

## INTERNATIONAL MONETARY FUND

### Concluding Statement of the 2012 Article IV Consultation Mission to Israel

February 13, 2012

- 1. Israel's economy remains strong.** Output fell for only two quarters during the "Great Recession", then grew almost 5 percent in 2010 and 2011 led by strong exports and consumption, with investment rising more recently. At 5½ percent, unemployment is at a historic low, while inflation and inflation expectations have both fallen back from slightly above to squarely inside the 1–3 percent target range—the latter reflecting in part the timely tightening of monetary policy in the upswing. The shekel is now broadly consistent with fundamentals and international reserves are appropriate by most measures.
- 2. In part, this reflects Israel's strong policy frameworks.** The budget expenditure rule is set to keep public debt of some 75 percent of GDP on track to decline to 60 percent. And this is reflected in the innovative "two year" budget framework, which has significantly strengthened expenditure planning and implementation. A modern central bank law entrenching inflation targeting was adopted in 2010, building on past successes. The recent Financial Stability Assessment Program (FSAP) Update concludes that vulnerabilities in banks and other financial institutions are well contained. Israel joined the OECD in 2010, and retains the option to issue public debt under a longstanding U.S. government guarantee scheme if necessary.
- 3. But vulnerabilities remain.** Public debt is high relative to stronger OECD and emerging market countries, and, reflecting regional tensions, security expenditures severely constrain room for fiscal maneuver. House prices have surged by over 50 percent in recent years, and notwithstanding welcome reform initiatives following the Hodek committee recommendations, structural fragilities in the corporate bond market remain. Despite strong growth, overall poverty is among the highest in the OECD, raising sharp social and sustainability concerns, notably in the Israeli-Arab and Haredi communities. And finally, a decade of stagnant real wages contributed to an eruption of social protests in 2011, with significant implications for spending and taxation policies over the medium term.
- 4. Furthermore, economic activity began to slow from early 2011.** Consumer and business confidence have softened as has activity growth and the housing market—with construction slowing, house prices flattening, and house sales falling. And in this overall context, risk premia in the corporate bond market have risen significantly.
- 5. Policies have responded well to the immediate challenges.** The Bank of Israel reversed its tightening cycle from September 2011, cutting its policy rate 75 bps to 2½ percent. In this context, earlier strong appreciation pressures on the shekel have abated.

And with budget spending ceilings for 2012 already set under the two-year budget for 2011–12 which was adopted at end 2010, automatic stabilizers are operating fully.

6. **So a severe downturn in 2012 is unlikely—absent an external crisis or contagion from within the corporate bond market—but the output gap will likely reopen a little.** Assuming that the current supportive monetary stance is maintained alongside the unfettered execution in 2012 of the 2011–12 budget expenditure authorizations, GDP growth is projected to decline to a little below 3 percent before returning to trend at 3¾ percent in 2013, with both sides of this cycle led by exports.

7. **Nevertheless, policies and policy frameworks should all be adjusted further in light of the risks.**

8. **On the fiscal side, the top priority is to keep public debt on a downward track over the medium-term.** This will maintain confidence in Israel despite strained international markets, and so allow some flexibility in the deficit path in the short term.

9. **This critical task has become considerably more difficult.** Near term global and Israeli growth projections have been marked down. A surge in retirements in coming years will reduce the growth of Israeli productive capacity to below the norms of the past decade. Social concern with prices will constrain options to raise indirect taxation. Calls for added public spending—including for social needs and security—have mounted. Unfunded fiscal commitments of some ¾ of a percentage point of GDP for 2012 have to be resolved within the 2012 budget framework. And even if so, the shortfall in revenues in 2011 due to housing and asset market-related receipts will likely persist, setting the stage for a deficit of 3-3½ percent of GDP in 2012, compared with a 2 percent of GDP ceiling.

10. **Accordingly, we warmly welcome the authorities' commitment to maintain the total spending limits in the 2012 budget.** We also welcome that the Trajtenberg committee's policy proposals in response to the social protests respect these and the medium-term spending limits. And we welcome the authorities' decision to withdraw plans for phased reductions in direct tax rates. All these actions have helped to underpin continued investor confidence in the Israeli sovereign in a difficult global environment.

11. **But more is needed—in particular, a decisive effort to approach the 2013 budget deficit ceiling should be made.** This will require contributions from all sides—from expenditure restraint including defense, from initiatives to raise additional revenues, and from efforts to strengthen the productive potential of the economy.

12. **Even so, unless the outlook for activity and revenues improves markedly in coming months, a full return to the headline target for 2013 would be unduly contractionary.** Final determination of the appropriate 2013-14 targets for the fiscal balance should be made before mid -2012 reflecting domestic and global developments at that time.

13. **This change in the 2013 deficit target will need to be accompanied by a further strengthening of the fiscal rules and frameworks.** Given commitment to the expenditure rule, there will likely need to be a reset of the path of targets for the deficit ceiling. Options for that include clarification that the path will be adjusted for automatic stabilizers. Alongside, and in response to the mounting difficulty of securing medium-term debt reduction, the establishment of a permanent and independent Fiscal Council to assess whether overall fiscal policies are consistent with debt reduction may help to secure that goal. And following the success in strengthening the arrangements for the taxation of natural resources under the Sheshinski report, proceeds not assigned to debt reduction should be placed in a sovereign wealth fund operating according to best international practice, with general transfers to the budget based on the long term expected yields of the fund.

14. **In this context, even with expenditure restraint fully playing its appropriate role, there is a good case for deficit-reducing discretionary fiscal policy actions to focus on taxation, over the near and medium terms.** Key non-security spending items--such as health and education--are around levels of moderate-spending OECD peers. And in some areas, there is need for increases, notably in education and public investment, including in the Arab-Israeli communities. So scope for additional overall spending compression on a significant scale is not apparent. On the other hand, with the VAT rate at only 16 percent—albeit with few exemptions—and given the priority attached to strengthening environmental and housing taxation, revenue increases in these areas alongside curbs to tax expenditures could reinforce the credibility of plans to lower public debt.

15. **The monetary stance is broadly appropriate under the baseline projections, but the recommended fiscal and financial stability policies would create scope for further relaxation.** Inflation is on track to fall towards and even beyond the mid-point of the inflation target range—with commodity prices, domestic demand, and the housing market all softening. All this is reflected in falling inflation expectations since the Fall of 2011. Aggregate nominal wage growth has been strong as wage settlements caught up with the 2009-10 recovery, but has recently slowed in recognition of global risks. But phased increases in the required minima for core tier 1 bank capital, possibly compounded by strains in the corporate bond market, and the strong fiscal stance recommended would all slow credit growth and activity. Given lags, monetary policy should anticipate and offset these effects, once they are adopted.

16. **Any remaining concerns with renewed housing inflation should be addressed with other tools.** These include measures to smooth the supply of land and steps to increase the taxation of second properties, possibly backed up by additional macroprudential steps.

17. **As on the fiscal side, the monetary framework should continue to be enhanced.** The new Bank of Israel Law rightly establishes inflation as the primary target for the Bank, to be delivered by a new Monetary Policy Committee which is subject to increased public accountability. In building on this progress, further developments will need to secure a

balance between confirming continuity and effecting change. In this light, in due course, options include lengthening the horizon of published inflation and GDP forecasts, and increased emphasis on the mid-point of the inflation target range as the goal for policy. In this connection, the arrangements for remuneration of Bank of Israel staff should be reviewed; current limits significantly impede recruitment and retention of appropriately qualified new staff, and the mechanisms raise concerns with effective independence of monetary and supervisory policy. If unaddressed, these issues will corrode the bank's core anti-inflationary and supervisory functions.

18. **Alongside, the easing of upward pressure on the shekel paves the way for maintaining a de facto free floating exchange rate regime.** Considerable intervention and the use of limited administrative controls on inflows were warranted by the exceptional circumstances of recent years. So while continued use of these instruments is appropriately not ruled out, continued signals that the clear preference is for their use to remain the exception rather than the rule will support the credibility of inflation as the prime target for monetary policy. Exit strategies from use of all of these instruments should be prepared.

19. **In the event of a major external shock, further policy adjustments would be needed.** Provided that market access by the Israeli sovereign is uninterrupted, automatic fiscal stabilizers should operate fully, accompanied by steps to reinforce the credibility of the commitment to medium-term debt reduction. Alongside, the monetary policy rate should be lowered. Were the external shock to induce safe haven capital inflows, compounding shekel appreciation and associated disinflationary pressures, monetary relaxation should be larger and nonconventional tools may be needed—possibly, a combination of quantitative easing, macroprudential policies aimed at deterring short-term inflows, and foreign exchange intervention. Such actions should be accompanied by clear exit strategies principally contingent on improved global conditions.

20. **On the financial stability side, “normal” risks are contained.** The FSAP Update stress tests indicate that banks and other financial institutions would likely be able to withstand even a severe downturn including a domestic housing crash, and heightened credit risk in the corporate sector. This reflects proactive supervision, and banks’ limited external exposures and wholesale funding. And steps underway to improve bond market infrastructure are welcome.

21. **Nevertheless, various actions are needed to strengthen supervision and regulation—and several are already underway.** Plans to raise bank capital ratios and to strengthen liquidity requirements in accord with Basle III are welcome. These follow the international schedule, raise the quality of bank capital, and address the role of groups and the systemic nature of the major banks.

22. **A stronger financial crisis management framework and preparations for shocks outside of historical experience should be implemented.** The use of the BoI’s emergency

liquidity facilities and the legal framework for early intervention and resolution powers should both be reviewed urgently. Means should be available to fund an eventual bank resolution, and at the same time to protect less sophisticated savers. Given strains already evident in corporate bond markets, the impact on financial stability of the bankruptcy of one or more of Israel's large corporate groups, combined with a severe and protracted economic downturn, should be studied. Plans for the strengthening of supervisory policies and the scheduling of reforms to corporate structures envisaged by the "Concentration Committee" should reflect lessons learned from this exercise. And contingency planning should include consideration of early activation of tools such as those that were established in 2009 to underpin the corporate bond market.

23. **The establishment of a Financial Stability Committee (FSC)—comprising all the main supervisors—could help substantially in facilitating a more systemic approach to financial sector policy.** The FSC would be charged with coordinating macro-prudential analysis and policy-making, and may help to implement full cooperation among financial supervisors, for example, in identifying cross-sectoral linkages and future sources of strain. But if the FSC does not succeed in that aim, the architectural layout of financial sector supervisors may need to be recast.

24. **But even if all these fiscal, monetary, and financial stability steps are taken, stability in Israel in the long run will remain in question unless the low participation in labor markets of minority populations--notably the Arab-Israeli and Haredi communities—is addressed.** In particular, employment rates of Arab-Israeli females and Haredi males are just 20 and 40 percent respectively. Their wage levels are also lower than other Israeli groups, even taking account of differences in qualifications. Accordingly severe poverty is concentrated in these groups. If, instead, the employment, wage, and productivity rates in their communities were on a par with others, every year Israeli output would be some 15 percent higher than it is, and annual fiscal revenues would also be higher than they are by some 5 percent of GDP. As these groups are set to grow to half of the entire population in 30 years, up from a quarter now, these participation issues are macroeconomic in scale.

25. **Both communities want work, and the realization of that goal should be encouraged.** Necessary steps include provision of basic child care and transportation in the Arab areas, arrangements for inclusion of Haredi males in the armed forces in ways that support their employment and productive potential, and action to remove impediments to business establishment in both communities. Both groups also need their particular education requirements to be addressed, notably equalization of education provision at all levels in Arab-Israeli communities with that elsewhere, and focused provision of adult education to address Haredi needs. And social benefits to both groups, including child care, should be increasingly tied to employment.

26. **A number of official initiatives to address the needs of these "currently" minority populations are underway--alongside the many ongoing private initiatives.** These include targets for participation, extension of the earned income tax credit,

establishment of a proactive unit for Arab affairs in the Prime Minister's office, and expansion of Haredi units in the defense forces. But as well as upgraded enforcement of anti discrimination legislation, much more is needed. This has implications, as noted, for additional education and public investment spending. Early and substantive progress will require all sides to adjust and to work closely together—requiring great political dexterity. But further progress is essential to secure the long-term sustainability of the Israeli economy, and with it, the welfare of all of its citizens.

\* \* \*

We would like to thank all of our counterparts for the exceptional warmth of the welcome that we were accorded during our visit to Israel.