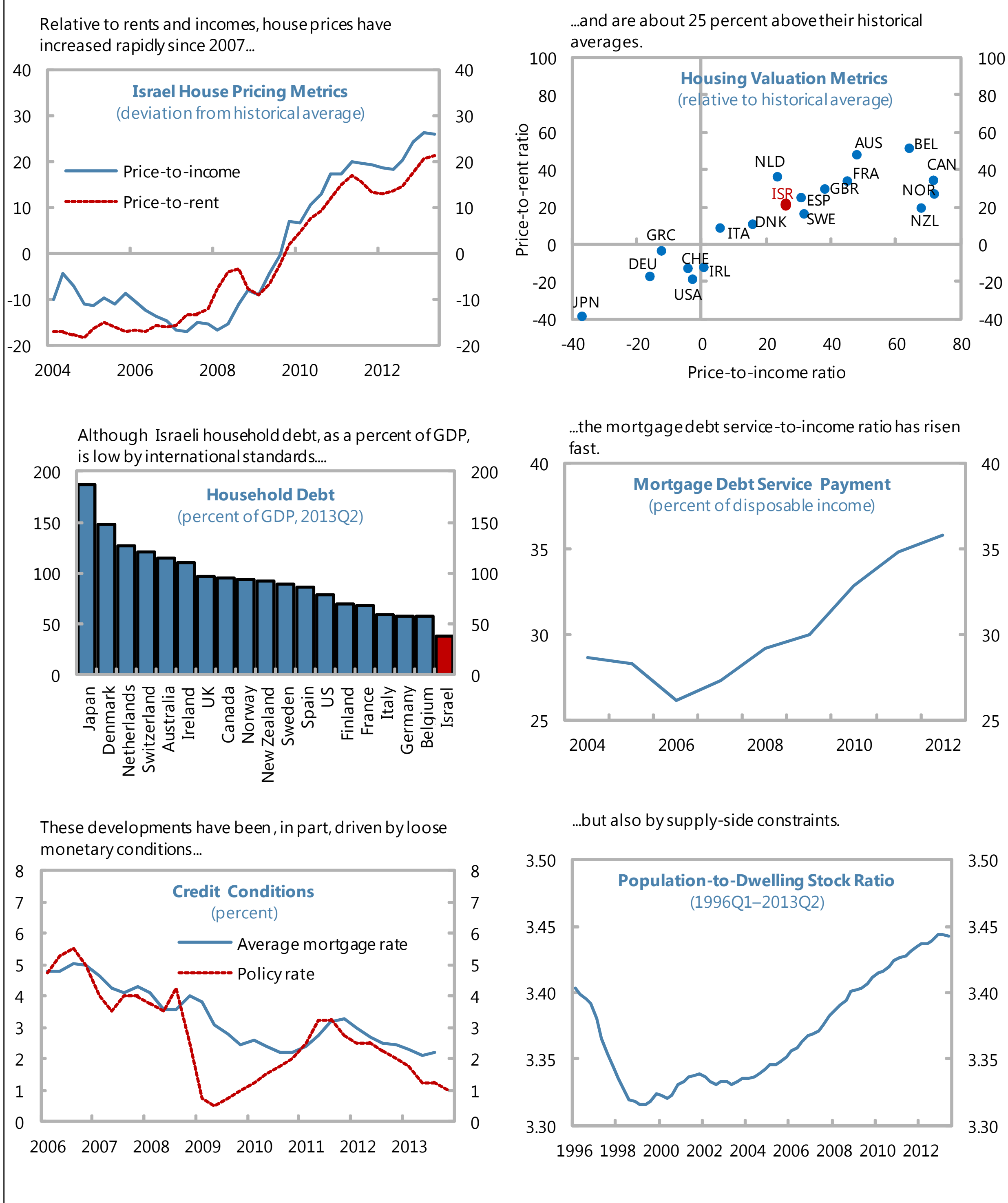
Sources: Bloomberg; Datastream; and Moody's KMV.

Figure 4. Israel: Selected Monetary Indicators, 2000–13



Sources: Bank of Israel; and Haver Analytics.
1/ Defined by the Bank of Israel as policy rate minus inflation expectations.

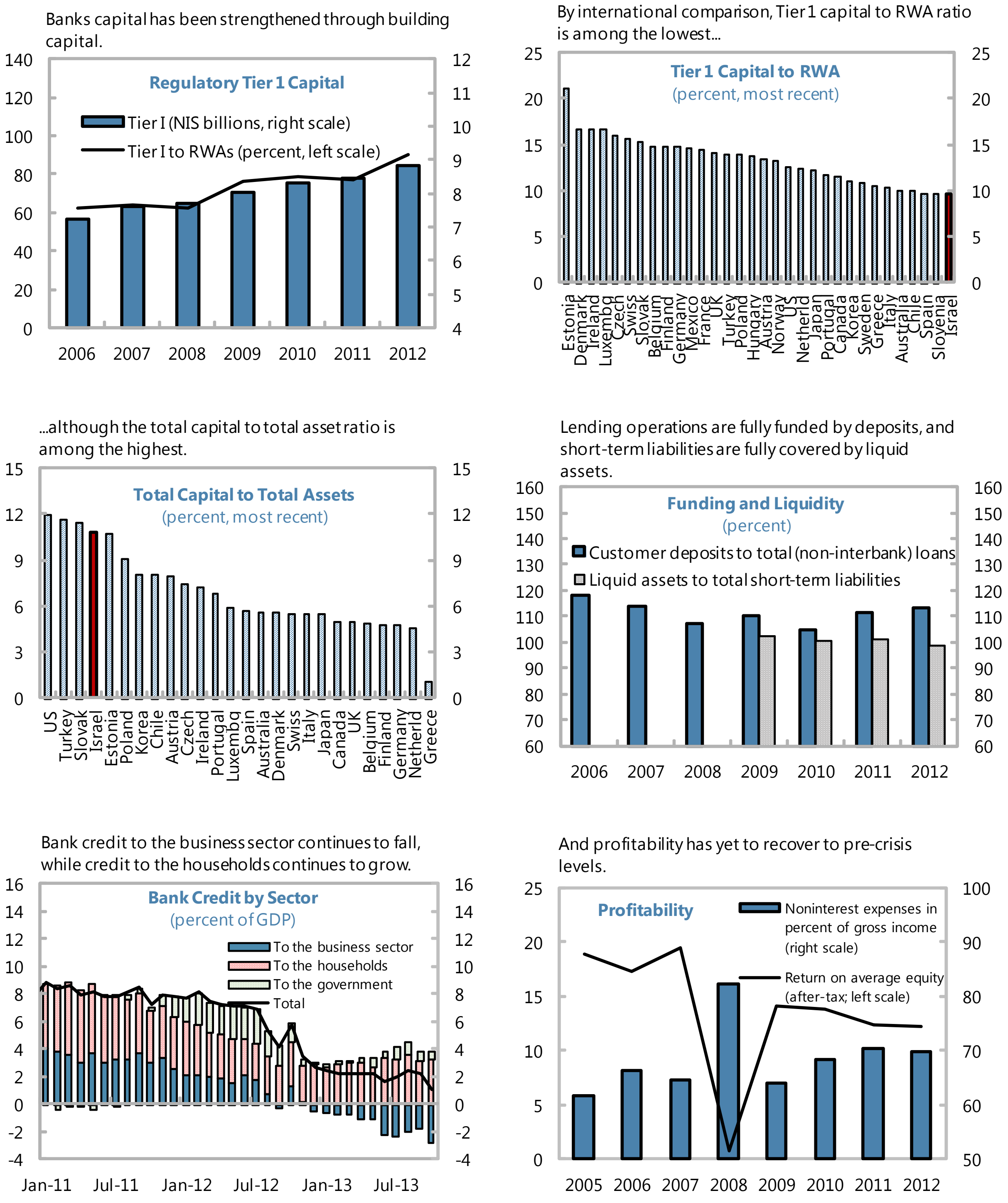
Figure 5. Israel: Housing Markets, 1996–2013



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

Figure 6. Israel: Performance of the Israeli Banking System, 2005–13

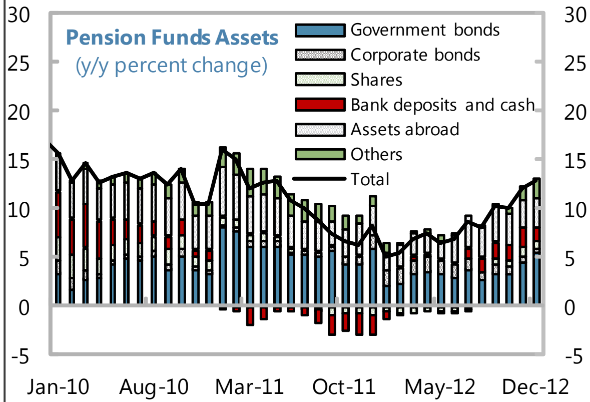
(Percent, unless otherwise indicated)



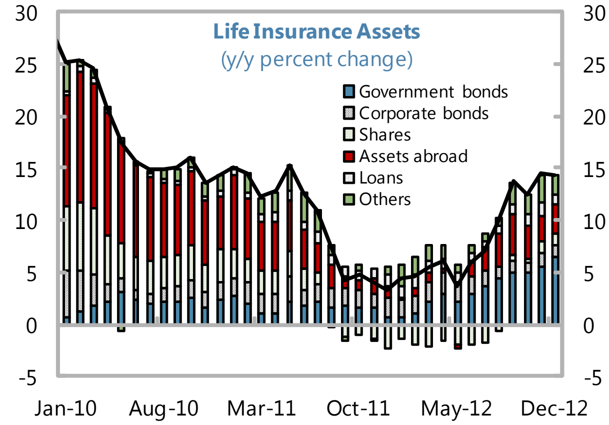
Sources: Bank of Israel; and IMF's Financial Soundness Indicator Database.

Figure 7. Israel: Performance of Non-Bank Financial Sector, 2006–12

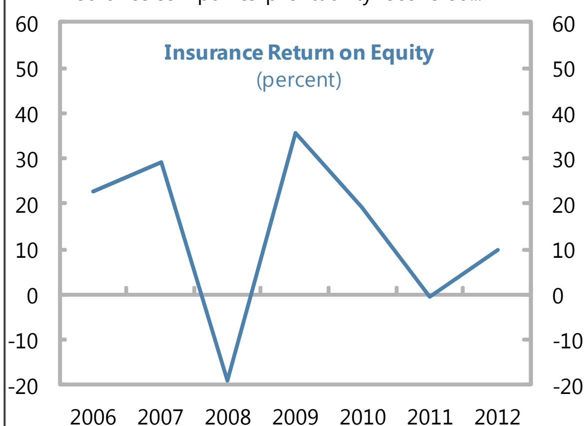
The growth rate of pension fund assets has picked up since mid-2012...



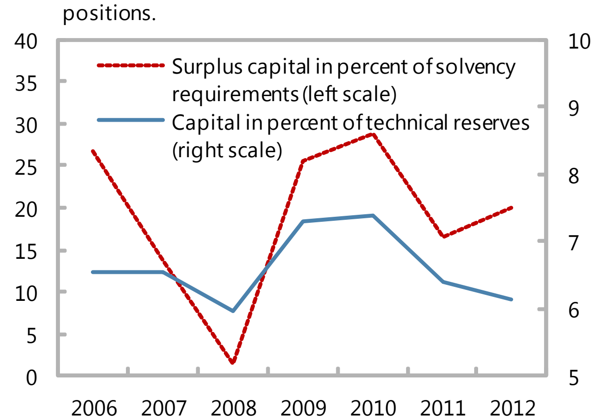
...as has the growth rate of life insurance assets.



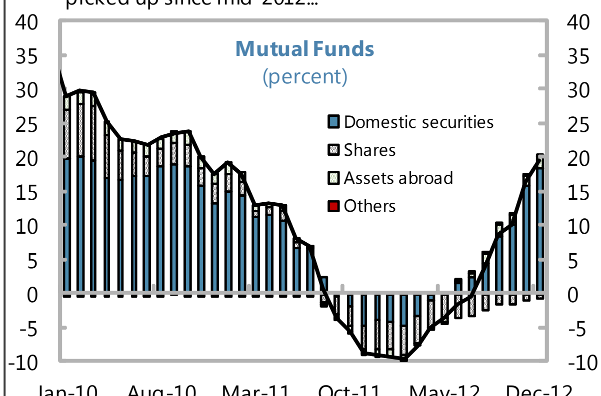
Insurance companies' profitability recovered...



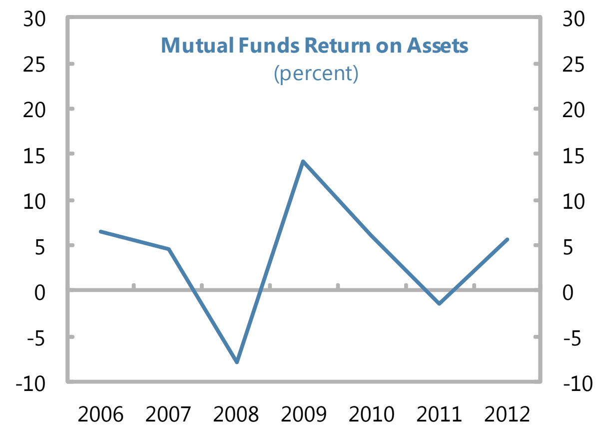
...but without palatable improvements in capital positions.



The growth rate of mutual fund assets has also picked up since mid-2012...



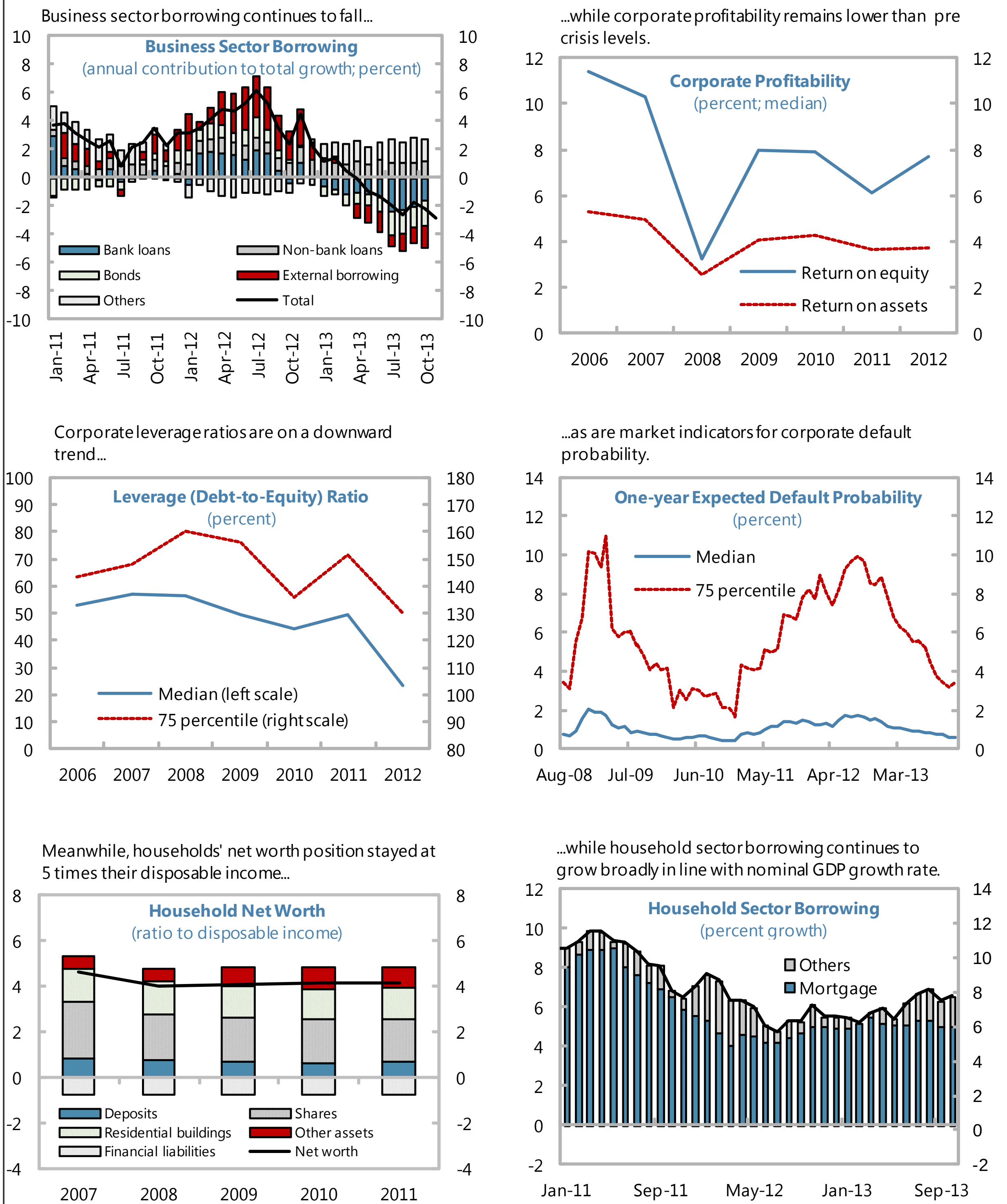
...and so have their asset returns.



Sources: Bank of Israel; Haver Analytics; and Israeli Ministry of Finance Capital Markets, Insurance, and Savings Department; and IMF staff calculations.

Figure 8. Israel: Corporate and Household Sector, 2006–12

(Percent, unless otherwise indicated)



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

Table 1. Israel: Selected Economic and Social Indicators, 2009–14
(Percent change, unless otherwise indicated)

	2009	2010	2011	2012	2013 Staff est.	2014 Staff proj.
Real economy						
Real GDP	1.2	5.7	4.6	3.4	3.4	3.4
Domestic demand	0.4	5.7	5.6	3.8	3.9	3.4
Private consumption	2.2	5.0	3.8	3.2	4.2	3.2
Public consumption	3.1	3.3	2.5	3.2	3.6	3.0
Gross capital formation	-8.0	11.2	15.3	6.3	3.2	4.3
Foreign demand (contribution to real GDP growth)	0.6	0.0	-0.9	-0.5	-0.5	0.0
Output gap (percent of potential)	-1.3	0.3	1.0	0.6	0.2	0.1
Output gap excl. gas impact (percent of potential)	…	…	…	…	0.2	-0.1
Unemployment rate (percent)	8.8	7.9	6.9	6.9	6.4	6.7
Overall CPI (end period)	3.9	2.7	2.2	1.6	1.8	2.0
Saving and investment balance						
Gross national saving (percent of GDP)	19.2	17.0	21.4	21.0	21.2	21.3
Foreign saving (percent of GDP)	-3.8	-3.1	-1.3	-0.3	-0.6	-0.7
Gross domestic investment (percent of GDP)	15.4	13.9	20.2	20.7	20.6	20.7
Money and interest rates						
M3 (period average)	14.1	2.3	7.1	8.9	…	…
Bank of Israel policy rate (percent, end year)	1.00	2.00	2.75	2.00	…	…
10-year government bond yield (percent, average)	5.07	4.70	4.98	4.33	…	…
Public finance (percent of GDP)						
Central government						
Revenues and grants	26.5	25.7	26.0	24.9	25.6	25.7
Total expenditure	31.5	29.2	29.0	28.9	29.1	28.5
Overall balance	-5.0	-3.6	-3.0	-4.1	-3.5	-2.8
General government						
Overall balance	-6.3	-4.6	-4.2	-3.9	-3.5	-3.0
Debt	75.3	71.5	69.7	68.2	67.5	66.6
Of which: foreign currency external debt	13.6	12.0	11.9	10.6	7.8	7.0
Balance of payments (percent of GDP)						
Exports of goods and services 1/	33.6	35.0	35.5	36.2	33.7	33.0
Real growth rate (percent)	-11.7	14.2	7.3	0.9	-2.3	2.2
Imports of goods and services 1/	30.8	33.2	36.0	36.0	33.8	32.4
Real growth rate (percent)	-13.7	15.1	10.5	2.3	-1.0	2.1
Trade balance	2.8	1.7	-0.5	0.2	0.0	0.4
Oil Imports (billions of U.S. dollars)	8.1	10.4	13.6	16.1	16.5	17.0
Current account	3.8	3.1	1.3	0.3	0.6	0.7
Foreign reserves (end period, billions of U.S. dollars)	61	71	75	76	82	85
Exchange rate						
Exchange rate regime			Free floating			
NIS per U.S. dollar	3.9	3.7	3.6	3.9	3.6	…
Nominal effective exchange rate (2005=100)	109.8	115.1	116.4	111.8	…	…
Real effective exchange rate (2005=100)	109.9	115.4	116.8	111.0	…	…

Social Indicators (reference year)

GDP per capita (2012): $32,265; Population density (2011): 359 people per sq. km; Poverty rate (2008)2/: 19.9 percent; Fertility rate (2009): 3.0 per woman; Life expectancy at birth (2009): 79.7 (male) and 83.5 (female); Infant mortality rate (2009): 3.4 per 1,000 births; Physicians (2007): 3.6 per 1,000 people; CO2 emissions (tons per capita, 2007): 9.3.

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

1/ National Accounts data.
2/ Poverty rate from National Insurance Institute of Israel.

Table 2. Israel: Balance of Payments, 2010–19
(In billions of U.S. dollars; unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Staff est.			Staff projections			
Current account balance	7.2	3.3	0.8	1.8	2.1	4.4	4.4	4.5	4.4	4.7
Merchandise	-2.0	-8.2	-9.3	-9.6	-8.6	-6.6	-7.4	-7.9	-8.7	-9.8
Exports, f.o.b.	56.4	64.3	62.3	61.1	63.0	65.9	67.9	70.8	74.1	77.5
Imports, f.o.b.	-58.4	-72.5	-71.7	-70.7	-71.6	-72.6	-75.3	-78.8	-82.9	-87.3
Civilian imports	-56.1	-70.0	-68.9	-68.8	-69.7	-70.7	-73.4	-77.9	-83.0	-88.4
Military imports	-2.3	-2.5	-2.8	-1.9	-1.9	-1.9	-1.9	-0.9	0.1	1.1
Services	6.0	6.9	9.8	9.5	9.8	11.0	11.6	12.4	13.0	13.4
Exports	24.8	27.4	30.9	30.6	31.7	33.8	36.2	38.8	41.5	43.4
Imports	-18.8	-20.5	-21.0	-21.1	-21.9	-22.8	-24.6	-26.4	-28.5	-30.0
Factor Income	-5.2	-4.4	-8.0	-7.0	-8.0	-8.8	-8.8	-8.8	-8.8	-8.8
Receipts	6.3	7.8	7.2	7.8	7.2	7.2	7.2	7.2	7.2	7.2
Payments	-11.4	-12.1	-15.2	-14.8	-15.2	-16.0	-16.0	-16.0	-16.0	-16.0
Net transfers	8.3	8.9	8.4	8.9	8.9	8.9	8.9	8.9	8.9	10.0
Official	4.5	4.7	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Private	3.8	4.2	3.8	4.3	4.3	4.3	4.3	4.3	4.3	5.4
Capital and financial account balance 1/	0.9	-0.6	-5.9	4.1	1.4	-3.8	-3.8	-3.9	-4.4	-4.7
Capital account	1.0	1.2	0.7	1.0	1.0	1.0	1.0	1.0	1.0	2.0
Financial account 1/	0.0	-1.8	-6.6	3.1	0.4	-4.8	-4.8	-4.9	-5.4	-6.7
Direct investment, net	-3.6	5.4	7.1	11.4	10.9	9.6	10.2	10.0	10.0	10.0
Foreign direct investment abroad	-9.1	-5.3	-2.4	-2.0	-3.9	-4.9	-4.3	-5.0	-5.0	-5.0
Foreign direct investment in Israel	5.5	10.8	9.5	13.4	14.8	14.5	14.5	15.0	15.0	15.0
Portfolio investment, net	-0.4	-8.9	-12.3	-8.1	-9.4	-12.0	-14.0	-14.1	-14.6	-15.4
Other investment	3.9	1.7	-1.4	-0.2	-1.1	-2.4	-1.0	-0.8	-0.8	-1.3
Change in reserves 2/	-11.9	-4.5	0.2	-5.9	-3.5	-0.6	-0.6	-0.6	0.0	0.0
Errors and omissions	3.8	1.9	4.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Current account balance (percent of GDP)	3.1	1.3	0.3	0.6	0.7	1.4	1.3	1.3	1.2	1.2
Gross external debt (percent of GDP)	46.5	40.8	37.6	32.0	28.2	24.4	20.4	16.5	12.8	9.3
Foreign reserves (billions of US dollars)	71	75	76	82	85	86	86	87	87	87
GDP (billions of U.S. dollars)	232	258	258	289	305	323	340	360	381	394

Sources: Central Bureau of Statistics.

1/ Excludes reserve assets.
2/ Negative (positive) sign denotes increase (decrease) in reserves.

Table 3. Israel: International Investment Position, 2004–12
(End-period)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
				(In billions of US dollars)					
Israeli assets abroad	108.0	125.4	170.1	197.7	194.6	227.0	260.7	265.3	278.7
Of which: reserve assets	27.1	28.1	29.2	28.6	42.5	60.6	70.9	74.9	75.9
Israeli liabilities abroad	131.0	147.4	170.1	198.6	180.5	214.8	235.5	222.7	221.5
Net international investment position	-23.0	-22.1	0.0	-0.9	14.1	12.2	25.2	42.6	57.2
				(In percent of GDP)					
Israeli assets abroad	82.2	90.5	112.7	113.0	91.3	110.3	112.3	102.7	108.2
Direct investment	14.1	16.7	26.0	28.5	25.5	27.9	29.7	27.4	28.7
Portfolio investment	14.1	19.2	23.4	24.1	15.7	24.0	26.9	24.2	29.4
Equity securities	3.8	6.3	8.8	9.7	6.0	12.3	15.3	13.8	17.4
Bonds and notes	10.3	12.9	14.6	14.4	9.6	11.7	11.6	10.4	12.0
Other investment	33.3	34.4	43.8	44.1	30.2	29.0	25.2	22.3	20.7
Net financial derivatives	…	…	…	…	…	-0.1	-0.3	-0.4	-0.5
Reserve assets	20.6	20.3	19.3	16.3	19.9	29.5	30.6	29.0	29.5
Israeli liabilities abroad	99.7	106.4	112.7	113.5	84.7	104.4	101.5	86.3	86.0
Direct investment	18.9	22.2	29.3	28.6	23.3	27.1	26.0	25.2	28.9
Portfolio investment	41.0	47.0	46.1	49.8	33.5	46.2	46.5	34.6	32.6
Equity securities	23.2	29.9	26.9	34.1	21.1	33.4	30.7	22.5	22.4
Bonds and notes	17.8	17.0	19.2	15.7	12.4	12.9	15.8	12.1	10.3
Other investment	39.8	37.2	37.3	35.2	27.9	31.0	29.0	26.5	24.5
Net international investment position	-17.5	-15.9	0.0	-0.5	6.6	5.9	10.9	16.5	22.2
Memorandum items:									
Gross external debts	59.8	56.4	58.7	52.8	42.0	46.0	46.5	40.8	37.6
Of which: short-term debts	…	…	24.5	22.8	18.9	20.5	24.0	19.7	17.0
Net external debts	-8.2	-14.7	-23.6	-26.3	-21.6	-28.8	-26.0	-24.2	-27.5

Source: Haver Analytics.

Table 4. Israel: Summary of Central Government Operations, 2010–14 1/
(In percent of GDP; unless otherwise indicated)

	2010	2011		2012		2013		2014	
		Budget	Actual	Budget	Actual	Budget	Staff proj.	Budget	Staff proj.
					(In billions of NIS)				
Revenue	222.4	244.9	240.3	265.1	246.9	263.4	267.7	287.5	284.5
Expenditure	253.3	270.1	267.6	283.4	287.5	309.0	304.0	318.6	315.6
Budget deficit	-30.9	-25.2	-27.4	-18.3	-40.6	-45.7	-36.3	-31.1	-31.1
Change in cash balances at the BOI	9,274	…	8,953	…	…	…	…	…	…
					(In percent of GDP)				
Revenue and grants	25.7	28.3	26.0	26.7	24.9	25.1	25.6	25.9	25.7
On income and profits	10.8	12.0	11.2	11.3	10.8	10.7	11.2	11.3	11.0
VAT and customs	11.2	12.1	11.1	11.6	10.6	11.0	11.1	11.3	11.3
Fees	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5
VAT on defense imports	0.1	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Interest	0.2	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Loans from NII	1.4	1.7	1.5	1.6	1.4	1.4	1.4	1.5	1.5
Grants	1.0	1.0	0.9	0.9	0.9	0.8	0.8	0.8	0.8
Other	0.4	0.5	0.4	0.5	0.3	0.3	0.3	0.3	0.3
Expenditure	29.2	31.3	29.0	28.5	28.9	29.4	29.1	28.7	28.5
Administrative Departments	4.1	4.2	4.0	3.9	4.0	4.1	4.0	4.0	4.0
Social Departments	11.3	12.2	11.3	11.0	11.4	11.5	11.5	11.1	11.1
Economic Departments	2.0	2.3	2.2	2.0	2.1	2.6	2.5	2.6	2.6
Defense Expenditure	6.7	5.9	6.4	5.3	6.3	5.2	5.2	4.8	4.8
Other Expenditures	0.3	0.7	0.3	0.7	0.4	0.7	0.6	0.7	0.7
Reserve	0.0	0.7	0.0	0.8	0.0	0.7	0.7	0.7	0.7
Interest	4.0	4.3	3.9	3.9	3.8	3.8	3.6	3.8	3.5
Repayment of Principal to NII	0.9	1.0	0.9	0.9	0.9	0.9	0.9	1.0	1.0
Budget deficit	-3.6	-2.9	-3.0	-1.8	-4.1	-4.3	-3.5	-2.8	-2.8
Unsettled Payment Orders 2/	-1.1	…	-1.0	…	0.2	…	0.0	…	…
Financing	2.5	2.9	2.0	1.8	4.2	4.3	3.5	2.8	2.8
Foreign (net)	-0.1	0.3	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.1
Loans	1.4	0.9	0.6	0.9	1.2	1.1	1.1	0.9	0.9
Repayment	-1.5	-0.7	-0.6	-0.9	-1.3	-1.1	-1.1	-1.0	-1.0
Domestic (net)	2.0	2.2	1.3	1.6	4.3	4.2	3.3	2.8	2.8
Loans	8.0	9.7	9.3	8.3	11.4	10.8	9.9	9.1	9.1
Repayment	-6.0	-7.5	-8.1	-6.7	-7.1	-6.6	-6.6	-6.3	-6.3
Sale of assets (net)	0.6	0.4	0.7	0.2	0.1	0.1	0.1	0.1	0.1
Memorandum items:									
Primary spending	25.2	27.0	25.0	24.6	25.1	25.6	25.5	24.9	25.0
Primary balance (PB)	0.2	1.1	0.8	1.8	-0.4	-0.7	0.0	0.8	0.6
Cyclically adjusted PB (percent of potential GDP)	-0.7	…	-1.0	…	-0.8	…	-0.7	…	-0.2
Deficit limit	…	3.0	…	2.0	…	4.0	…	2.8	…
Real expenditure growth (in percent)	…	5.8	5.5	4.8	7.3	8.9	5.7	3.1	3.7
Ceiling on the real expenditure growth (percent)	…	2.7	2.7	3.2	3.2	4.6	4.6	3.0	3.0
Public debt to GDP	71.5	…	69.7	…	68.2	…	67.5	…	66.6
Nominal GDP (in billions of NIS)	866	864	924	993	993	1,051	1,045	1,112	1,108
Real GDP growth (in percent)	5.7	3.8	4.6	4.0	3.4	3.7	3.4	3.3	3.4
Inflation (in percent)	2.7	2.2	3.5	2.2	1.7	1.6	1.5	2.1	2.0
Exchange rate (NIS per US$)	3.7	3.8	3.6	3.8	3.9	3.9	3.6	3.9	3.6
Nominal GDP growth excl. gas (in percent)	7.0	…	6.7	…	7.5	4.7	4.4	5.1	5.7

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

1/ Data as per the MOF definition, on a cash basis, covering the budgetary sector and the National Insurance Institute.
2/ Registered spending but for which the equivalent cash has not yet been disbursed, hence it does not appear in financing.

Table 5. Israel: Summary of General Government Operations, 2007–12

	2007	2008	2009	2010	2011	2012
			(In billions of NIS)			
Revenue	305.0	301.8	297.3	325.9	348.4	361.4
Total expenditure	315.9	330.5	348.6	365.4	387.0	400.1
Expense	314.4	328.5	347.0	363.6	384.2	398.5
Net acquisition of nonfinancial assets	1.5	2.0	1.6	1.8	2.8	1.6
Overall balance	-10.9	-28.6	-51.2	-39.5	-38.5	-38.7
			(in percent of GDP)			
Revenue	42.4	39.5	36.7	37.6	37.7	36.4
Taxes	29.1	26.5	24.4	25.2	25.3	24.4
Taxes on income, profits, and capital gains	13.0	10.9	9.1	9.2	9.6	9.3
Taxes on payroll & workforce	1.4	1.2	1.2	1.2	1.2	1.2
Taxes on property	2.9	2.8	2.7	2.9	2.8	2.6
Taxes on goods & services	11.5	11.3	11.1	11.6	11.5	11.1
Value added Tax	7.5	7.4	7.3	7.6	7.6	7.3
Excise	1.6	1.6	1.7	1.8	1.7	1.7
Other G&S taxes	2.4	2.2	2.1	2.2	2.2	2.1
Taxes on international trade & transactions	0.3	0.3	0.3	0.3	0.3	0.3
Other taxes	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	6.3	6.3	6.1	6.2	6.2	6.0
Grants	1.4	1.3	1.0	1.1	1.1	1.3
Other revenue	5.6	5.4	5.2	5.2	5.1	4.7
Of which: Interest income	0.9	0.8	0.8	0.7	0.6	0.5
Total expenditure	44.0	43.2	43.1	42.2	41.9	40.3
Expense	43.7	43.0	42.9	42.0	41.6	40.1
Compensation of employees	11.3	11.3	11.2	11.1	11.1	11.0
Purchases/use of goods & services	12.4	12.2	12.0	11.9	11.8	11.9
Consumption of fixed capital (CFC)	1.4	1.4	1.4	1.4	1.4	1.3
Interest	5.6	5.0	4.7	4.6	4.5	2.9
Subsidies	0.8	0.7	0.8	0.7	0.7	0.7
Grants	0.1	0.1	0.1	0.0	0.0	0.1
Social benefits	9.0	8.8	9.3	9.1	9.1	9.1
of which: Social security benefits	5.5	5.6	5.8	5.8	5.7	5.7
Other expense	3.2	3.3	3.4	3.2	2.9	3.1
Net acquisition of nonfinancial assets	0.2	0.3	0.2	0.2	0.3	0.2
Overall balance	-1.5	-3.7	-6.3	-4.6	-4.2	-3.9
Memorandum item:						
Primary spending (Billions NIS)	275.6	292.1	310.2	325.5	345.3	370.9
Primary balance (percent of GDP)	3.2	0.5	-2.4	-0.6	-0.3	-1.5
Public debt to GDP	74.6	72.9	75.3	71.5	69.7	68.2
Real GDP growth (percent)	6.9	4.5	1.2	5.7	4.6	3.4
Inflation (percent)	0.5	4.6	3.3	2.7	3.5	1.7
Exchange rate (NIS to US$)	4.1	3.6	3.9	3.7	3.6	3.9
Nominal GDP (Billions NIS)	718.8	764.7	809.2	866.2	923.9	993.4

Source: IMF Government Financial Statistics and Israeli Central Bureau of Statistics.

Table 6. Israel: Financial System Structure, 2005–12

	2005			2008			2010			2012				
	Number of Institutions/ funds	Total assets: NIS billions	Total assets: Percent of GDP	Number of Institutions /funds	Total assets: NIS billions	Total assets: Percent of GDP	Number of Institutions /funds	Total assets: NIS billions	Total assets: Percent of GDP	Number of: Institutions /funds	Number of: Branches	Number of: Employees	Total assets: NIS billions	Total assets: Percent of GDP
A. Banks														
Five major banks, consolidated	**5**	**859.2**	**138.2**	**5**	**1,012.8**	**132.4**	**5**	**1,068.8**	**123.4**	**5**	**1,248**	**48,010**	**1,221.0**	**122.9**
Bank Leumi Le Israel	1	272.8	43.9	1	310.8	40.6	1	328.2	37.9	1	326	13,566	376.1	37.9
Bank Hapoalim	1	273.3	43.9	1	306.8	40.1	1	320.9	37.0	1	316	13,629	376.4	37.9
Israel Discount Bank	1	154.8	24.9	1	182.2	23.8	1	185.8	21.5	1	250	10,016	200.9	20.2
Mizrahi Tefahot Bank	1	86.3	13.9	1	114.0	14.9	1	133.3	15.4	1	175	5,613	162.2	16.3
First International Bank of Israel	1	71.9	11.6	1	98.9	12.9	1	100.7	11.6	1	181	5,186	105.4	10.6
Other Israeli banks	**3**	**42.1**	**6.8**	**3**	**49.0**	**6.4**	**3**	**52.8**	**6.1**	**3**	**54**	**1,808**	**59.4**	**6.0**
Foreign bank branches	…	…	…	…	…	…	…	…	…	**4**	**4**	…	**20.2**	**2.0**
B. Non-bank financial institutions		**667.7**	**107.4**		**765.2**	**100.1**		**1,068.0**	**123.3**				**1,218.8**	**122.7**
Provident and severance pay funds	104	165.6	26.6	87	145.4	19.0	66	194.1	22.4	75	…	…	190.8	19.2
Advanced study funds	…	72.0	11.6	…	72.6	9.5	…	112.0	12.9	…	…	…	126.8	12.8
Old pension funds	18	142.5	22.9	18	237.2	31.0	18	287.2	33.2	18	…	…	332.9	33.5
New pension funds	18	44.7	7.2	13	71.0	9.3	10	111.3	12.9	13	…	…	153.9	15.5
New general pension funds	…	0.3	0.0	…	0.6	0.1	…	1.3	0.1	…	…	…	1.9	0.2
New comprehensive pension funds	…	44.5	7.1	…	70.4	9.2	…	110.1	12.7	…	…	…	152.1	15.3
Mutual funds	918	124.6	20.0	1,185	98.1	12.8	1,247	156.6	18.1	1,247	…	…	170.1	17.1
Assured yield life insurance plans	…	47.3	7.6	…	54.9	7.2	…	66.1	7.6	…	…	…	74.8	7.5
Profit sharing life insurance plans	…	71.1	11.4	…	86.1	11.3	…	140.7	16.2	…	…	…	169.5	17.1
Total financial system (A+B)	…	**1,526.9**	**245.5**	…	**1,778.0**	**232.5**	…	**2,136.8**	**246.7**	…	…	…	**2,439.8**	**245.6**
Memorandum items:														
GDP (NIS billions)	…	…	621.9	…	…	764.7	…	…	866.2	…	…	…	…	993.4

Sources: Bank of Israel; Ministry of Finance; and Israel Securities Authority.

Table 7. Israel: Financial Soundness Indicators, 2006–12
(End-period, in percentage)

	2006	2007	2008	2009	2010	2011	2012
Capital Adequacy							
Regulatory capital to risk-weighted assets 1/	10.9	11.0	11.3	13.7	14.1	14.0	14.9
Regulatory Tier I capital to risk-weighted assets 1/	7.6	7.7	7.6	8.3	8.5	8.4	9.2
Capital as percent of assets (leverage ratio)	8.5	9.0	9.1	10.6	11.1	10.6	10.8
Asset quality and exposure							
Nonperforming loans to total gross loans	…	…	…	…	…	2.5	2.8
Nonperforming loans net of loan-loss provisions to capital	…	…	…	…	…	21.9	23.8
Sectoral distribution of bank credit (percent) 2/							
Industry	13.0	12.4	13.0	11.1	10.5	9.6	8.9
Construction and real estate	15.2	15.8	16.9	16.8	16.7	16.6	16.4
Commerce	8.7	8.4	8.5	7.5	7.5	6.4	6.5
Finance services	13.0	16.1	12.5	11.8	11.7	8.0	7.7
Households	33.5	31.1	32.8	37.1	38.3	35.2	36.7
Of which: mortgages	20.5	18.7	19.8	22.8	24.2	17.7	19.1
Borrowers with activity abroad	…	…	…	…	…	13.0	12.4
Others	16.7	16.2	16.3	15.7	15.2	11.3	11.3
Large exposures as percent of regulatory capital	545.2	537.1	521.1	399.8	397.2	395.0	362.2
Earnings and profitability							
Return on average assets (before tax)	1.0	1.2	0.0	0.9	0.9	0.8	0.8
Return on average equity (before tax)	17.3	19.5	0.7	14.1	13.8	12.3	12.2
Net interest income as percent of gross income	61.5	61.1	59.4	59.5	63.5	65.2	60.7
Trading and fee income as percent of gross income	6.4	7.3	8.8	8.0	8.0	7.1	6.4
Noninterest expenses as percent of gross income	66.3	64.5	82.2	64.0	68.4	70.3	69.8
Personnel expenses as percent of noninterest expenses	62.3	59.7	58.5	56.2	57.3	59.0	58.2
Liquidity							
Liquid assets as percent of total assets	…	…	…	64.6	62.4	63.3	62.7
Liquid assets as percent of short-term liabilities	…	…	…	102.4	100.7	101.2	99.2
Customer deposits as a percent of total (non-interbank) loans	118.3	113.7	107.2	110.4	104.7	111.3	113.1
Foreign exchange risk							
Net foreign exchange open position to capital	0.8	-5.7	-9.2	-5.3	-6.2	-6.0	1.0
Foreign currency-denominated loans as percent of total loans	28.7	26.8	24.9	21.7	16.2	16.6	14.9
Foreign currency-denominated liabilities as percent of total liabilities	40.4	39.1	35.6	32.9	29.6	29.7	27.7
Liquid foreign currency assets to short-term foreign currency liabilities	77.5	64.3	64.5	53.8	45.5	52.2	48.3

Sources: Bank of Israel, and IMF Financial Soundness Indicators Database.
1/ From 2009, the calculation of capital base follows rules under Basel II.
2/ Prior to 2010, data do not include off-balance sheet data and "borrowers with activity abroad" are not classified separately. From 2011 onward, data include off-balance sheet data.

Table 8. Israel: Financial Soundness Indicators: Non-Banks, 2006–12
(End-period, in percentage points; unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012
Insurance sector							
Return on equity	22.6	29.3	-19.0	35.9	19.3	-0.5	14.4
Net premiums as percent of capital	260.6	251.9	302.6	204.1	192.5	224.5	213.2
Capital as percent of technical reserves	6.5	6.6	6.0	7.3	7.4	6.4	6.4
Surplus capital as percent of required solvency 1 capital	26.6	13.8	1.5	25.5	28.8	16.6	32.7
Liquid assets as percent of total assets	43.7	46.0	41.4	49.5	52.4	51.2	53.3
Households							
Household assets as percent of disposable income	519.1	550.7	495.3	503.1	510.9	510.7	…
Of which: residential buildings	150.8	150.0	147.9	138.5	140.0	140.0	…
Household debt as percent of disposable income	72.0	75.2	75.7	75.9	76.1	78.6	…
Corporate sector							
Non-financial sector borrowing	83.8	80.5	79.4	76.9	76.3	74.3	…
From residents	68.9	66.6	65.8	64.0	64.3	62.2	…
From non residents	14.9	13.9	13.6	12.9	12.0	12.1	…
Debt to equity ratio							
All nonfinancial corporate	1.8	2.2	2.6	2.2	2.2	2.5	2.4
Of which: Manufacturing sector	1.2	1.2	1.3	1.1	1.1	1.4	1.4
Construction corporate	2.7	2.7	4.1	3.8	3.0	2.9	2.5
Net income to equity ratio							
All nonfinancial corporate	0.1	0.1	0.0	0.1	0.1	0.1	0.1
Of which: Manufacturing sector	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Construction corporate	0.1	0.1	-0.2	0.0	0.1	0.0	0.1
Earning before interest and tax to equity ratio							
All nonfinancial corporate	0.2	0.2	0.1	0.1	0.2	0.2	0.2
Of which: Manufacturing sector	0.2	0.2	0.1	0.1	0.2	0.2	0.1
Construction corporate	0.1	0.2	0.0	0.1	0.2	0.2	0.2
Equity markets							
Tel Aviv Stock Exchange Index 75 (annual percent change)	22.2	16.4	-37.5	-4.7	38.3	-5.5	-10.1
Equity prices of financial institutions (annual percent change)	8.1	0.2	-55.7	126.9	9.3	-34.0	23.1
Equity prices of real estate firms (annual percent change)	68.2	1.2	-80.0	125.2	15.4	-23.2	14.1
Equity prices of banks (annual percent change)	3.7	6.2	-55.5	114.0	6.8	-34.6	22.9
Market capitalization in percent of GDP	101.4	125.9	53.1	88.3	93.1	65.0	60.8
Corporate bond markets							
Corporate bond yields over government bond yields (in basis points)							
Real estate and construction	1.8	3.5	17.1	8.3	4.4	7.3	5.2
Manufacturing	1.9	2.2	6.8	3.2	3.0	3.5	3.1
Corporate bond outstanding (in billions of NIS)	109.0	188.3	202.3	234.7	254.2	276.8	286.5
Average daily turnover (in billons of NIS)	0.3	0.7	0.9	0.9	0.9	0.9	1.0
Real estate markets (prices; annual percent change)							
Average prices of owner occupied dwelling	-3.2	2.5	6.5	22.4	17.0	0.0	5.8
Jerusalem	7.3	3.7	13.3	15.5	14.7	8.6	0.6
Tel Aviv	-7.9	14.9	10.7	34.1	16.9	-4.8	7.3
Memorandum items							
GDP (year on year percent change, constant prices)	5.8	6.9	4.5	1.2	5.7	4.6	3.4
Nominal GDP (in billions of NIS)	673	719	765	809	866	924	993
Total financial sector assets (in billions of NIS)	1,612	1,732	1,778	2,002	2,137	2,258	2,439.8
Of which: Five major banks (in percent of total financial assets)	56.6	55.5	57.0	52.1	50.0	52.1	50.0
Total financial sector assets (in percent of GDP)	239.6	240.9	232.5	247.4	246.7	244.3	245.6
of which: Five major banks (in percent of GDP)	135.6	133.8	132.4	128.8	123.4	127.3	122.9

Sources: Bank of Israel, and IMF staff estimates.

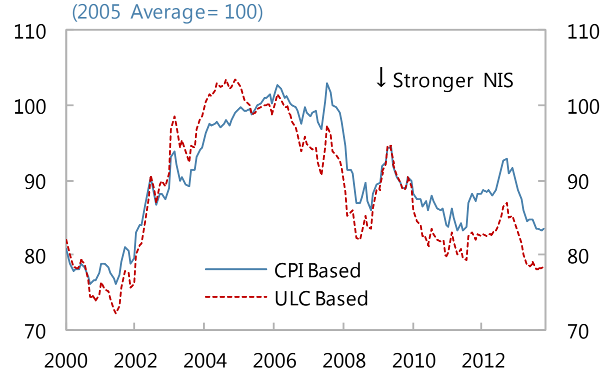
Annex I. Israel's External Sector Assessment[1]

The shekel has appreciated by 20 percent in nominal and real terms since 2007 and is now 10 percent above its longer-term average. While from an economy-wide perspective, the shekel is broadly in line with fundamentals, the impact on the tradable sector has clearly been felt. To some extent, Israel may be suffering from a Dutch disease phenomenon, owing to large capital inflows related to the coming on stream of gas production and foreign purchases of start-up companies in the high-tech sector.

The appreciation of the real exchange rate

1. Since mid-2007, Israel's real exchange rate (REER) has appreciated to about 10 percent above its longer-term average, amid high volatility. Israel's CPI and ULC-based real effective exchange rates (REER) have appreciated by 20 percent since July 2007. During this period, however, the shekel also depreciated sharply following the collapse of Lehman Brothers, the Eurozone crisis, and periods of heightened geopolitical tensions.

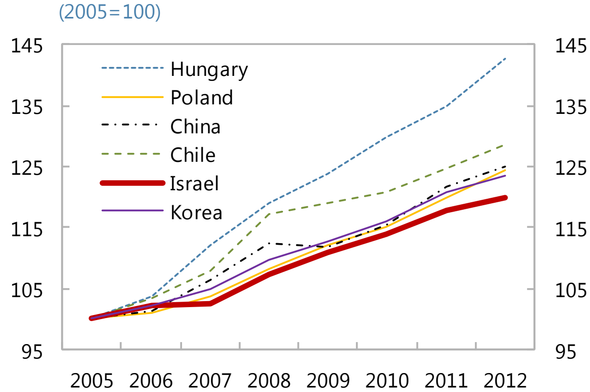
REER
(2005 Average= 100)



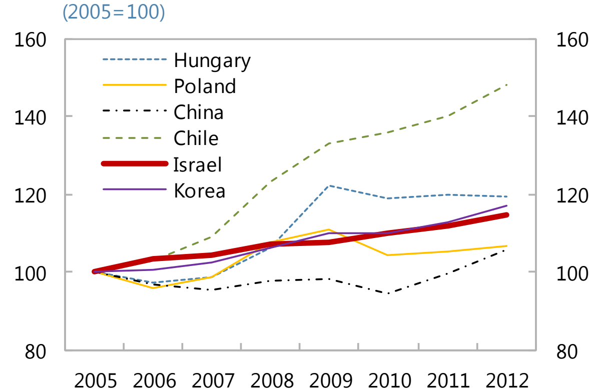
Sources: IMF and International Financial Statistics

2. The strengthening of the real effective exchange rate largely reflects a nominal appreciation. While the nominal effective exchange rate has appreciated by nearly 20 percent since 2007, prices and wages in Israel have not grown faster than in other countries.

Consumer Prices
(2005=100)



Unit Labor Costs
(2005=100)



Sources: OECD and IMF staff caluclations

[1] Prepared by Carolina Osorio-Buitron.

3. The appreciation of the shekel has been driven in part by Israel's sound fundamentals.

- Israel weathered the global financial and Euro Area crises relatively well, owing to the absence of large imbalances in the pre-crisis period. Growth has averaged 3.7 percent since 2008, compared with 0.7 percent on average in OECD countries.

- Since 2003, Israel has maintained a current account surplus of around 2.3 percent of GDP, owing largely to its dynamic export activity. High-tech manufacturing and services are the main drivers of export growth in Israel, representing about 50 percent of total industry exports. The emergence of Israel's export based high-tech sector is explained by its excellence in technology development, resulting from sizeable investments in R&D and a large skilled labor force, both of which are high by international standards.

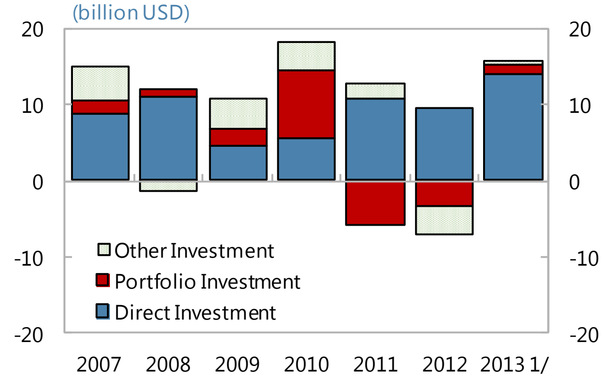
- Net FDI inflows have remained strong. Unlike in other advanced countries, FDI *inflows* into Israel did not fall in the aftermath of the crisis. Direct investment in Israel is stable and largely accounted for by high-tech companies. Although new direct investments are generally the main driver of inward FDI, in 2012 FDI inflows were largely explained by reinvestments, owing to a considerable increase in retained profits of foreign companies operating in Israel.

- Over the past several years, vast reserves of natural gas have been found in the Israeli off-shore economic zone, and production from the Tamar field began on April 2013. The gas sector is estimated to contribute to improving the current account balance by 1–1¼ percentage points of GDP in 2013 and 2014. Furthermore, Israel could start exporting natural gas by the end of the decade, which will further contribute to boost the current account balance.

4. Occasionally, portfolio flows have influenced short-term fluctuations in the exchange rate.

- During 2010 and the first half of 2011, portfolio inflows soared, as foreign investors brought large volumes of capital to take advantage of the interest rate differential between Israel and the major advanced economies. The appreciation pressures brought about by these "hot money" flows receded shortly thereafter, as speculative capital left the economy in response to the Bank of Israel's interest rate cut, the removal of the tax exemption on capital gains for foreign investors, and the increase in the economy's risk premium. Since then, carry-trade flows from abroad have remained small.

Capital Inflows by Type
(billion USD)



Sources: Haver Analytics and IMF staff calculations
1/ Through Q3-2013, annualized

- In 2012 and 2013, portfolio flows turned negative, mainly because domestic institutional investors made sizeable portfolio investments abroad. However, in anticipation of further appreciations, institutional investors increased their hedging positions to protect the value of their foreign investments in shekels—i.e., they sold dollars forward (mostly to Israeli banks), which offset the downward pressure (put by their investments abroad) on the currency.[2]

Model based current account and exchange rate valuations

5. Staff's estimates suggest that the exchange rate is broadly in line with fundamentals. Results from various equilibrium exchange rate assessment models are mixed.

- The estimates for real exchange rate misalignment vary across different methodologies. The Equilibrium Real Exchange Rate (ERER) measure suggests an overvaluation of 10 percent, while Macro Balance (MB) and External Stability (ES) measures suggest that the exchange rate is undervalued by 7 and 8 percent, respectively.
- The IMF's new External Balance Assessment (EBA) suggests that the norm for the current account balance for Israel is about zero. In 2013, the current account balance is projected at about ¾ percent of GDP, which in cyclically adjusted terms is about 1¾ percent of GDP. The deviation of the cyclically adjusted current account from the norm is estimated at about 2 percent of GDP, which can be largely attributed to the impact of emerging natural gas production.

Current Account and REER Gaps 1/

	EBA 2/	CGER-type 3/		
		MB	ERER	ES
Current account norm (percent GDP)	-0.2	-1.2	...	...
Exchange rate gap	-9.0	-6.9	10.1	-8.2

1/For the exchange rate, positive values indicate overvaluation. The estimated gaps are adjusted to impose a multilateral consistency.

2/ The EBA estimate for the current account norm is in cyclically adjusted terms. The gap is estimated for 2013.

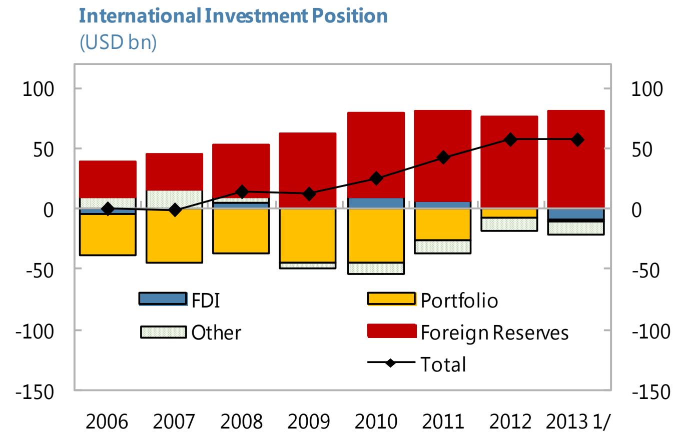
3/ The macroeconomic balance (MB) approach calculates the difference between the medium term current account balance and an estimated equilibrium "norm". The latter is a function of various fundamentals (fiscal balance, old-age dependency ratio, NFA, oil balance, real GDP per capita, and real GDP growth). The ERER is estimated as a function of medium-term fundamentals (NFA, relative productivity differentials, the terms of trade, and trade restrictions). The ES approach calculates the difference between the actual current account balance and the Net Foreign Assets -stabilizing CA balance. The real exchange rate adjustment is calculated to bring the current account balance in line with its NFA-stabilizing level.

Sources: IMF Staff Estimates.

[2] The counterpart of this transaction is an increase in foreign liabilities of Israeli banks, who borrow dollars with the same maturity of the forward transaction and sell them in the spot market.

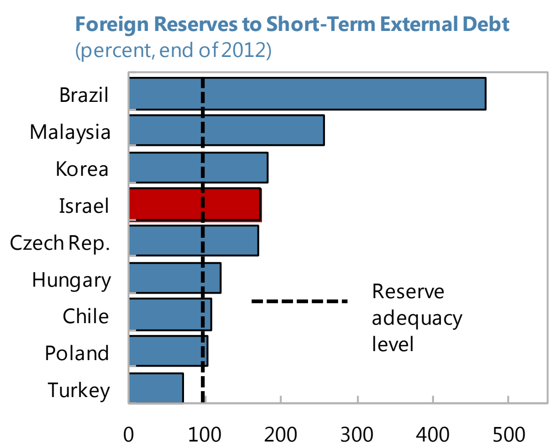
Foreign Reserves and International Investment Position

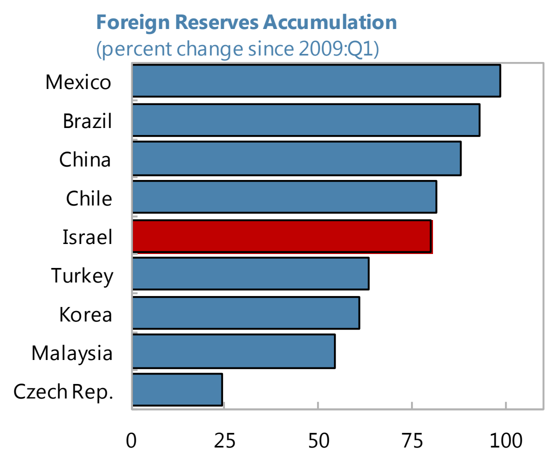
6. Israel's net investment position (IIP) has improved and stabilized in positive territory. This trend has been underpinned by an increase in foreign reserves and a decline of portfolio liabilities. The latter has contributed to reduce Israel's external debt. Moreover, the stock of foreign liabilities is low by international standards, and a part of it is denominated in shekels, thereby reducing the vulnerability of the economy to external shocks.



Sources: Haver Analytics
1/ As of September 2013

7. Reserve assets have increased sharply, owing to the intervention policy undertaken by the BoI. In 2009, the BoI modified its exchange rate policy and announced its intention to engage in discretionary intervention to counteract excessive volatility in the foreign exchange market, or to affect the level of the exchange rate, when the latter deviates considerably from its fundamental value. In May 2013, the BoI launched an additional intervention program, whereby announced purchases of foreign currency are made to offset the effects of gas production on the current account. Standard metrics – reserves to monthly imports and reserves to short term external debt ratios- suggest that foreign reserves may have grown beyond their adequate level. Yet, the authorities' analysis indicates that the adequate level of reserves is somewhere between $65–$90 billion. By international standards, reserves accumulation in Israel does not appear to have been excessive.

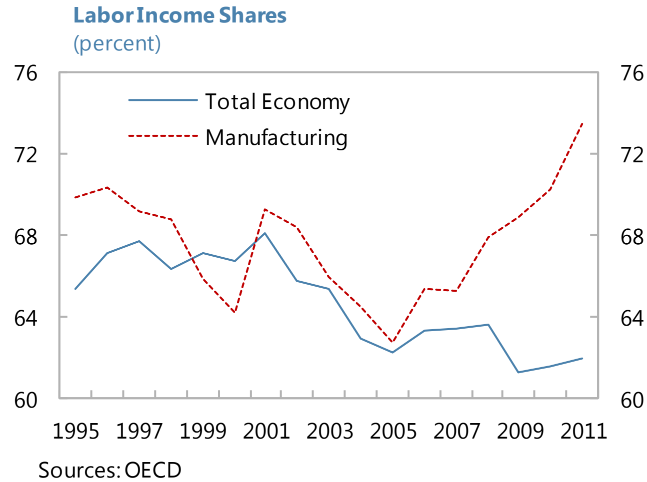




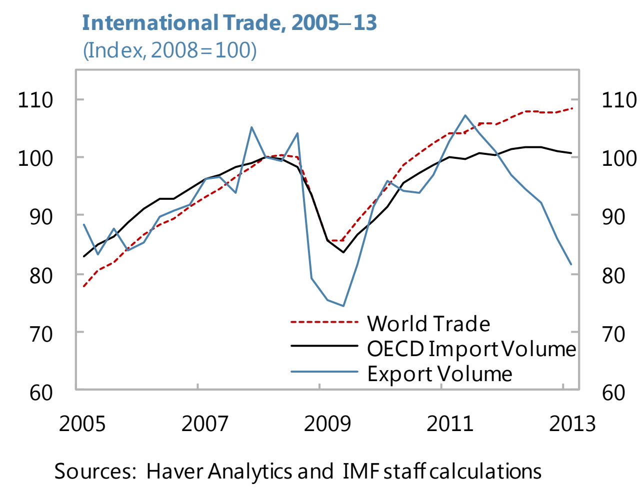
Sources: IMF and IMF staff calculations

The Impact of the Exchange Rate Appreciation on the Tradable Sector

8. The appreciation of the shekel is undermining the competitiveness of the economy. Against the backdrop of a stronger currency, revenues and profit margins in the tradable sector have declined. This is evidenced by the upward trend of the labor income share in the manufacturing industry, which stands in stark contrast with the stable share observed for the economy as a whole.



9. The deterioration of competitiveness in the tradable sector is visible in the weakness of exports. Export volumes have been falling continuously since mid-2011. In the aftermath of the crisis, Israeli exports fell alongside world trade, but the recent downward trend has been accompanied by stable global demand. This reflects a contraction in trade with the US and Europe, which remain mired in an economic slump and represent about 50 percent of the Israeli export market. More importantly, the trend appreciation of the shekel has weakened the economy's external competitiveness, leading to sluggish export and output growth in the manufacturing sector.



Dutch Disease Concerns: Natural Gas and Start-up Companies

10. So far, the impact of gas discoveries on the current account has been relatively limited, especially compared to its potential in the future. The impact of natural gas production in reducing fuel imports has been lower than anticipated, as refinery companies are still importing energy fuels, in part, in fulfillment of previous contracts. However, these imports have been exported subsequently, thus contributing to improving the current account balance.

11. Meanwhile, expectations about future production of natural gas have caused disorderly movements in the foreign exchange market. The expected improvement in the current account due to the production of gas has been known for a long time, and has led to some adjustment in the exchange rate. In June 2013, however, the exchange rate overreacted in anticipation of future developments in the energy sector, prompting the BoI to engage in discretionary intervention.

12. Israel will start exporting gas by 2018, generating major revenues that could strengthen the currency. Exports of natural gas will contribute to boost the current account balance. This will put appreciation pressures on the shekel, which could impair the competitiveness of other industries. Against this background, the government has decided to establish a Sovereign Wealth Fund (SWF), which will invest gas levy receipts abroad and contribute to the fair distribution of gas revenues.

13. Until the SWF is established, the BOI will offset the current account effects of gas production though reserves accumulation. Since the SWF cannot function before super-profit taxes are collected, the BoI launched a foreign currency purchase program to offset the balance of payments effects of natural gas production, as an interim measure. The planned intervention program—announced in May 2013—was introduced to address concerns related to Dutch disease effects from the gas sector. Under this scheme, the BoI announces yearly amounts of foreign currency purchases and executes them on a regular basis throughout the year.

14. Israeli start-up companies are an important supplier of foreign currency. Start-up companies raise significant amounts of financing from global investors, notably through venture capital funds[3]. In addition, start-ups attract foreign currency flows through "exits"; that is, the sale of an Israeli firm to large foreign—often US-companies. About 60 Israeli companies are currently traded in NASDAQ, one of the largest numbers of non-US listed companies. Furthermore, many of the leading international high-tech companies, such as Intel, Apple, Microsoft, Cisco and IBM, have established R&D activities in Israel.

15. But start-up exits could also be giving rise to a Dutch-disease phenomenon. In most countries, FDI inflows entail a transfer of technology from overseas, which stimulates domestic investment and mitigates appreciation pressures on the exchange rate. By contrast, an important fraction of FDI flows into Israel have the same properties as portfolio investments: through start-up exits, which are recorded as inward FDI or exports of services[4], foreigners acquire know-how and

[3] Israel is leading the world in terms of per capita venture capital investment, and is only second to the US in terms of the number of start-ups.

[4] Companies that are sold out are recorded as services exports, while equity investments that entail a transfer of ownership (or control) are recorded as FDI.

technology. About 50 percent of the stock and flow of inward FDI is accounted for by the ICT and high-tech manufacturing industries, where there are a large number of startups. The ICT sector represents 30 percent of exports, but it only contributes to 10 percent of the economy's GVA and to 6 percent of employment. Hence, to the extent that start-up exits contribute to the appreciation of the exchange rate, they undermine the competitiveness of more labor intensive-industries. This is evidenced by the declining market share of Israel's goods exports, compared with the increase in the share of services exports.

Israel's Share of World Exports, 2000–12
(percent of world exports)

Sources: World Trade Organization

Annex II. Israel: Risk Assessment Matrix[1]

(Scale—low, medium, and high)

Source of risks	Relative Likelihood	Impact	Israel's Preparedness
1. Financial stress in the euro area remerges	**Medium**	**Medium**	**High** Israel has strong fundamentals with foreign reserves amounting to 180 percent of short-term external debts and a positive net international investment position. The US government guarantee program provides additional assurance. Israel has space to ease monetary policy. Fiscal policy stance can be eased by allowing the automatic stabilizer to operate fully.
2. Protracted period of slower growth in advanced economies and emerging economies	**High (Europe) Medium (elsewhere)**	**Medium/ High**	
3. Surges in global financial market volatility, leading to economic and fiscal stress	**Medium**	**Low**	
4. A slippage in meeting fiscal targets in 2014	**Low/Medium**	**Low/medium**	**Medium** If inflation pressures rise, monetary policy should be tightened. There remains substantial scope to strengthen budgetary institutions.
5. Failure of systemically important financial institutions	**Low**	**Medium-High**	**Medium** Bank capital and liquidity requirements have been strengthened. A formal macroprudential oversight mechanism has yet to be established. There remains ambiguity in crisis management framework. The legislation of a new bank resolution is underway.
6. Sharp reversal of a housing boom	**Low/ Medium**	**Low/ Medium**	**Medium** If house prices fall sharply, reverse macroprudential policies that the BOI implemented in recent years. If house prices continue to rise, tighten further macroprudential policies.
7. Severe escalation in regional geopolitical security concerns	**Medium**	**High**	**N/A**

[1] The Risk Assessment Matrix shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed 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 of 30 percent or more). The matrix reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non mutually exclusive risks may interact and materialize jointly.

Annex III. Israel: Macroprudential Policy Measures to Stabilize the Housing Markets

Macroprudential policy response while tightening monetary policy

- August 2009: to reduce potential default losses in response to interest rate increases, banks were required to tighten their risk management, scrutinize the mortgage loans to households, and enhance disclosure, particularly with respect to loans carrying floating interest rates that were extended to households.
- March 2010: to reflect better the true risk inherent in bank business models, a new treatment was required for loans taken out by a "purchasing group"—individuals who organize themselves for the joint purchase of land rights, in part, to get tax benefits. Loans extended to purchasing groups were required to be classified as "construction and real estate" credit, which embed a higher risk.
- July 2010: To increase banks' loss absorption capacity in the event of a housing crisis or an economic downturn, supplemental reserve requirements of 0.75 percent were instituted for all outstanding mortgages with a Loan-to-Value ratio (LTV) that exceeds 60 percent.
- October 2010: to further improve banks' loss absorption capacity and reduce the supply of risky mortgages, a capital surcharge was imposed on high-risk housing loans. The risk-weight factor for mortgages with a floating component of over 25 percent, an LTV of at least 60 percent, and a mortgage value higher than NIS 800,000 was raised from 35 to 100 percent.
- May 2011: to reduce the probability of mortgage default in the event of an interest rate increase, the variable component of mortgages was capped at 1/3 of the principal amount of the loan, for mortgages with an adjustable rate period of less than 5 years. In addition, banks were asked to notify customers whose mortgage loans carry a floating interest rate component that applies to one-third or more of their loan.

Macroprudential policy response while loosening monetary policy

- July 2012: a 100 percent capital surcharge was imposed on groups of borrowers, who buy new built residential properties collectively, and who also engage with third parties to execute the construction and development of residential projects.
- November 2012: LTVs for housing loans were capped at 70 percent —excluding first-time buyers, for whom a maximum LTV of 75 percent was imposed. In addition, the LTV for mortgage loans for investment purposes was capped at 50 percent.
- February 2013: To restrict the supply of mortgages, capital requirements and provisioning for mortgages was tightened. For loans with an LTV between 45 and 60 percent capital risk weights were raised from 35 percent to 50 percent. For loans with an LTV above 60 percent, the risk weight was raised to 75 percent. The allowance for credit losses from housing loans was raised — such that the ratio between the group allowance and the balance of housing loans is at least 0.35 percent.
- August 2013: To restrict the supply of risky mortgages the debt-to-income ratio (DSI) of new loans was capped at 50 percent; capital surcharges were imposed on mortgages with DSI between 40–50 percent; the maximum repayment period was set to 30 years; and the floating component of mortgages was capped at two-third of the loan. This applies to all mortgages with an adjustable rate component, and comes in addition to the limitation imposed in May 2011.

Annex IV. Israel: Debt Sustainability Analysis 2013[1]

Public debt sustainability has substantially improved, with the debt-to-GDP ratio decreasing from 98 percent in 2003 to 68 percent in 2012.[2] The debt structure would help to assure resilience to shocks, with debt maturity averaging 7 years and debt held by non residents amounting to 18 percent of the total. Nevertheless, high interest payments and elevated gross financing needs still place the country in a vulnerable position. Although most indicators are below early warning benchmarks, Israel's debt profile appears to be highly vulnerable to growth shocks.

1. Under staff' baseline scenario, public debt-to-GDP ratio is projected to decline to about 61 percent of GDP in 2018, a path consistent with the authorities' implicit goal of reducing public debt to 60 percent of GDP by 2020 (Figures A4.1-A4.3). The DSA covers debt of the general government. The baseline scenario is underpinned by the following assumptions:

- Real GDP is projected to grow at about 3.5 percent annual average. The output gap is expected to be broadly closed through the projection period;[3]
- CPI inflation is expected to remain constant at 2 percent;
- The budget deficit is expected to improve from 3.5 percent of GDP in 2013 to about 3 percent of GDP in 2014. Thereafter, it is projected to remain at about 2 percent.
- The primary expenditure is projected to remain constant as percentage of GDP.[4]
- The effective interest rate is forecast to slowly decline from 5.5 percent in 2013 to 4.5 percent in 2018, as the debt outlook improves and borrowing conditions—facilitated by comfortable sovereign ratings (A+ and A1) and the US debt guarantee program (about 15 percent of external debt until 2016)—remain favorable.
- However, as the level of interest payments would remain elevated throughout the projection period, gross financing needs would hover around 12 percent of GDP.

[1] For more information, please consult http://www.imf.org/external/pubs/ft/dsa/mac.htm

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

[3] Staff's scenario does not assume a boom-bust scenario presented in Figure A4.2.

[4] The expenditure path envisaged by the authorities to attain the deficit targets has not yet been specified; but it will be probably different from the current expenditure rule in place.

2. Risks to the baseline remain to the downside, as indicated in the Figure A4.1, given that the adjustment plan is ambitious given historical fiscal performance, and fiscal slippages will result in higher debt levels.

Shocks and Stress Tests

3. A range of stress tests indicate that debt sustainability is particularly susceptible to growth, interest rate, and combined macro-fiscal shocks (Figures A4.4 and A4.5).

- Growth shock. Lower real GDP growth rates (by 1 standard deviation for 2 years starting in 2014) would lead to a slower improvement in the primary balance, as revenues fall (while expenditure remains unchanged). Financing needs would increase to 15 percent of GDP by 2018. The debt-to-GDP ratio would rise to 70 percent in 2015 and then would decline only slowly to 66 percent by 2018.

- Interest rate shock. A geopolitical shock might raise market concerns about medium-term debt sustainability, pushing up borrowing costs by 200 basis points. Financing needs would jump to 15 percent of GDP by 2018, while public debt would stay broadly constant at 65 percent of GDP for the projection period as an average high maturity of new borrowing would maintain the rate of debt accumulation low.

- 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 financing needs to 17 percent of GDP and debt would reach 70 percent of GDP by 2018.

4. Finally, a tail risk scenario, combining house price shock with a geopolitical shock, is considered. The scenario assumes that: (i) interest rates increase by 200 basis points; (ii) real exchange rates depreciate by about 13 percent; and (iii) house prices drop by 20 percent. Because impact on growth is highly uncertain, the results of debt sustainability are presented for two growth scenarios (Figure A4.6).

- Moderate impact on growth: The growth decline is assumed to take place over three years (about 0.7 percent less than the baseline in 2014 and 2.3 percent less in 2015–16). Under this scenario, gross financing needs would expand to 20 percent of GDP, and public debt would reach 79 percent of GDP by 2018.

- Severe impact on growth: The growth decline is concentrated in 2015, with growth rates lower than the baseline by 1.5 percent in 2014, 5 percent in 2015, and 2.9 percent in 2016. Under this scenario, gross financing needs would rise to 25 percent of GDP and public debt to about 89 percent of GDP by 2020.

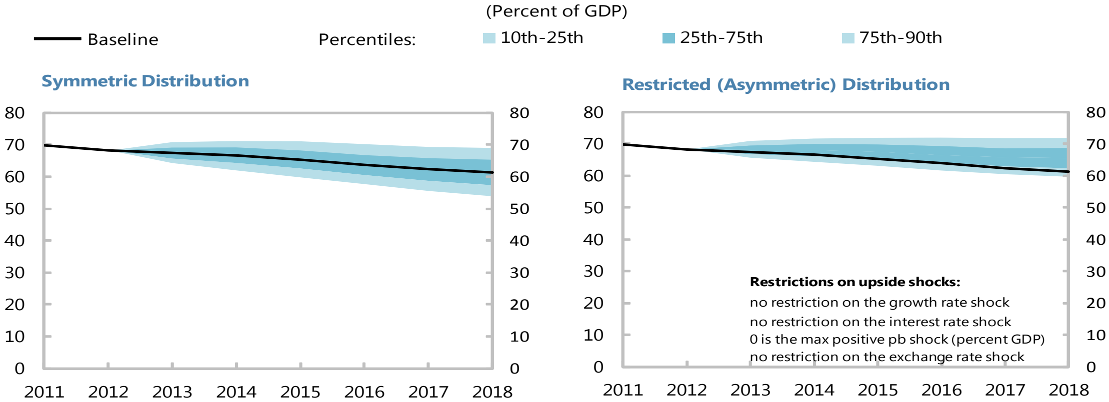
Figure A4.1. Israel: Public DSA Risk Assessment

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

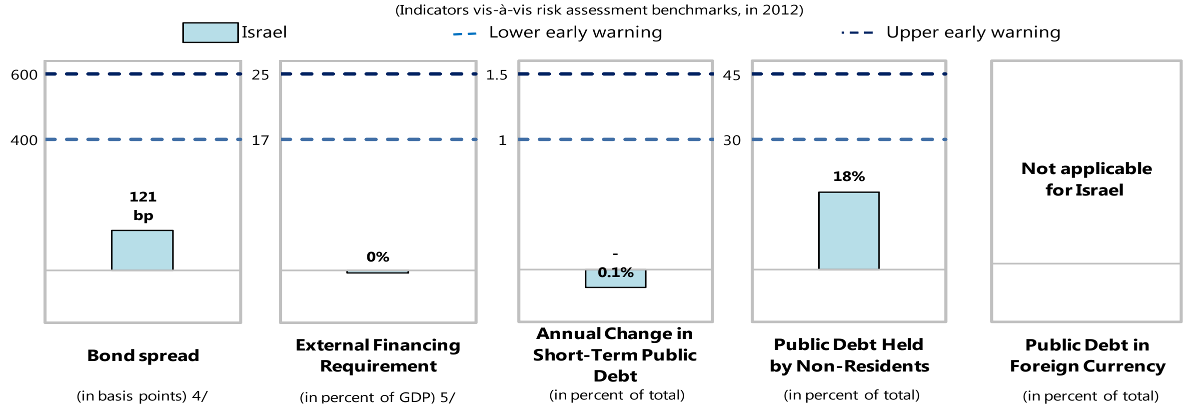
Evolution of Predictive Densities of Gross Nominal Public Debt

(Percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2012)



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.

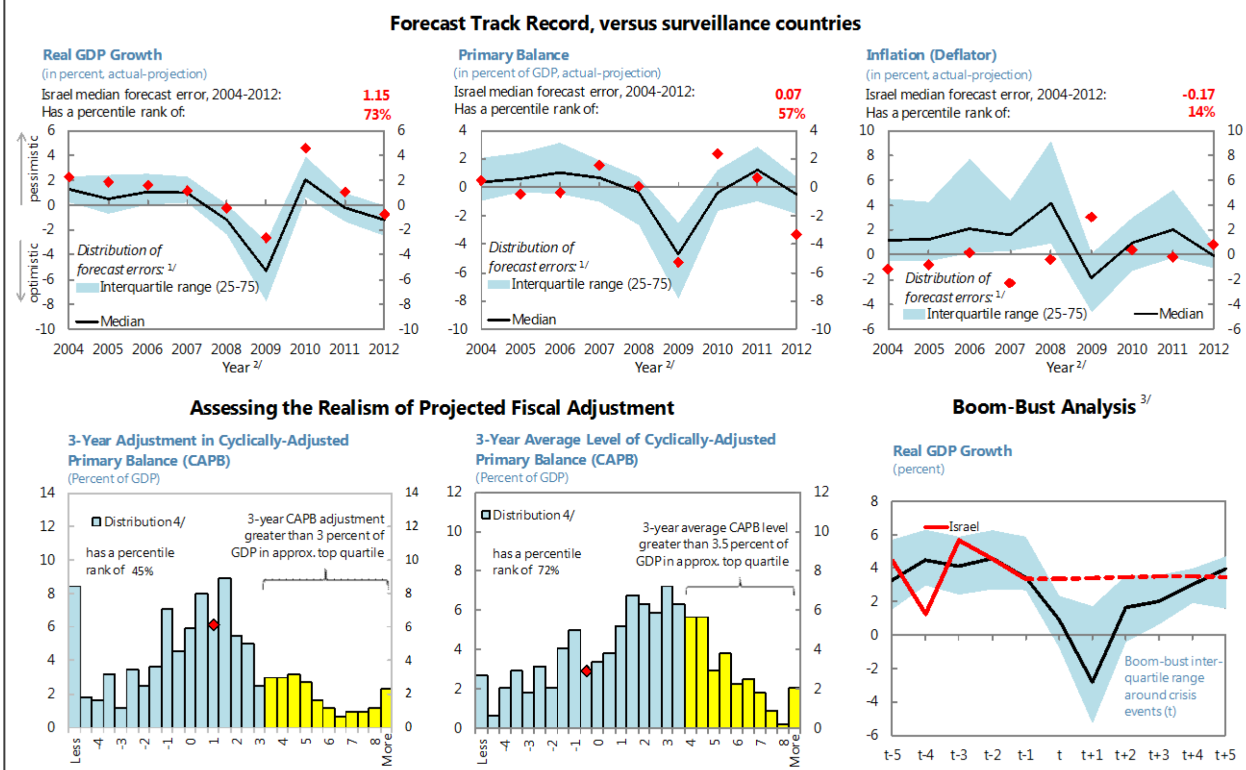
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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, 27-Jul-13 through 25-Oct-13.

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

Figure A4.2. Israel: Public DSA – Realism of Baseline Assumptions



Source: IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Israel has had a positive output gap for 3 consecutive years, 2010-2012. For Israel, t corresponds to 2013; for the distribution, t corresponds to the first year of the crisis.
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.

Figure A4.3. Israel: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(Percent of GDP unless otherwise indicated)

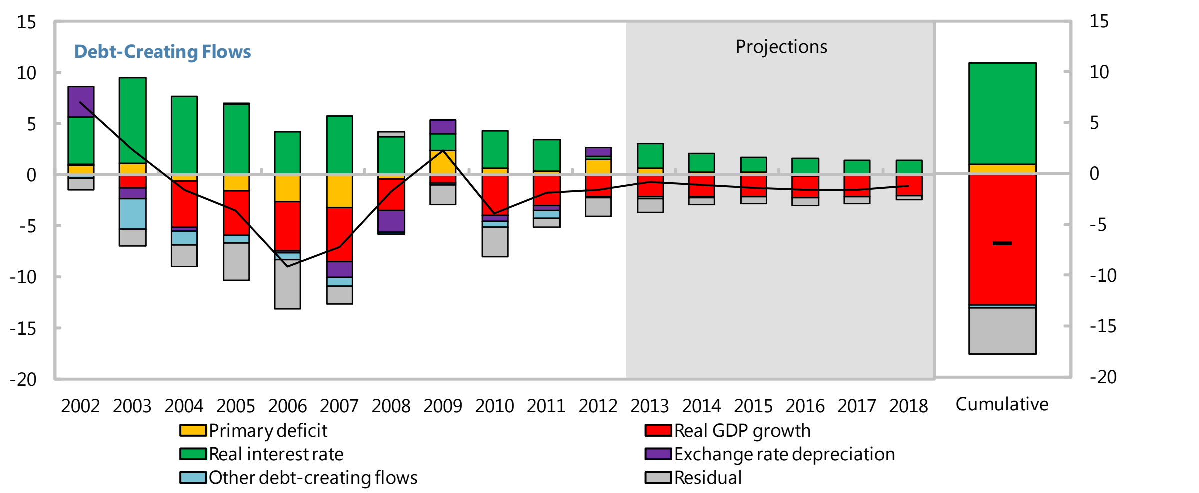
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2002-2010 [2]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	83.3	69.7	68.2	67.5	66.6	65.3	63.8	62.4	61.3
Public gross financing needs	6.0	12.8	13.2	12.3	12.4	11.6	12.1	13.7	14.2
Real GDP growth (in percent)	3.9	4.6	3.4	3.4	3.4	3.4	3.5	3.5	3.5
Inflation (GDP deflator, in percent)	1.6	2.0	4.0	1.8	2.6	2.4	1.9	2.1	2.1
Nominal GDP growth (in percent)	5.5	6.7	7.5	5.2	6.1	5.9	5.5	5.7	5.7
Effective interest rate (in percent) [4]	7.8	6.7	4.5	5.5	5.5	4.7	4.6	4.5	4.5

As of October 25, 2013		
Sovereign Spreads		
EMBIG (bp) 3/		114
5Y CDS (bp)		114
Ratings	Foreign	Local
Moody's	A1	A1
S&Ps	A+	A+
Fitch	A	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	-1.6	-1.7	-1.5	-0.7	-0.9	-1.3	-1.5	-1.4	-1.1	-6.9	
Identified debt-creating flows	0.5	-0.9	0.4	0.6	-0.3	-0.5	-0.7	-0.7	-0.7	-2.3	
Primary deficit	-0.4	0.3	1.5	0.6	0.2	0.2	-0.1	0.0	0.0	0.9	-0.7
Primary (noninterest) revenue and gra	40.6	37.1	35.8	35.9	37.5	37.6	37.9	37.7	37.6	224.2	
Primary (noninterest) expenditure	40.2	37.4	37.3	36.5	37.7	37.8	37.8	37.7	37.6	225.1	
Automatic debt dynamics [5]	1.8	-0.5	-1.0	0.2	-0.3	-0.8	-0.6	-0.7	-0.7	-2.9	
Interest rate/growth differential [6]	2.0	0.0	-1.9	0.2	-0.3	-0.8	-0.6	-0.7	-0.7	-2.9	
Of which: real interest rate	5.1	3.1	0.2	2.4	1.8	1.4	1.6	1.4	1.3	10.0	
Of which: real GDP growth	-3.1	-3.1	-2.2	-2.2	-2.2	-2.2	-2.2	-2.1	-2.1	-12.9	
Exchange rate depreciation [7]	-0.2	-0.5	0.9	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.9	-0.7	-0.1	-0.2	-0.2	0.0	0.0	0.0	0.0	-0.3	
Privatization Receipts (negative)	-0.9	-0.7	-0.1	-0.2	-0.2	0.0	0.0	0.0	0.0	-0.3	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euro	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]	-2.2	-0.9	-1.9	-1.3	-0.6	-0.7	-0.8	-0.7	-0.4	-4.6	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ 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 $r - \pi(1+g)$ and the real growth contribution as -g.

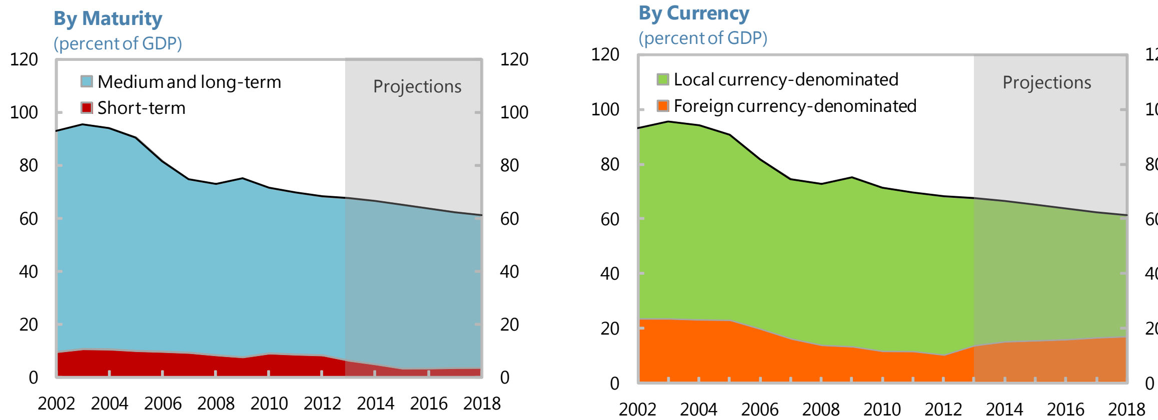
7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

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

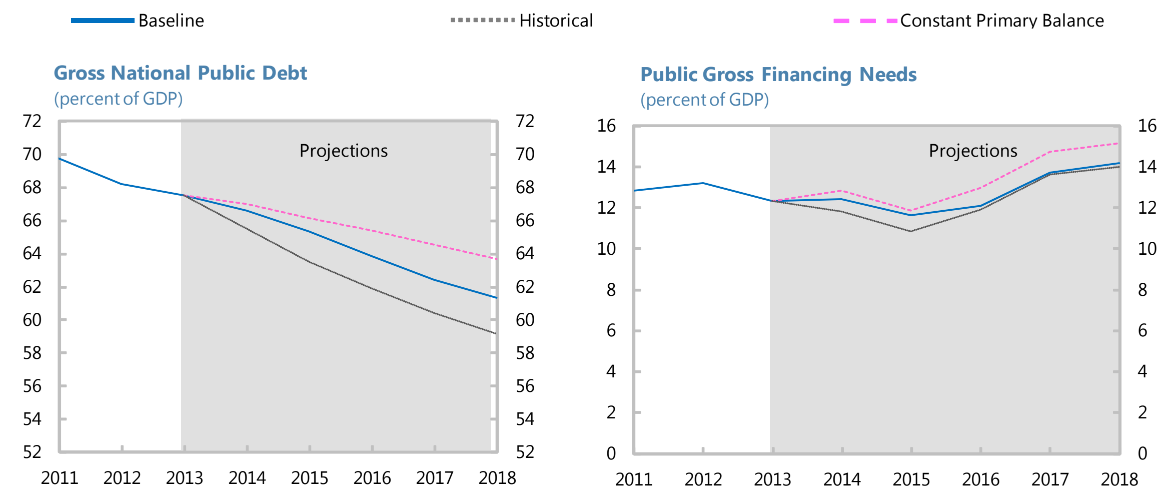
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A4.4. Israel: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



Underlying Assumptions
(in percent)

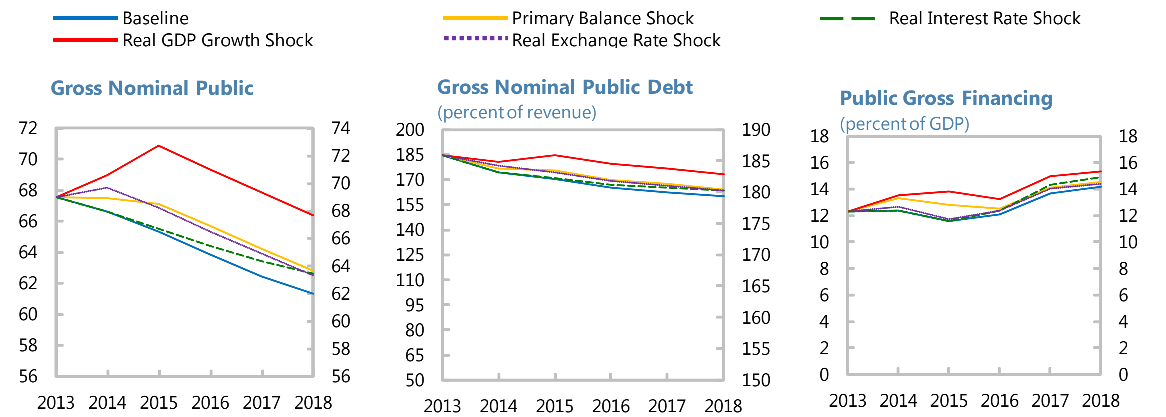
Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	3.4	3.4	3.4	3.5	3.5	3.5
Inflation	1.8	2.6	2.4	1.9	2.1	2.1
Primary Balance	-0.6	-0.2	-0.2	0.1	0.0	0.0
Effective interest rate	5.5	5.5	4.7	4.6	4.5	4.5
Constant Primary Balance Scenario						
Real GDP growth	3.4	3.4	3.4	3.5	3.5	3.5
Inflation	1.8	2.6	2.4	1.9	2.1	2.1
Primary Balance	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	5.5	5.5	4.7	4.6	4.4	4.4

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	3.4	4.3	4.3	4.3	4.3	4.3
Inflation	1.8	2.6	2.4	1.9	2.1	2.1
Primary Balance	-0.6	0.3	0.3	0.3	0.3	0.3
Effective interest rate	5.5	5.5	5.1	5.4	5.6	5.9

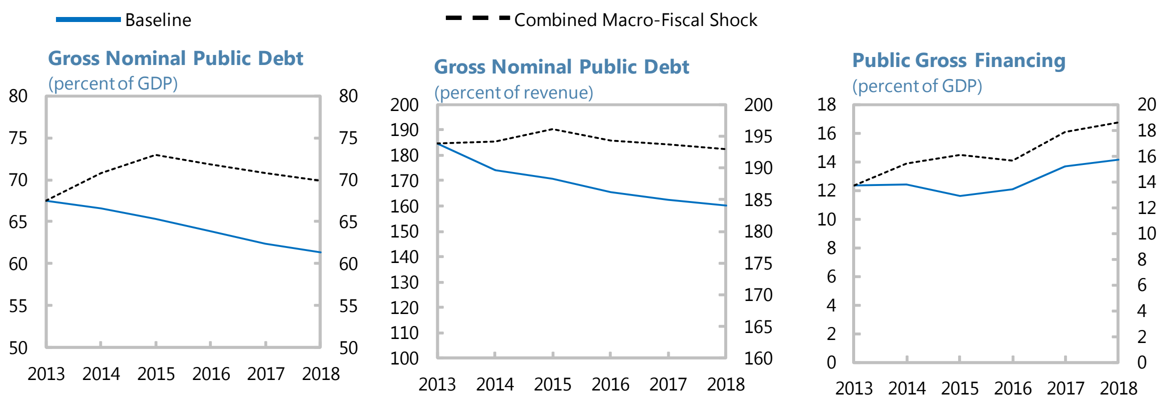
Source: IMF staff.

Figure A4.5. Israel: Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



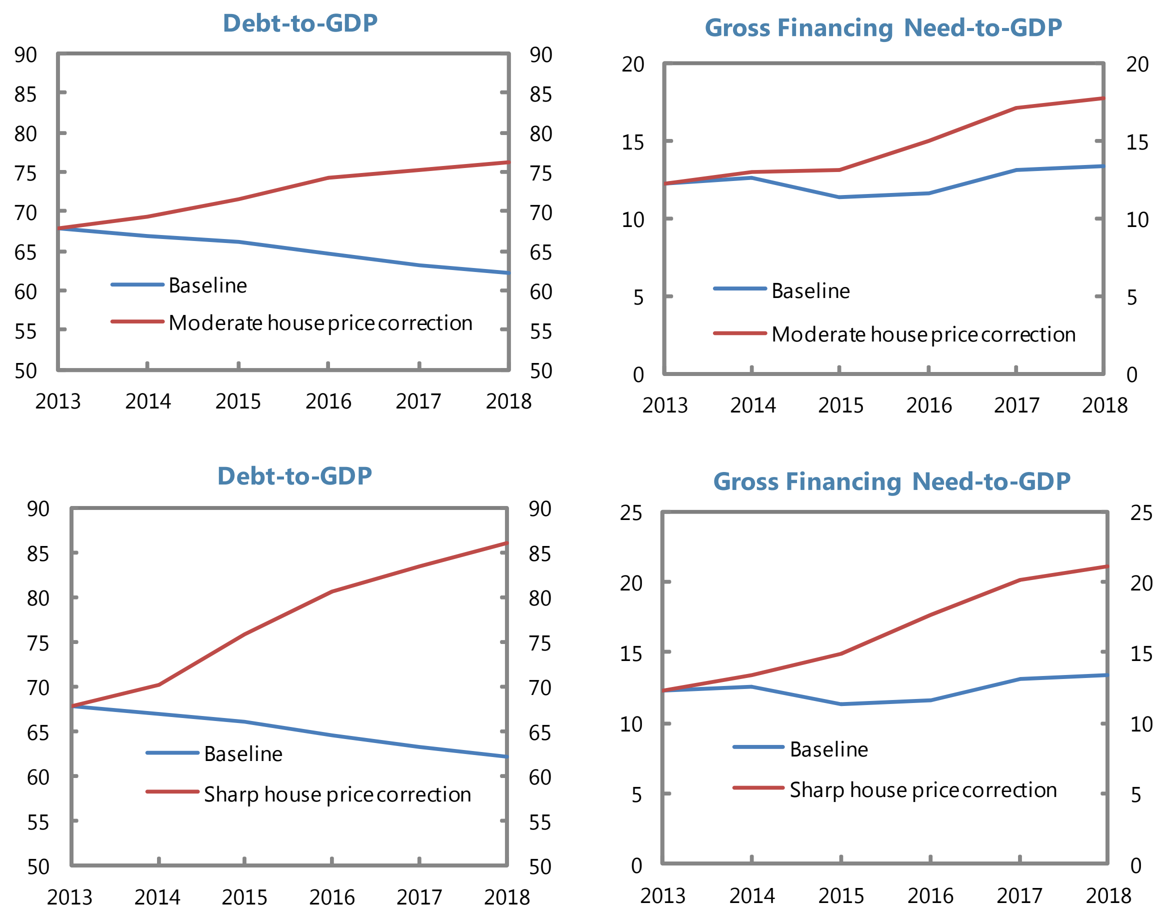
Underlying Assumptions
(in percent)

	2013	2014	2015	2016	2017	2018
Primary Balance Shock						
Real GDP growth	3.4	3.4	3.4	3.5	3.5	3.5
Inflation	1.8	2.6	2.4	1.9	2.1	2.1
Primary balance	-0.6	-1.1	-1.1	0.1	0.0	0.0
Effective interest rate	5.5	5.5	4.7	4.6	4.5	4.5
Real Interest Rate Shock						
Real GDP growth	3.4	3.4	3.4	3.5	3.5	3.5
Inflation	1.8	2.6	2.4	1.9	2.1	2.1
Primary balance	-0.6	-0.2	-0.2	0.1	0.0	0.0
Effective interest rate	5.5	5.5	5.0	5.1	5.2	5.5
Combined Shock						
Real GDP growth	3.4	1.6	1.6	3.5	3.5	3.5
Inflation	1.8	2.1	1.9	1.9	2.1	2.1
Primary balance	-0.6	-1.1	-2.0	0.1	0.0	0.0
Effective interest rate	5.5	5.6	5.0	5.1	5.3	5.5

	2013	2014	2015	2016	2017	2018
Real GDP Growth Shock						
Real GDP growth	3.4	1.6	1.6	3.5	3.5	3.5
Inflation	1.8	2.1	1.9	1.9	2.1	2.1
Primary balance	-0.6	-1.0	-2.0	0.1	0.0	0.0
Effective interest rate	5.5	5.5	4.7	4.6	4.5	4.5
Real Exchange Rate Shock						
Real GDP growth	3.4	3.4	3.4	3.5	3.5	3.5
Inflation	1.8	3.0	2.4	1.9	2.1	2.1
Primary balance	-0.6	-0.2	-0.2	0.1	0.0	0.0
Effective interest rate	5.5	5.6	4.7	4.6	4.5	4.5

Source: IMF staff.

Figure A4.6. Israel: Public DSA – Customized Scenario: House Price Correction



Source: IMF staff.

Annex V. 2012 FSAP Update: Status of Main Recommendations

Recommendation	Authority	Status
Overall Financial Sector Oversight		
Strengthen the institutional framework for macroprudential oversight and policy setting by more formally establishing a Financial Stability Committee (FSC) and initiating its operations	All	The BoI, the CMISD, and the ISA signed a Memorandum of Understanding (MoU) that sets the principles for coordination, aimed at promoting effective, fair, and uniform supervision of financial markets and providing better supervision. In addition, a team comprising of government ministries and the BoI is working to produce a formal framework that would detail the procedures for continuous coordination and information sharing of financial regulators. This framework will constitute an important step towards the goal of establishing a formal FSC. Extensive work has also been in progress in drafting a new law to establish an FSC. However, views differ among authorities on how exactly an FSC be set up.
Further improve stress testing techniques, including the capacity to analyze systemic risks, credit risk, and liquidity risk	BoI, CMISD	There is ongoing work on improving stress testing techniques. These efforts include corporation between the BoI and the CMISD. **BoI** The BoI employs a variety of models to estimate credit losses for four different sectors: real estate and construction, other corporate, housing and retail. It has developed econometric models based on aggregate data as well as other methodologies based on loan level data. In other areas, work is still in progress, especially in the area of construction risks and liquidity stress tests. For the second straight year, the BoI is conducting stress tests based on a uniform scenario in conjunction with banks. And it has recently completed a stress test on banks' mortgage portfolios based on loan-level data. The BoI has already constructed several indices to assess systemic risk and its sources, and is currently working on enhancing the toolbox. These are planned to be integrated in stress testing and in macro models to better assess the contribution of systemic risk to the broader economy.

Recommendation	Authority	Status
		<u>CMISD</u> The CMISD is running on a monthly basis stress testing of the insurance companies' capital against investments risk which include credit and market risks. In additions the CMISD is using an early warning system (Compass system). The CMISD is constantly tracking market indicators: such as spreads of deferred capital notes issued by the insurers, credit ratings and other market indicators.
Eliminate gaps and overlaps in supervisory responsibilities, ensuring that like activities are subject to equally stringent regulation and supervisions	BoI, ISA CMISD	Regular coordination among the regulators continues. A joint team of the BoI and the ISA has been set up to eliminate regulatory gaps and overlaps in the broker-dealer sector. Since it began its operation, the joint team has been concentrating in forming the foundational requirements that would apply on broker-dealers under the future regulation. The oversight of underwriters is one of the ISA's duties, while the Supervisor of Banks is entitled to set regulations for banks and their subsidiaries (e.g. if it comes to the conclusion that misbehavior by an underwriter that is a subsidiary of a bank can harm the goodwill of the bank itself).
Undertake more systematically cost-benefit analysis of regulatory changes, and streamline regulations where possible	BoI, ISA CMISD	**<u>BoI</u>** Systemic cost-benefit analysis of significant regulatory changes is being performed on a case by case basis. **<u>CMISD</u>** The CMISD has taken several measures to increase transparency. 1. Draft regulation documents are published in two rounds, first to obtain public feedback and afterwards the industry feedback. 2. Prior to amending major regulations, the commissioner publishes a "green paper" which includes a number of approaches where the public are invited to address the issues (e.g. concentration accountants, LTC – Long Term Care insurance). 3. Issues which have a broad effect on the capital markets are reviewed by public committees which include representatives of regulated institutions, public and regulatory authorities. Reports are published for public review.

Recommendation	Authority	Status
		4. The Commissioner publishes positions papers reflecting policies and expectations regarding implementation of special regulations. In addition the commissioner publishes documents which reflect findings of reviews and include appropriate and faulty implementation of the policies. In addition, the CMISD has been working on consolidating all regulations as part of recent reforms into a comprehensive codex of regulation. As part of this process, all regulations are re-examined to ensure internal consistency and congruency with the CMISD's long-term objectives for the regulated activity. All these initiatives reflect to goal of the CMISD to rely on principle-base supervision. **ISA** In September 2012 the ISA published for public comments a detailed list of possible reliefs to supervised entities. Following an intensive process, some of the reliefs were already implemented, and many others were forwarded for a parliamentary approval, likely to be received in 2014.
Strengthen the AML/CFT legal and regulatory framework, in particular with regard to the designated non-financial businesses and professions, and the transparency of beneficial ownership.	Government	*Designated Non-Financial Business and Professions (DNFBP)* On May 7, 2012, the Knesset approved an amendment to the Prohibition on Money Laundering Law. The amendment applies the AML/CFT regime on dealers in precious stones sector. The sector will be supervised by the Ministry of Industry, Trade and Labor and will be subject to Administrative sanctions. An AML/CFT order has yet to be enacted for the amendment to come into force and specify the obligations. In addition, on May 11, 2012, a draft bill concerning the application of AML/CFT obligations on DNFBPs' was approved in first reading by the Knesset Plenary but has not been enacted yet. A draft order applying AML/CFT obligations on DNFBP's has been disseminated to representatives of the relevant sectors (Lawyers, trusts service providers, accountants, tax consultants and real estate agents) and meetings were held with them in order to improve cooperation and to reach agreed understandings in advance. *Transparency of beneficial ownership* Information on beneficial ownership is retained by AML/CFT regulated businesses as part of their compliance obligations. The AML/CFT Orders determine the obligation to receive from the customer a declaration stating

Recommendation	Authority	Status
		whether he is acting on his behalf or on behalf of another (a beneficial owner declaration), and to state the name and identity number of the beneficiary. The Orders (including the Banking Order that was approved by the Knesset Committee in October 2013 and shall enter into force in a few months) also oblige taking reasonable measures to verify the identity of the beneficial owner, using relevant information or data obtained from reliable sources. With regard to transparency for private companies, the Corporations Authority has submitted to the legislation department and the Ministry of Justice a draft amendment to the Companies Regulations, aims at enhancing transparency with respect to the reporting requirements of private companies including, inter alia, provisions regarding beneficial ownership, subject to the current legal measures. Finally, the Corporations Authority has undertaken in the past two years measures to ensure compliance with the annual reporting requirements for private companies that include relevant details about directors and shareholders. Some of these companies are also required to submit their balance sheet annually. These measures included the implementation of sanctions against "violating companies" as well as public campaigns to increase compliance and public awareness of these reporting requirements. The information reported is available to the public and most of it is publicly accessible on the website of the Corporation Authority.
Banking Oversight		
Further strengthen regulation and supervision of interest rate risk and market risk	BoI	Furthermore, a new directive regarding interest-rate risk management was issued in May 2013.
Develop regulation of liquidity risk as international practice in this area evolves, and intensify monitoring	BoI	An updated directive regarding liquidity risk management was issued in January 2013. The update is an interim step towards implementing Basel III liquidity requirements. The BoI is in progress of adopting the Basel III Liquidity Coverage Ratio requirement, and a joint working group with banks has been established. Liquidity risk monitoring is also being strengthened, subject to resource limitations.

Recommendation	Authority	Status
Introduce greater flexibility in personnel management and budgets to attract and retain financial sector experts with the required skill mix	BoI	The Banking Supervision Department has neither the flexibility to hire professional workers who are in mid-career nor the managerial prerogative regarding staff incentives and retention. Accordingly, the department continues to hire workers who are beginning their career. To make up for the lack of experienced specialists, it hires external advisors.
Insurance Sector Oversight		
Intensify cross-border supervisory coordination and information-sharing	CMISD	The CMISD joined the Multilateral MoU with the International Association of Insurance Supervisors. This is expected to serve to enhance and strengthen the Israeli insurance market, as well as ties with international insurance markets.
Widen powers to supervise groups connected to insurance companies, and in particular related holding companies	CMISD	The CMISD supervises groups with insurers, provident and pension funds. Banks and insurance companies cannot exist in the same group. The enforcement and supervision powers of the CMISD commissioner have been significantly expanded. In August 2011, the Insurance Supervision Law was amended to enhance the CMISD's powers. The CMISD is now authorized to demand or confiscate documents and computer data related to supervised activities. Besides, the law now allows for administrative penalties, including financial sanctions on officers. Restrictions on inter-group transactions were introduced in 2012, limiting transactions with related parties such as those companies that hold more than 20 percent of the institutional entity's shares, or the case that the insurer holds more than 10 percent of the shares of a related financial institution. Inter-group transactions are allowed only if approved by the group entities (for example the board of the institutional entity) and the CMISD. On consolidated supervision, minimal capital requirements need to be consolidated on a group basis for insurer, provident, or pension funds in the same group.
Securities Markets Oversight and Securities Markets Development		
Enforce uniformly high standards of due diligence in the underwriting of securities issues	ISA	The ISA is putting currently more emphasis on two wide scale projects. The first project aims at simplifying and shortening the reports, mainly the annual report. The second project is to review and evaluate the advantages and disadvantages of introducing new financial instruments to be offered to the public and traded on the TASE.

Recommendation	Authority	Status
		As for fit and proper criteria for underwriters, this issue has not been carried forward because of administrative reasons. But relevant draft legislation is planned to be resent to the Knesset in 2014.
Establish an appropriate licensing and supervisory framework for currently unregulated broker-dealers	ISA	The ISA has established an internal working group to examine and propose a legislative framework to regulate the broker-dealer activity in Israel. The group has been conducting a comparative review of broker-dealer regulation in foreign systems in order to identify the regulatory gaps and to draft a comprehensive legislative scheme. The ISA and BoI have set up a joint team to ensure that the future regulation proposal by the ISA would be consistent and comprehensive in a manner that would reduce gaps and overlaps in regulatory requirements. Since it began its operation the joint team has been concentrating in forming the foundational requirements that would apply on broker-dealers under the future regulation.
Ensure consistency of relevant supervisory practice by TASE, the ISA, and the BOI	TASE, ISA, BoI	A new joint working group has been set up (see above).
Remove impediments (including tax treatment) to repo market development	MoF	Currently, the Israeli Tax Authority *de facto* recognizes repo transactions as lending (for tax purposes). The Tax Authority and other regulatory bodies are still working to resolve the issue.
Payments and Securities Systems Oversight		
Develop and test more comprehensive business continuity plans	BoI	The BoI continues to implement the business continuity plan for the payment systems it operates. This includes conducting periodic emergency preparedness tests
Protect finality of settlements in payments systems linked to Zahav	BoI and TASE	The Payment Systems Law, 5768–2008, establishes the finality of payments transmitted via the Zahav system, including the finality of the net payments sent to the system from the various other payment systems—the Tel Aviv Stock Exchange clearing houses, Masav (ACH), and the Paper-based (Checks) Clearing House. In accordance with the FSAP recommendation, the Tel Aviv Stock Exchange clearing houses advanced an amendment to the Securities Law, to arrange the finality of occasional payments transmitted through the TASE Clearing House connected to the Zahav system. Likewise, in 2013, the BoI declared the Masav system to be a

Recommendation	Authority	Status
		"controlled system", and thus subject to its payment systems oversight.
Complete development of payment system oversight	BoI	The BoI's payment systems oversight has begun to formally oversee the Zahav (RTGS) system, the Masav (ACH) system, and the Shva (ATM SWITCH) system. Oversight of the TASE clearing houses (SSS) is carried out by the ISA, and the BoI has signed a MoU with the ISA for transferring data on clearing house operations.
Crisis Management		
Establish a policy framework for ELA	BOI	Extensive work has been in progress in drafting a new law on bank resolution. However, a policy framework for ELA has yet to be established.
Establish by law and make operational: a full set of early intervention tools; and a special framework for going-and-gone concern resolution	BOI, MOF	Extensive work has been in progress in drafting a new law on bank resolution. The BoI has drafted a work plan for dealing with the subject of bank resolution, including early identification and measures to be taken in different stages of the difficulties.
Establish mechanism for providing solvency support and for funding bank resolution, protecting the BOI from quasi-fiscal activities	BOI, MOF	Extensive work has been in progress in drafting a new bank resolution law. A resolution fund scheme and a deposit insurance scheme are still being discussed. As soon as the new bank resolution law is adopted, the BoI will update its internal procedures and establish a MOU with the relevant regulators.
Agree on a protocol for the coordination of, and assignment of responsibilities for system-wide crisis management	All	Still under discussions. Views differ among authorities on how exactly a crisis management committee be set up.

INTERNATIONAL MONETARY FUND

ISRAEL

January 24, 2014

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | The European Department (In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of January 24, 2013)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	1,061.10	100.00
Fund holdings of currency	700.57	66.02
Reserve position in Fund	360.53	33.89
Lending to the Fund		
New arrangements to Borrow	65.01	…

SDR Department:

	SDR Millions	Percent Allocation
Net cumulative allocations	883.39	100.00
Holdings	999.47	113.14

Outstanding Purchases and Loans: None

Financial Arrangements: None

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

		Forthcoming			
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.00	0. 00	0. 00	0.00	0. 00
Total	0.00	0. 00	0. 00	0.00	0. 00

Implementation of HIPC Initiative: Not applicable

Safeguards Assessments: Not applicable

[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.

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

Israel accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 21, 1993. Israel maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, with the exception of measures introduced for security reasons pursuant to Decision No. 144-(52/51). Israel subscribes to the SDDS and is in full observance of the SDDS's prescriptions for data coverage, periodicity and timeliness, and for the dissemination of advance release calendars

Last Article IV Consultation:
The last Article IV consultation was concluded on March 27, 2012. Israel is on the standard 12-month consultation cycle.

ROSCs:

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

Technical Assistance:
The Fund has been providing policy advice and technical assistance to the Palestinian Authority (PA) since the 1993 Oslo Accords, and presently has a senior resident representative based in Jerusalem. The Fund's work in the West Bank and Gaza (WBG) has intensified since 2007, with a focus on the macroeconomic, fiscal, and financial areas. Staff missions to the WBG have been assisting the PA in the design and implementation of its macroeconomic and fiscal framework in line with the objectives set out in the Palestinian Reform and Development Plan (PRDP) presented at the Paris international donors' conference in December 2007. The most recent progress report on that framework was presented at the Ad-Hoc Liaison Committee (AHLC) meeting of donors held in New York on September 22, 2009. Technical assistance has also been stepped up since 2007, in particular in the areas of public expenditure management, banking supervision and regulation, and macroeconomic statistics.

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

STATISTICAL ISSUES

(As of January 24, 2014)

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

Table of Common Indicators Required for Surveillance

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	Same day	Same day	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec-13	14-Jan-14	M	M	M		
Reserve/Base Money	Dec-13	14-Jan-14	M	M	M	LNO, LO, NO, LO	O, O, O, NA, NA
Broad Money	Nov-13	14-Jan-14	M	M	M		
Central Bank Balance Sheet	Nov-13	18-Dec-13	M	M	M		
Consolidated Balance Sheet of the Banking System	Q3-2013	…	Q	Q	Q		
Interest Rates[2]	Same day	Same day	D	D	D		
Consumer Price Index	Dec-13	15-Jan-14	M	M	M	O, O, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2012	30-Sep-13	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Dec-13	14-Jan-14	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2-2013	23-Oct-13	Q	Q	Q		
External Current Account Balance	Q3-2013	18-Dec-13	Q	Q	Q	NA	NA
Exports and Imports of Goods and Services	Dec-13	20-Jan-14	M	M	M		
GDP/GNP	Q3-2013	16-Jan-14	Q	Q	Q	O, O, O, LO	LO, O, LO, O, LO
Gross External Debt	Q3-2013	18-Dec-13	Q	Q	Q		
International Investment Position[6]	Q3-2013	18-Dec-13	Q	Q	Q		

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

Statement by the IMF Staff Representative on Israel
February 10, 2014

This statement provides information that has become available since the issuance of the staff report. The new information does not alter the thrust of the staff appraisal.

1. **The budget performance for 2013 is projected to be better than previously anticipated.** December data on budget execution point to an overall fiscal deficit of 3¼ percent of GDP for 2013, an improvement from the 4¼ percent expected in the Budget Law and the 3½ percent projected in the Staff Report. The better-than-expected performance relative to budget stems from lower expenditures (around 0.5 percent of GDP), owing to tighter spending control, and higher revenues (around 0.7 percent of GDP), owing largely to greater-than-anticipated revenue collections from one-off measures (such as taxes collected on "trapped" profits of multinationals and from the sale of start-up companies in the high-tech sector). Revenue collection was also boosted by a rebound in the stock market and higher real estate taxes.

2. **The Government has submitted to the Knesset a revised expenditure rule**. The new formula is based on a target debt ratio of 50 percent of GDP (10 percentage points less than what is used in the prevailing rule) and caps real expenditure growth at population growth (currently 1.7 percent) plus one percent. The new formula implies lower real expenditure growth, consistent with deficit targets set through 2020.

3. **On January 22, 2014, the Government raised €1.5 billion in new debt issuance.** The initial offering was aimed at raising €1 billion, but investor bids totaled €5.7 billion, inducing the Government to increase the amount sold. The bonds were issued for a period of 10 years with a yield of 2.932 percent.

Press Release No. 14/52
FOR IMMEDIATE RELEASE
February 12, 2014

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

IMF Executive Board Concludes 2013 Article IV Consultation with Israel

On February 10, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Israel.

Israel's economic fundamentals remain strong. GDP growth is solid, unemployment is low, and inflation remains firmly anchored within the 1–3 percent target range. The financial sector is in good health and the external position is strong.

However, excluding the impact of a new large-scale natural gas production, growth momentum is expected to remain moderate, as planned fiscal tightening and a further strengthening of the currency will weigh on the economy and offset, in part, the pick-up in demand in Israel's major trading partners. The economy also faces other important challenges: public debt remains high despite a noticeable decrease over the past several years; rapid house price inflation, if it persists, poses risks to financial stability; and the large employment and productivity gaps between the general Jewish population, the Ultra-Orthodox Jewish (Haredi) and Israeli-Arab communities, if sustained, could undermine the economy's long-run growth potential.

Given the still uncertain global environment, as well as the headwinds to growth from fiscal tightening and exchange rate appreciation, monetary policy should stay the course. But the Bank of Israel should respond nimbly to changes in the economic environment. A further tightening of macroprudential measures may be needed to alleviate risks of a boom-bust cycle in the housing market. On the fiscal side, the likelihood of slippages in meeting the deficit target should be minimized by firm adherence to the expenditure ceiling and full implementation of announced revenue measures. In addition, to put public debt firmly on a downward trend, further adjustment is required in 2015 and beyond, along with a strengthening of fiscal institutions. This policy mix,

[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.

combined with structural reforms to boost productivity, should help alleviate appreciation pressures on the shekel and boost competitiveness.

In line with the recommendations of the 2012 Financial Sector Assessment Program (FSAP) Update, a Financial Stability Committee should be established, led by the Bank of Israel and focusing on macroprudential policies in normal times. Legal reforms aimed at strengthening the bank resolution framework should be legislated as soon as practicable.

On the structural front, concerted action is required to boost competition in the non-tradable sector, while it is imperative to promote the participation of Haredi and Israeli-Arab populations in the labor force to reduce poverty and inequality and bolster the economy's long-run productive capacity.

Executive Board Assessment[2]

Executive Directors welcomed the Israeli economy's resilience through the global crisis, which has been underpinned by sound macroeconomic and financial fundamentals. They also welcomed the progress made in reducing public debt and the government's commitment to fiscal discipline.

Directors noted that growth would continue to be moderate, but the outlook is vulnerable to external and longer-term domestic risks. Weak external demand and appreciation pressures on the shekel are a drag on growth, house prices continue to rise rapidly, public debt is high, and growth is not inclusive. Against this backdrop, Directors underscored that policies should aim at ensuring sustainable growth, preventing the build-up of imbalances, and deepening structural reforms to bolster the economy's productive capacity and to reduce poverty and inequality.

With inflation well anchored within the target range, a still uncertain external environment, and headwinds to growth from the planned fiscal tightening and a stronger currency, Directors agreed that monetary policy should maintain the current stance. Should growth prospects improve more than anticipated, the monetary stance would need to be gradually normalized. Directors considered that the risks ensuing from rapid house price increases should be addressed through a further tightening of macroprudential measures.

Directors commended the authorities for the bold fiscal consolidation measures embedded in the 2013–14 budget. They noted that strict adherence to the expenditure ceiling and full implementation of the announced revenue measures will be necessary to meet the fiscal targets.

[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 concurred that achieving the deficit targets and ensuring debt sustainability would require further fiscal adjustment in the medium term through efforts on both the expenditure and revenue fronts.

Directors considered that embedding the current fiscal rules within a fully-fledged medium-term fiscal and expenditure framework would strengthen the budgetary and fiscal institutions. Most Directors agreed that establishing an independent fiscal council would enhance the credibility and transparency of fiscal policy while a few other Directors were of the view that the current framework has served the economy well.

Directors noted that the mix of accommodative monetary and tight fiscal policies, alongside reforms aimed at boosting productivity, would alleviate appreciation pressures on the currency and improve competitiveness. In this context, Directors saw merit in the Bank of Israel continuing their program of pre-announced foreign exchange intervention, aimed at alleviating risks of appreciation pressures emanating from promising prospects of large-scale natural gas production. Directors recognized that discretionary intervention may be needed to stem excessive exchange rate volatility.

Directors welcomed the authorities' ongoing initiatives to buttress the financial system. They underscored that progress could be expedited on the key issues identified by FSAP Update. In particular, they encouraged the authorities to establish a Financial Stability Committee with a clear mandate and operational independence, and to legislate the draft bank resolution law as soon as practicable.

Directors noted that low labor participation of the Arab-Israeli and Haredi populations exacerbates inequality and poverty concerns and would undermine the economy's long-run growth potential. They welcomed recent reforms and encouraged the authorities to promote further the integration of these groups in the labor market.

Israel: Selected Economic and Social Indicators, 2009–14
(Percent change, unless otherwise indicated)

	2009	2010	2011	2012	2013 Staff est.		2014 Staff proj.
Real economy							
Real GDP	1.2	5.7	4.6	3.4	3.4		3.4
Domestic demand	0.4	5.7	5.6	3.8	3.9		3.4
Private consumption	2.2	5.0	3.8	3.2	4.2		3.2
Public consumption	3.1	3.3	2.5	3.2	3.6		3.0
Gross capital formation	-8.0	11.2	15.3	6.3	3.2		4.3
Foreign demand (contribution to real GDP growth)	0.6	0.0	-0.9	-0.5	-0.5		0.0
Output gap (percent of potential)	-1.3	0.3	1.0	0.6	0.2		0.1
Output gap excl. gas impact (percent of potential)	…	…	…	…	0.2		-0.1
Unemployment rate (percent)	8.8	7.9	6.9	6.9	6.4		6.7
Overall CPI (end period)	3.9	2.7	2.2	1.6	1.8		2.0
Saving and investment balance							
Gross national saving (percent of GDP)	19.2	17.0	21.4	21.0	21.2		21.3
Foreign saving (percent of GDP)	-3.8	-3.1	-1.3	-0.3	-0.6		-0.7
Gross domestic investment (percent of GDP)	15.4	13.9	20.2	20.7	20.6		20.7
Money and interest rates							
M3 (period average)	14.1	2.3	7.1	8.9	…		…
Bank of Israel policy rate (percent, end year)	1.00	2.00	2.75	2.00	1.00		…
10-year government bond yield (percent, average)	5.07	4.70	4.98	4.33	3.85		…
Public finance (percent of GDP)							
Central government							
Revenues and grants	26.5	25.7	26.0	24.9	25.6		25.7
Total expenditure	31.5	29.2	29.0	28.9	29.1		28.5
Overall balance	-5.0	-3.6	-3.0	-4.1	-3.5		-2.8
General government							
Overall balance	-6.3	-4.6	-4.2	-3.9	-3.5	3/	-3.0
Debt	75.3	71.5	69.7	68.2	67.5		66.6
Of which: foreign currency external debt	13.6	12.0	11.9	10.6	7.8		7.0
Balance of payments (percent of GDP)							
Exports of goods and services 1/	33.6	35.0	35.5	36.2	33.7		33.0
Real growth rate (percent)	-11.7	14.2	7.3	0.9	-2.3		2.2
Imports of goods and services 1/	30.8	33.2	36.0	36.0	33.8		32.4
Real growth rate (percent)	-13.7	15.1	10.5	2.3	-1.0		2.1
Trade balance	2.8	1.7	-0.5	0.2	0.0		0.4
Oil Imports (billions of U.S. dollars)	8.1	10.4	13.6	16.1	16.5		17.0
Current account	3.8	3.1	1.3	0.3	0.6		0.7
Foreign reserves (end period, billions of U.S. dollars)	61	71	75	76	82		85
Exchange rate							
Exchange rate regime	Free floating						
NIS per U.S. dollar	3.9	3.7	3.6	3.9	3.6		…
Nominal effective exchange rate (2005=100)	109.8	115.1	116.4	111.8	…		…
Real effective exchange rate (2005=100)	109.9	115.4	116.8	111.0	…		…

Social Indicators (reference year)

GDP per capita (2012): $32,265; Population density (2011): 359 people per sq. km; Poverty rate (2008)[2/]: 19.9 percent; Fertility rate (2009): 3.0 per woman; Life expectancy at birth (2009): 79.7 (male) and 83.5 (female); Infant mortality rate (2009): 3.4 per 1,000 births; Physicians (2007): 3.6 per 1,000 people; CO2 emissions (tons per capita, 2007): 9.3.

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

1/ National Accounts data.
2/ Poverty rate from National Insurance Institute of Israel.
3/ The preliminary outturn for the fiscal deficit in 2013 is estimated at 3¼ percent of GDP.

Statement by Menno Snel, Executive Director of Israel and Amit Friedman Advisor to the Executive Director
February 10, 2014

1. **The Economy and Economic Policy**

The performance of the economy is solid. The Israeli economy is operating at a near-potential level, and growing at a moderate but stable pace of above 3 percent, which is high by advanced-economy standards, but is probably below its potential. The unemployment rate fell in the last quarter of 2013 to 5.7 percent, and the participation rate is high; the external position is robust, as illustrated by the current account surplus and the net investment position being in positive territory; the public deficit is down to 3.2 percent of GDP[1] and public debt fell to 66.7 percent of GDP. Inflation, at 1.8 percent, is fairly close to the midpoint of the inflation target band, the financial system is robust, and the financial markets are calm.

The policy mix is growth-friendly. The current policy mix, which includes expansionary monetary policy and moderately tight fiscal policy, is designed to support economic activity while facilitating the continuation of fiscal consolidation, as reducing the public deficit and the public debt-to-GDP ratios is a major goal of the government's economic agenda. A set of housing-related macro-prudential policies geared to restrain excess demand and contain risks to financial stability, have been implemented by the BoI.

Not all is bright, however, and a mix of short-run and fundamental challenges looms. Growth is mostly driven by local demand, as weak global demand and exchange rate appreciation are a drag on export growth. Moreover, appreciation pressures persist. Growth is not inclusive, and does not trickle down to the middle class in full. The high cost of living, and especially elevated and still rising housing prices are a source of social tension. In the medium run and beyond, formidable challenges related to the inclusion of groups that are weakly attached to the labor market lie ahead. These issues keep policymakers and society alike occupied, and are at the heart of ongoing public debates.

2. **Fiscal Policy**

Fiscal policy is designed to reduce the levels of deficit and debt, which are still above the desirable levels, while keeping tax rates at competitive levels. The high deficit in 2012 led to a slowdown in the process of debt reduction. Following the formation of the

[1] This figure was published after the staff report was finalized.

new government in 2013, a biennial budget for 2013-2014 was adopted that includes a series of corrective actions to secure the consolidation process. The budgetary results so far are better than expected, and the deficit came down from 3.9 percent in 2012 to 3.2 percent of GDP in 2013[2]. Furthermore, the deficit in 2014 is expected to be 3.0 percent of GDP, which is expected to yield an additional modest reduction in the ratio of debt to GDP. It is important to put the 2012 fiscal slippage, on which staff elaborates, in context. First, even in 2012, the debt to GDP ratio was reduced by 1.4 percent of GDP. Thus, the slippage was not so significant so as to jeopardize debt reduction. Secondly, the slippage was promptly dealt with, including by an initial, unpopular, VAT hike in late 2012 just before the elections.

The 2015 budget looks tight and the Ministry of Finance acknowledges the challenge. The deficit target for 2015 is 2.5 percent. A revised expenditure rule, which caps the growth of public expenditure by the rate of population growth, which is currently 1.7 percent, plus one percentage point at most, was approved by the government and sent to the parliament. This rule ensures that expenditures are lower than potential growth, and hence the increase in the tax burden in 2015 and onwards, required in order to meet the declining deficit targets, will be modest. With a broad-based VAT set at 18 percent, a CIT at 26.5 percent, and a marginal PIT rate at 50 percent, the MoF sees only limited scope for further tax rate hikes. Consequently, an effort to reduce exemptions will be made.

Fiscal policy is guided by well-defined fiscal rules. Fiscal policy is guided by two rules: an expenditure rule that caps the maximum growth of the real expenditure, and a deficit target expressed in percent of GDP. Every budget has to meet the terms of both. The forecasts on which the deficit targets are based are judged - by staff - to be conservative and unbiased, but as the deficit target is not cyclically adjusted, and there are no escape clauses that define when and how the deficit trajectory is modified, substantial unexpected revenue shortfalls tend to result in discretionary recalibration of the targets.

The current fiscal rules and institutions have proven to be useful. This two-rule framework, which has been in place since 2005, proved to be useful for conducting responsible yet flexible policies, and it was previously assessed by the Fund to have helped reduce public debt from very high levels.[3] The results speak for themselves: since this framework is in place, debt went down from 89.8 percent of GDP to 66.7 percent of GDP. Yet, when the global financial crisis hit, the framework was flexible enough to let the automatic stabilizers operate in full. Thus, the MoF does not see a clear advantage in explicitly introducing the debt ratio into the fiscal rule, while the disadvantage is that the rule

[2] The target set in the 2013 budget, adjusted for the SNA revision, was 4.3 percent.

[3] See 2010 Article IV report.

becomes more pro-cyclical, which is undesirable. The current framework, however, can be improved, and the MoF fully agrees with staff that strengthening the monitoring and analysis of the medium-term projections of expenditures is of the essence. Regarding the institutional setup, since the MoF tax revenue forecasts are unbiased and the BoI is providing a high-quality, independent assessment of the fiscal position, the authorities are not fully convinced that there is a case for an independent fiscal council, given the large costs involved in establishing and maintaining a high-quality council.

The strong fiscal position was demonstrated recently in the international financial markets. On January 22, 2014 Israel sold 1.5 billion euro worth of 10-year euro-denominated sovereign bonds in London, at an average yield of 2.93 percent and bid-to-cover ratio of 5.7. The low spread over comparable German *bunds*, 117 bp, reflects the strength of the fiscal position and the trust in the economy.

3. Monetary and Macroprudential Policies

The BoI's policy is geared to support economic activity under an inflation targeting regime, while containing risks to financial stability and pressures on the currency. As economic activity slowed down, inflation pressures dissipated, and the appreciation pressures on the shekel intensified, the interest rate has been reduced gradually during 2013 from a rate of 2 percent to currently 1 percent. The lower spread between the policy rate and those of the major advanced economies takes off some of the appreciation pressures and the low rate provides additional support for private consumption and investment. Market-based inflation expectations remained close to the midpoint of the 1-to-3 percent inflation target band throughout the interest rate reduction process.

The exchange rate intervention policy is aimed at curbing overvaluation. Foreign exchange intervention policy is based on two pillars. The first pillar is a non-discretionary program designed to offset the effect on the current account of lower energy costs resulting from locally produced natural gas. The quantity of foreign currency purchases under this program is communicated to the public in advance, and in October 2013 the BoI announced that in 2014 the purchases will amount to US$ 3.5 billion. The purpose of this policy is to temporarily substitute for a lacking SWF, and to ease the Dutch disease symptoms that the Israeli economy seems to display. The second pillar of exchange rate intervention is discretionary and designed to curb excessive appreciation beyond that attributed to fundamental factors. The current level of the shekel - which is already affected by this policy - is assessed to be moderately overvalued, and the BoI occasionally acts whenever additional pressure on the shekel builds up.

A set of macroprudential measures is used to reduce the risks associated with the low level of the interest rate. In order to offset the undesirable effect of low interest rates on the risks associated with the elevated level of housing prices, a series of macroprudential measures were taken. These include direct measures such as capping the LTV to 70 percent and debt services to income to 50 percent, and limiting the mortgage repayment period to 30 years. In addition a series of indirect measures aimed at reducing the risks associated with mortgage lending, both to banks and to households, were implemented. As some of the MPs were implemented recently, and the full data on the housing market are available at a considerable lag, it is probably too early to assess the policy's impact. The BoI is encouraged, however, by the initial evidence, as well as by staff's assessment, that points to the effectiveness of direct measures, and it stands ready to tighten these measures if they prove to be insufficient.

4. Financial Stability Issues

The financial system is solid and conservative, and the banks are stable, liquid, and profitable. As part of a gradual adoption of Basel III starting in 2015, the core capital ratio further improved to 9.3 percent. The quality of the banks' credit portfolio is high, with NPLs as low as 3.1 percent of total loans; deposits equal 89 percent of outstanding credit, and the direct exposure to international markets is low.

The financial system is robust and tightly supervised. The regulators, namely the Banking Supervision Department of the BoI, the Capital Markets, Insurance, and Savings Division of the MoF, and the Israel Securities Authority are exchanging information and analyses regularly through a joint working group that analyzes systemic risks. **The authorities realize the necessity of establishing a formal Financial Stability Council.** The report lays out two clear options to move ahead with the process, and the authorities are grateful for the constructive and thorough suggestions made by staff. A continued effort to resolve the outstanding impediments is currently taking place.

A new bank resolution framework is underway. The authorities would like to thank management for promptly accommodating their request for TA on this issue, and staff for providing a valuable contribution to finalizing the draft law for early intervention and resolution. The authorities expect to solve the remaining issues in the near future.

The authorities are grateful to the Article IV team for the excellent, analytical report they have written and for the open and constructive dialogue behind it.