

Israel: 2006 Article IV Consultation—Staff Report; Staff Report Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Israel

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with Israel, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 6, 2006, with the officials of Israel on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 13, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;
- a staff report supplement of January 17, 2007 updating information on recent developments;
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 19, 2007 discussion of the staff report that concluded the Article IV consultation; and
- a statement by the Executive Director for Israel.

The document listed below has been or will be separately released.

Selected Issues Paper

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ISRAEL

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Israel

Approved by Ajai Chopra and Adrienne Cheasty

December 13, 2006

- Consultation discussions were held in Jerusalem and Tel Aviv during October 25–November 6, 2006. The staff team—Messrs. Decressin (head), Catalan and Epstein (all EUR), and Mr. Pratt (MCM Consultant)—met with Minister of Finance Hirschson, Bank of Israel Governor Fischer, and other senior officials of the government, the Israeli Securities Authority, and the Bank of Israel. It also met with members of the Knesset Finance Committee, academics, and representatives of the private sector, including financial institutions, the manufacturing association, and the labor union. Mr. Klein (OED) participated in the meetings.
- The authorities released the mission’s concluding statement and have agreed to the publication of the staff report.
- Israel is an Article VIII country and maintains a freely floating exchange rate and an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. 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.

Contents		Page
Executive Summary		3
I. Background		4
II. Report on the Discussions.....		7
A. Growth Prospects		7
B. Inflation Outlook.....		8
C. Monetary Policy.....		9
D. Fiscal Policy.....		11
E. Fiscal Governance.....		13
F. Financial Sector Policies.....		16
G. Combating Poverty		17
III. Staff Appraisal		18
 Tables		
1. Selected Economic and Financial Indicators, 2001–07		21
2. Central Government Accounts, 2002–07		22
3. Balance of Payments, 2001–07		23
4. Indicators of External and Financial Sector Vulnerability, 2001–06		24
5. Financial Soundness Indicators, 2000–06		25
6. Medium-Term Scenarios, 2004–11		26
 Figures		
1. The Long View, 1996–2006.....		27
2. Recent Economic Indicators		28
3. Fiscal Developments, 2001–06.....		29
4. External Indicators, 2001–06.....		30
5. Selected Financial Indicators, 2004–06.....		31
6. Public Debt Sustainability: Bound Tests		32
7. External Debt Sustainability: Bound Tests.....		33
 Boxes		
1. Key Policy Recommendations and Implementation.....		5
2. Monetary Policy—Baseline Forecast and Risk Assessments.....		10
3. The Political Economy and Fiscal Institutions		15
4. Financial Sector Supervision		18
 Appendix		
I. Fund Relations		34
II. Staff Research		36
III. Statistical Issues		39

EXECUTIVE SUMMARY

Strong macroeconomic conditions and sound domestic policies have significantly improved Israel's growth performance and prospects, notwithstanding political uncertainties and the latest hostilities. During 2004–06, the economy expanded in the 4–6 percent range annually; the fiscal deficit was more than halved; the current account surplus moved toward 5 percent of GDP; and structural reforms improved the supply-side of the economy. Financial markets have been remarkably stable, even during the hostilities in the north in the summer of 2006.

For 2007, real GDP growth is forecast to be about 4 percent or somewhat more, with low inflation. The risks to growth lie on the downside and include a disruptive unwinding of global current account imbalances as well as geopolitical uncertainties. Inflation would remain below the Bank of Israel's 1–3 percent target range but return toward the midpoint during 2007, assuming unchanged exchange rates and energy prices. Under this scenario, the shared view was that monetary policy could afford some easing but that a fundamental change in the policy stance was not required.

The discussions also focused on fiscal and financial sector policies and frameworks. The resilience of the economy to shocks needs to be strengthened, notably through reduction of the 90 percent public debt-to-GDP ratio. Therefore:

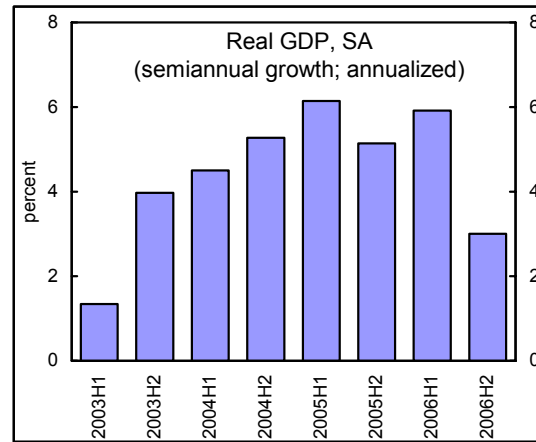
- Staff supported the government's objective to limit central government real spending growth to 1.7 percent annually (excluding war-related outlays), with a view to reducing the deficit to 1 percent of GDP by 2009. However, staff advocated aiming at an outturn appreciably below the 2007 draft budget's 2.9 percent of GDP deficit ceiling, cautioning against tax cuts if revenues during the year turned out higher than projected.
- Staff pressed for more medium-term fiscal policy analysis in budget documents, more forward-looking fiscal planning, and better fiscal governance.
- Staff argued for adapting prudential policies and practices to rapid financial deepening, which is contributing to higher growth but also raising new risks. Key priorities include strengthening the independence of the regulatory authorities and providing them with adequate resources, harmonizing the regulatory requirements for different institutions and savings products, and improving collaboration between supervisors.

The authorities underscored their objective to do more to combat poverty. Staff concurred that an Earned Income Tax Credit, which is under discussion to achieve this goal, could be useful. However, it should be considered as part of a broader, preferably budget-neutral program to address poverty, which is to be studied by a newly-formed National Economic Council.

I. BACKGROUND

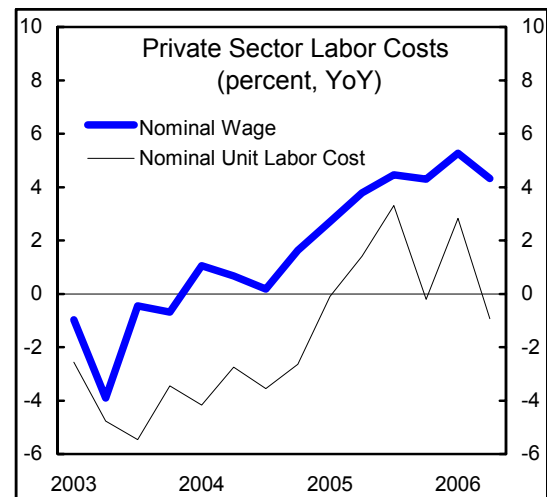
1. Economic growth accelerated sharply following a prolonged recession during 2001–02, and the conflict along the northern border has not derailed the upswing

(Table 1, Figure 1). Key drivers of the expansion included improving internal security and productivity; buoyant external demand; exceptionally benign financial conditions, notably falling risk premia; and sound macroeconomic policies (Box 1). Real GDP growth thus reached 6 percent in 2006H1. The hostilities that broke out at the beginning of 2006Q3 significantly disrupted activity, notably in the trading and services industries, which temporarily depressed net exports. Nonetheless, output fell less than originally expected amid surprisingly strong consumption of durables and fixed investment. While revisions are likely—data for 2006Q3 are more preliminary than usual because of the war—growth is widely forecast to average about 4½ percent or more in 2006 and continue apace in 2007.



Sources: Central Bureau of Statistics; IMF staff estimates.

2. As spare capacity was reduced through mid 2006, inflationary pressure built and the Bank of Israel (BoI) raised its policy rate, but since then the pressure has abated and the rate has been cut. The CPI rose by 1.6 percent during 2006H1, leaving prices in June 2006 some 3.5 percent above last year's level, or above the BoI's 1–3 percent target range (Figure 2). Concurrently, wage growth accelerated, although unit labor costs were kept in check by a surge in productivity, a large part of which was judged cyclical. Together with uncertainties in currency markets when the hostilities started, this prompted the latest BoI rate hike to 5.5 percent effective August 2006. But since then, wages have decelerated, the exchange rate has appreciated, and energy prices have fallen. The pass-through to consumer prices has been larger and much faster than widely expected, pushing year-on-year inflation close to zero.¹ This prompted the BoI to cut rates in two 25bp steps, to 5 percent. Markets foresee another 25bp easing over the coming year.



¹ Exchange rate changes pass through to the CPI very quickly, as roughly one quarter of the CPI basket comprises contracts that are denominated in U.S. dollars.

Box 1. Key Policy Recommendations and Implementation

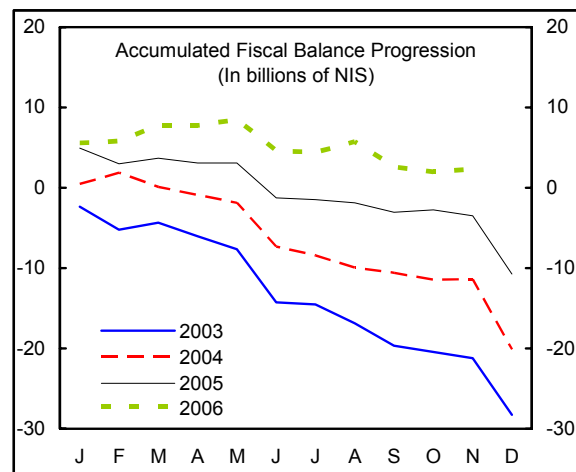
Monetary policy: In line with staff advice, the authorities have improved the transparency of monetary policy by (i) giving greater prominence to the analysis of inflation dynamics in the Inflation Reports; and (ii) initiating the publication of minutes from policy meetings.

Fiscal policy: Fund staff has been pushing for giving debt reduction priority over further tax cuts. The implementation of the VAT reduction in mid-2006 went counter to this advice. While the 2006 fiscal performance was strong and public debt has fallen more than projected, the debt remains high.

Structural Fiscal Reform: Fund staff has advocated the adoption of a multi-year budget framework to help ensure that future budgets are better insulated from political pressures and reflect long-term priorities. The authorities were concerned about the ensuing loss of budget flexibility and staff now suggests other avenues to strengthen the medium-run orientation of fiscal policy (see para. 23)

Financial Sector: In line with staff advice, the authorities have taken measures to reduce banks' exposure to credit risk, including by increasing required provisions. But more progress is needed in further improving risk-based supervision and advancing the implementation of Basel II.

3. **Tight expenditure policy together with the recovery significantly reduced the central government budget deficit, anchoring investor expectations during the war, but public debt remains high** (Table 2, Figure 3). Following years of unsuccessful implementation of the Deficit Reduction Law (DRL), the government buttressed the framework in 2004 with a 1 percent ceiling on real central government expenditure growth during 2005–10. As a result, the central government cash deficit fell to 1.9 percent of GDP in 2005 and is expected to narrow further to around 1½ percent of GDP in 2006, notwithstanding the hostilities.² The general government deficit (accrual basis) would be close to 3 percent of GDP in 2006 and the public debt-to-GDP ratio, which is high, would fall to about 90 percent of GDP, faster than Fund staff and others had expected.³ The debt constrains the room for policy maneuver but does not present a liquidity problem: the average maturity



Source: Ministry of Finance

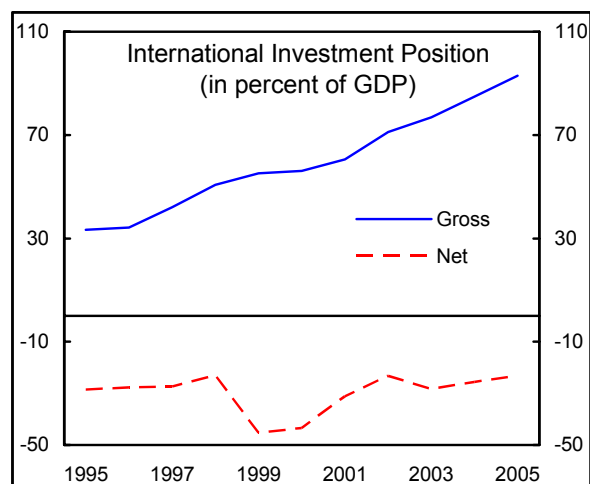
² A June VAT cut (annual cost: ½ percent of GDP) as well as conflict-related spending (1 percent of GDP) and revenue losses (½ percent of GDP) unexpectedly added to the deficit, while receipts deemed one-off and related to FDI and other activities (1 percent of GDP) detracted from it. Previously legislated tax cuts added (½ percent of GDP) to the deficit.

³ Half of the fall reflects a 4–5 percent upward revision in GDP.

is about 6½ years, with a fairly smooth repayment profile; only about one quarter of the debt is foreign and some 80 percent of that is either guaranteed by the U.S. government or nontradable, below-market-yield paper held mainly by Jewish foundations located abroad. Accordingly, Israel's ten-year government bond yields are standing only about 80bp above those on comparable U.S. paper.

4. **Israel's external position has improved** (Tables 3, 4, Figures 4–6). Exports are strong and following a decade of deficits, the current account has been in surplus since 2003, now reaching just under 5 percent of GDP. While Israel has a net external liability position of some 20 percent of GDP, it is less

vulnerable than that suggests. The reason is that its liabilities are mainly FDI and equity, while it has just under 20 percent of GDP in net external “debt instruments” assets as well as high net international reserves. The free-floating exchange rate has lately been appreciating against the U.S. dollar but, taking a two-year perspective, has remained broadly constant. At the current real effective exchange rate, staff projects a narrowing of the current account surplus over the medium term, to about 3½ percent. This is higher than



staff estimates of the “equilibrium” (or net foreign asset-stabilizing) current account balance, a deficit of just over 1 percent of GDP, but which, by its nature, comes with a sizeable margin of error. At the same time, the real effective exchange rate stands some 10 percent below its 1986–2006 average, which (consistent with the difference between projected and “equilibrium” current account) suggests some undervaluation.

5. **Financial soundness indicators are recovering** (Table 5). Stock and bond markets performed well in early 2006 and the market swings since the spring have been similar to those in advanced (rather than emerging) market economies, notwithstanding the conflict. The improved economic outlook and enhanced fiscal policy and credibility continued to attract strong foreign capital inflows through 2006Q3, even during the hostilities, which testifies to the growing resilience of the economy.

6. **However, weaknesses remain and date back to the boom-bust cycle that started in the early 1990s, a time when the financial sector was still largely in public hands.** Accordingly: (i) bank profitability and capitalization, although benefiting from economic growth, have generally not been strong; (ii) problem loans remain high (especially in the construction sector) relative to bank capital and loan loss provisions; and (iii) nonfinancial corporate leverage is considerable.

	2000	2002	2004	2005	2006 June
Return on (average) equity	11	3	12	14	15
Capital adequacy ratio	9	10	11	11	11
Problem credit to equity	107	160	145	126	116
Problem credit to total gross credit	7	10	11	10	9
Nonperforming loans to total gross loans	...	2	3	2	2
Loan-loss provision to gross problem credit	31	29	33	36	37

Source: Bank of Israel.

7. **With privatization and banks' preparations for Basel II risk management has been improving, but new risks are emerging.** The development of, and exposure to, new financial instruments and risks has rapidly accelerated in response to the cessation of the practice of requiring institutions to buy guaranteed nontradable government bonds; the pension reforms; the removal of tax disincentives to invest abroad; and the elimination of barriers to insurance companies and provident and pension funds extending credit to companies and households. As a result, households are faced with a wider array of risk-return choices and institutional investors are moving out of government paper into corporate bonds, equity, and foreign assets. The prudential regime has yet to catch up with the implications of the wider choices available to investors, the assumption of investment risk by households, and the extension of nonbank institutions into credit and new instruments.

	2002	2003	2004	2005	2006 June
Credit from the financial sector	83	84	80	79	77
Banks	75	73	68	61	58
Provident funds	6	7	7	10	11
Pension funds	0	1	2	3	3
Insurance companies	2	3	4	5	5

Source: Bank of Israel

II. REPORT ON THE DISCUSSIONS

A. Growth Prospects: Fundamentally Strong but with Downside Risks

8. **The conditions for activity in 2007 were widely considered propitious and real GDP growth forecasts of the authorities and the staff are in the vicinity of 4 percent or higher.** Factors that bode well for growth include: broad-based activity, improved household and corporate balance sheets, continued strong external demand, low risk premia and an ample supply of funds for investment, broadly neutral monetary policy, and somewhat expansionary fiscal policy (see para. 18). But the fiscal impulse to the economy is likely to be small because the economy is very open and the public debt high. While the exchange rate

has been appreciating, the sheqel was still seen as undervalued on a multilateral basis, which is consistent with Fund staff estimates, and thus no hindrance to growth.

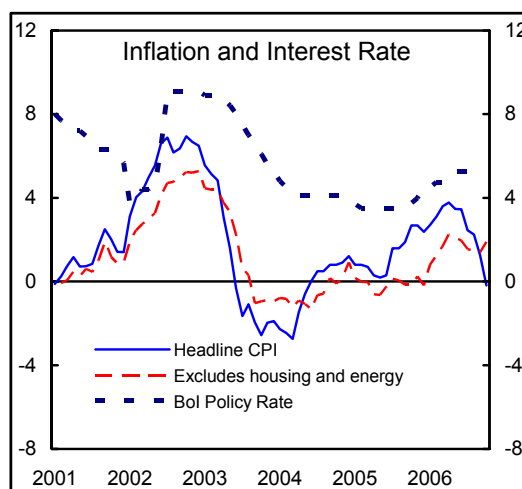
9. **All were concerned about the downside risks for growth in 2007.** The authorities emphasized geopolitical uncertainties but agreed that a sharp unwinding of global current account imbalances with a global economic downturn, investor flight from risk, and renewed oil price hikes were also potential risks.

10. **Over the medium term, real GDP growth was seen near 4 percent, closing a small output gap** (Table 6). Falling population growth—from 2.4 percent in 2000 to 1.6 percent in 2007—is beginning to hold back output. Assuming a continuation of the upward trend in labor force participation, the authorities thought that potential growth was 3½–4 percent, which is in line with staff views, and that slightly higher growth would close the small remaining output gap.

B. Inflation Outlook: External and Domestic Forces Pushing in Opposite Directions

11. **Headline inflation is likely to stay below the BoI target range for some time but is projected to return toward the midpoint later in 2007.** There was agreement on the following points:

- The exchange rate has been appreciating since the war and the pass-through, which has been unexpectedly large and rapid, together with moderating energy prices, would push year-on-year inflation below the lower bound of the BoI 1–3 percent target range for some time into 2007. If the exchange rate and energy prices had remained unchanged from their mid-2006 levels, inflation would likely be around the middle of the target range.
- Pressures on wages—which stand about 4½ percent above last year’s level—subsided after the war but would likely intensify again as above-trend growth resumed.



Overall, assuming a stable exchange rate and oil prices as well as market interest rates, year-on-year inflation would gradually increase toward the BoI midpoint later in 2007. This is consistent with markets’ expectations of about 1.4 percent year-on-year inflation for the coming 12 months.

12. **The risks around this central scenario for prices are significant but appear broadly balanced.** Wage developments present an upside risk if activity evolves as projected or energy prices start rising again: (i) the latest minimum wage hikes (totaling 7½ percent)

will be feeding through the economy; and (ii) following two years of no public sector wage negotiations and only limited (if any) wage increases, the public sector union is asking for a large hike to make up for lost purchasing power. On the other hand, a sudden weakening in external demand or further appreciation of the exchange rate would soften price pressures.

C. Monetary Policy: Balancing Short- and Medium-Term Pressures

13. **Under these circumstances, the BoI saw some room for monetary policy easing.** BoI officials explained that the August 2006 rate hike had been partly motivated by concerns about the potential for capital outflows and a depreciation of the sheqel because of the war. These have not materialized. On the contrary, the exchange rate soon appreciated again, buoyed by capital inflows even during the war. Amid slowing year-on-year headline inflation, moderating wage pressures, and falling inflation expectations, the BoI thus decided to cut rates again by 25bp for November, hinting at one more cut for December, which it has since implemented.

14. **Staff concurred and considered that a fundamental change in the policy stance was not needed for as long as the downside risks to inflation did not grow noticeably.** The central scenario was for above-potential economic growth and rising headline inflation in the year ahead and thus a significant addition of stimulus appeared unnecessary, unless the downside risks—notably those related to an exchange rate appreciation—increased materially. The BoI broadly agreed with staff’s analysis of the fundamental drivers of inflation and related risks over the medium term, which are significant, as staff model simulations suggest (Box 2). Accordingly, it intended to proceed cautiously in changing rates, also because of lingering uncertainties related to the 2007 budget and the geopolitical situation.

15. **The BoI was concerned about the frequency with which inflation had been outside the 1–3 percent target range since the adoption of this target.** The key reason is the rapid transmission of the volatile exchange rate to domestic prices because housing rent and some other service contracts are typically denominated in U.S. dollars. BoI officials considered that frequently missing the target range might destabilize inflationary expectations. However, the BoI’s experience is not unusual among inflation-targeting countries.⁴ Also, in the staff’s view, it did not detract from the success of the BoI’s monetary policy, as evidenced by stable inflation expectations. However, maintaining this performance would require convincing the public that inflation can temporarily be outside the target range while policy is consistent with price stability over the medium term.

⁴ See “On Target? The International Experience with Achieving Inflation Targets”, IMF Working Paper 05/163.

Box 2: Monetary Policy—Baseline Forecast and Risk Assessments

The **central scenario** assumes a small negative output gap that closes in 2007; and stable exchange rates and oil prices. Headline inflation would then likely remain below the 1-3 percent target range for the first half of the year but return toward the mid-point thereafter.

Baseline Forecast on October 30, 2006

	2007Q1	2007Q4	2008
Policy Rate	4.6	5.1	5.8
Inflation	0.9	1.7	1.8
Sheqel per \$US	4.29	4.27	4.26
Output Gap	-0.6	0.0	0.1

The central scenario is subject to several **risks**. Their potential policy rate implications—determined with a model of the economy, as explained in IMF Country Report 06/121, Chapter III—are illustrated below:

- Policy slippage: higher risk premium/sheqel depreciation. This would require higher policy rates.

Higher Risk Premium/Sheqel Depreciation (deviation from baseline)

	2007Q1	2007Q4	2008
Policy Rate	1.1	0.6	0.3
Inflation	0.4	0.4	0.2
Sheqel (%Δ)	-2.0	-1.4	-1.4
Output Gap	0.1	0.0	0.0

- Enhanced policy credibility: lower risk premium/sheqel appreciation. This would create room for significant policy rate cuts.

Lower Risk Premium/Sheqel Appreciation (deviation from baseline)

	2007Q1	2007Q4	2008
Policy Rate	-1.0	-0.7	-0.3
Inflation	-0.5	-0.5	-0.2
Sheqel (%Δ)	1.9	1.4	1.4
Output Gap	0.0	0.1	0.0

- Acceleration in wages: positive output gap. Policy rates would have to be raised to keep inflation low.

Positive Output Gap (deviation from baseline)

	2007Q1	2007Q4	2008
Policy Rate	0.8	0.8	0.2
Inflation	0.0	0.1	0.1
Sheqel (%Δ)	0.4	1.6	1.9
Output Gap	1.5	0.9	0.0

- Oil prices up 25 percent. A modest hike in policy rates would be needed to anchor inflation expectations.

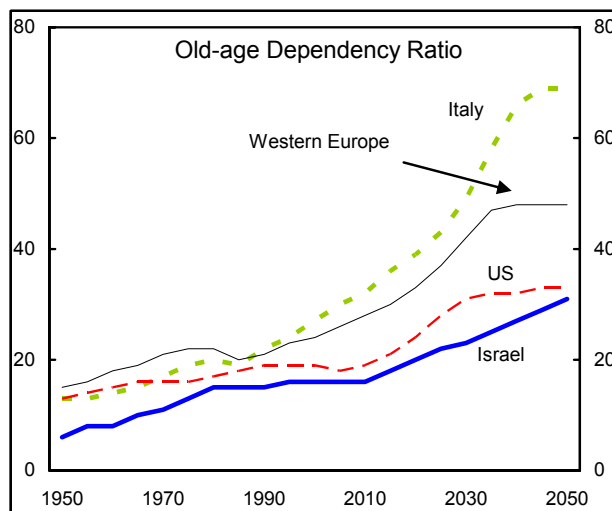
Higher Oil Prices (deviation from baseline)

	2007Q1	2007Q4	2008
Policy Rate	0.3	0.4	0.4
Inflation	0.1	0.1	0.5
Sheqel (%Δ)	0.4	0.9	0.9
Output Gap	0.0	-0.1	-0.2

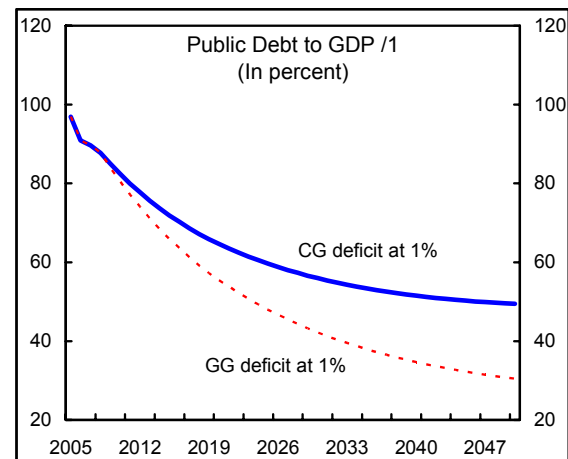
16. **Staff thought that publishing an inflation forecast might help anchor inflation expectations going forward but BoI officials were not convinced.** Staff considered that the minutes of policy discussions, which have been published since May 2006 and complement the Bank's Inflation Report, were useful for that purpose. However, the report did not include an explicit inflation forecast together with a discussion of technical assumptions and risks, which is unlike standard practice among inflation-targeting central banks in other advanced economies. BoI officials replied that they had published fan charts in some past Inflation Reports and would not rule out doing so again in the future. But their main concerns were (i) the conceptual difficulty of publishing a forecast other than at the mid-point of the target range; and (ii) their inflation forecast record, which would probably be poor on account of the exchange rate. Alternatively, the forecast range would have to be so wide as to be of little use as an anchor.

D. Fiscal Policy: Advancing the Consolidation Effort

17. **All interlocutors agreed that the public high debt was constraining policy options and needed to be lowered.** A debt sustainability analysis suggests that there is little room for more public support during period of relatively low growth—even more so during recessions—without causing adverse debt dynamics (Figure 7). Furthermore, there is a need to begin preparing for a growing proportion of older and needier citizens in the future, even if Israel's population is still relatively young. In fact, assuming that the central government achieved its deficit targets for 2007-09 and maintained the deficit at 1 percent of GDP thereafter—implying balance or surpluses in years of high growth—it would take until at least 2025 to reach a debt-to-GDP ratio of 60 percent, a level that is considered an upper bound reference value for many advanced economies. At that time, Israel's old-age dependency ratio and social needs would be similar to those of many advanced economies today that are struggling to advance welfare reform amid slowing potential output growth.



Source: United Nations Secretariat.



1/ Staff projections; central scenario based on central government (CG; general government, GG) deficits of 1 percent of GDP starting in 2009 and long-run output growth potential averaging 3 percent.

18. **The authorities explained that their consolidation strategy was to stick to the pre-war central government expenditure path except for a temporary deviation on account of war-related spending.** For 2007, real expenditure growth would be held to 1.7 percent upon excluding war-related outlays (equivalent to $\frac{3}{4}$ percent of GDP). Keeping expenditure within this constraint required measures equivalent to just over $\frac{1}{2}$ percent of GDP. The budget proposed freezing welfare benefits; cutting railroad investments; and various other measures, including across-the-board cuts. Concurrently, revenues would fall by about $1\frac{1}{2}$ percent of GDP relative to 2006 because some receipts in that year were deemed one-off in nature (1 percent of GDP) and previously-scheduled tax cuts ($\frac{1}{2}$ percent of GDP) would kick in. Overall, the central government budget deficit in 2007 was therefore expected to be no higher than 2.9 percent of GDP, assuming real GDP growth of 3.8 percent and average inflation of 1.4 percent.⁵ War-related spending would continue to affect the 2008 budget but in 2009 the pre-war deficit target of 1 percent of GDP would be attained. Under this baseline scenario, the public debt would fall below 85 percent of GDP in 2009.

Fiscal Projections for the Central Government, 2005–09 1/					
(In percent of GDP)					
	2005	2006	2007	2008	2009
Revenue	35.7	36.0	34.2	33.5	33.0
Expenditure	37.6	37.4	36.5	34.9	34.0
Deficit	-1.9	-1.4	-2.3	-1.4	-1.0
Pre-war official deficit targets		-3.0	-2.0	-1.5	-1.0
Post-war official deficit targets		...	-2.9	-2.0	-1.0
Memorandum item:					
War-related expenditure		1.0	0.7	0.5	...

1/ Staff baseline projections (excludes credit).

19. **Staff supported the central government expenditure policy but, pointing to the significantly larger general government deficit—expected at over 4 percent—and the challenges presented by the high debt, underscored the need for greater ambition with respect to deficit reduction in 2007.** The mission specifically cautioned against new tax cuts, even if revenues turned out stronger than projected, and in this connection was also critical of the June 2006 VAT cut that had been implemented at short notice amid buoyant tax receipts. To bring the 2007 deficit closer to the pre-war targets the mission called for pruning the many tax expenditures, which account for the equivalent of roughly 5 percent of GDP.

Tax Expenditures, 2007	
	Percent of GDP
Total	4.9
Manufacturing	0.4
Capital markets 1/	2.6
Of which: advanced training funds	0.4
Welfare	0.5
Family status	0.3
Property Tax	0.4
VAT	0.5
Of which:	
Fruit and vegetables	0.3
Tourist services	0.1
City of Eilat law	0.1
Other	0.3

Source: Ministry of Finance

1/ Reflect tax exemptions on various capital gains and interest income vehicles, including tax deferrals on the distribution of employee stock options.

⁵ A price reserve of 3 percent of total expenditure will become available only if the actual rise in prices is in line with the forecast.

20. **The authorities emphasized that 2.9 percent of GDP was a ceiling and not a target for the budget deficit in 2007.** They defended the VAT cut because it had served to diminish expenditure demands and were hopeful about their ability to hold the line on the deficit, notwithstanding pressure to raise spending on defense and welfare. This would be studied by two commissions, including a newly-formed National Economic Council (NEC). However, judging by past attempts, they thought that lowering tax expenditures would be very difficult.

21. **There was agreement on the need to adhere to the consolidation path over the medium run.** The authorities intend to reduce the central government deficit to 1 percent by 2009. The mission underscored that the expenditure growth ceiling needed to be respected and further tax cuts be eschewed. The reasons are that: (i) once currently-scheduled rate cuts have been implemented, statutory income and consumption tax rates will be in line with those in advanced economies with similar welfare aspirations; and (ii) staff analysis suggests that giving debt reduction precedence over tax cuts would boost growth.⁶ Together with some progress in curtailing the many tax expenditures, this would allow some overperformance against the 2009 fiscal targets and could bring the general government account (accrual basis) close to balance (implying surpluses for the central government cash balance) in just over 5 years. This medium-run target for the general government—which a number of other advanced economies have chosen—would create more room for policy maneuver, maintaining the debt on a declining path even in the presence of shocks that could temporarily set back the adjustment effort.

E. Fiscal Governance: Building Awareness of Medium- and Long-Run Challenges

22. **Staff considered that the frequent fiscal policy slippages in the past and the high debt ratio were partly due to a budget debate that is overly focused on the short run and weaknesses in the fiscal policy framework.** The DRL lacked stability and credibility, although the adoption of a real expenditure growth ceiling had improved fiscal performance. However, that ceiling had already been raised once, from 1 to 1.7 percent, and had been suspended repeatedly because of the geopolitical events. Moreover, the frequent and noticeable deviations of fiscal outcomes from targets detracted from the predictability of fiscal policy and thus might be harming economic activity. Overall, staff thought that there was insufficient awareness of the risks posed by the high public debt in a political economy environment that is not naturally conducive to debt reduction (Box 3).

23. **The mission thus proposed various options to strengthen the policy framework and raise awareness of the detrimental impact of the public debt:**

⁶ See “Fiscal Consolidation in Israel: A Global Fiscal Model Perspective,” IMF Working Paper 06/253.

Israel. Central Government: DRL Ceiling Versus Actual Deficits																		
Deficit Targets by year announced	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
1991	6.2	3.2	2.2	0.0														
1994 1/			3.0	<u>2.8</u>	<u>2.5</u>													
1997						2.8	2.4	2.0	1.8	1.5								
2000 2/									2.5	<u>1.8</u>								
February, 2002											3.0	2.0	1.5	1.0				
June, 2002												3-3.5	2.5-3	2-2.5	1.5-2	1-1.5		
2004 3/ 4/													2.5-4.0	3.4	up to 3.0			
2006 5/																2.0	1.5	1.0
Actual Deficits 6/	3.6	2.3	2.2	3.9	3.6	2.5	2.2	2.3	0.7	4.2	3.6	5.4	3.7	1.9				

Sources: Ministry of Finance and Bank of Israel.

1/ No specific deficit targets were given for the years 1995-1997. The only requirement was that the deficit, as percent of GDP, would decrease compared to its level in the previous year. Numbers underlined represent the deficit targets that the government decided on when it presented the budget for this year.

2/ No specific deficit targets were given for the years 2001-02. The only requirement was that the deficit, as percent of GDP, would decrease by 0.25 percentage points compared to the previous year, and that the deficit in 2003 would be up to 1.5 percent of GDP. Numbers underlined represent the deficit targets that the government approved when it presented the budget for this year.

3/ In 2004, the DRL was amended to include ceilings on expenditures growth between 2005-10. Accordingly, budget expenditure, indexed to the CPI, would not increase by more than 1 percent each year and the budget deficit would not exceed 3 percent of GDP.

4/ In the 2005 budget, the original deficit target was 3 percent of GDP, but it was later revised upward to account for the estimated cost of Gaza disengagement of 0.4 percent of GDP.

5/ In 2006, the DRL was further modified, with the 1 percent cap on the growth in real expenditure rising to 1.7 percent, starting in 2007, with the deficit target falling gradually to 1 percent by 2009.

6/ Actual deficits reflect the revisions made to the national accounts in July 2006, the result of which raised the GDP series by a cumulative 5 percent through end of 2005.

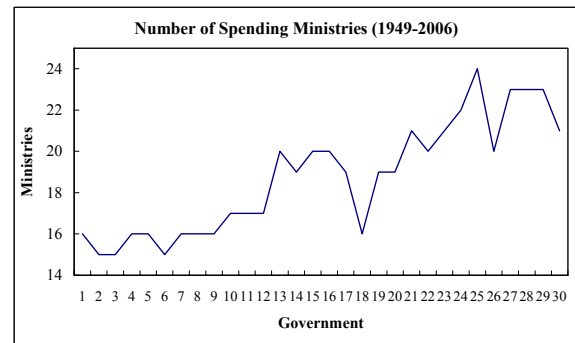
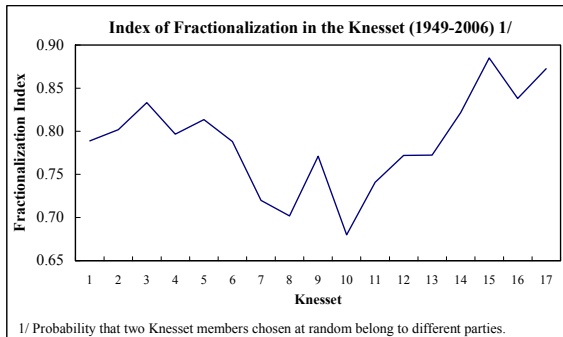
- *Better budgetary preparation and transparency, in line with the recommendations of the 2003 Fiscal ROSC.* Specifically, the mission called for the budget documentation to include a medium-term fiscal scenario based on unchanged policies; a listing of all the policy changes and their fiscal impact; a systematic assessment of the impact of shocks and forecast errors on fiscal variables; and a long-term fiscal sustainability analysis.
- *Stronger fiscal governance mechanisms.* Staff thought that one option for Israel could be a committee of independent experts, possibly similar in structure to the new National Economic Council, that regularly publishes comprehensive fiscal policy analysis and advises on the design and implementation of the fiscal framework. But other options that built on existing commissions or institutions might well deliver similar results.

24. **The authorities were sympathetic to the staff's views and endorsed the call for more medium-term fiscal policy analysis but saw no pressing need for significant institutional change.** Governor Fischer thought a committee of independent experts was unnecessary because the BoI could deliver the required analysis—indeed, the Bank already evaluates the budgets in its Recent Economic Developments reports of the fall. The MoF noted that several commissions/councils were already looking into fiscal matters. Also, the transparency of public finances had been improved by publishing for the first time large portions of the defense budget. Nonetheless, Minister Hirschson agreed on the need to enhance the exchange of information between the MoF and the Knesset Finance Committee, which has only one professional staff to conduct fiscal analysis. He was considering establishing an MoF-Knesset working group to achieve this goal.

Box 3: The Political Economy and Fiscal Institutions

A selected issues paper (Chapter I) finds that, as in other countries, fragmented parliaments and short average government duration have boosted public debt and deficits in Israel. International experience suggests that various fiscal governance mechanisms can counter political economy biases to fiscal policy, notably:

- *Enhanced budgetary transparency and analysis.* A review of budget documents in best-practice countries—including Australia, New Zealand, Canada, and some EU countries—reveals many areas for improvement in Israel.
- *Independent fiscal policy assessment.* Countries have found various mechanisms useful to broaden the debt reduction constituency, from independent agencies that conduct fiscal analysis to ad-hoc committees that report on specific aspects of the public finances.



Transparency of budget documentation in selected countries

	Israel	New Zealand	Australia	Canada
Policy statements				
Detailed statement of long and short-term fiscal policy goals		x	x	x
Budget speech in parliament	x	x	x	x
Year in course				
Revised projections to year in course 1/		x	x	x
Supplementary appropriations to year-in-course budget		x	x	
Budget year				
Central macroeconomic scenario in budget year 2/	x	x	x	x
Baseline fiscal projections (central scenario)	x	x	x	x
Fiscal sensitivities: linkage revenue-macroeconomic scenarios		x	x	x
Detailed agencies and ministries budgets and policy goals		x	x	
Listing of measures and budgetary effects				
revenue		x	x	x
expenditure		x	x	x
Risks to central scenario				
macroeconomic risks and non-central scenarios		x	x	x
specific fiscal risks 3/		x	x	x
Medium and long term				
Long-term fiscal projections 4/		x	x	
Contingent liabilities 5/		x	x	
Disclosure of provisions and charges against future budgets		x	x	
Other				
Detail of fiscal relations with sub-national governments			x	x
Description of fiscal model underlying projections		x		
Cyclically-adjusted balance estimates		x		

1/ These include mid-year updates of fiscal indicators and rest-of-the-year projections.

2/ It includes underlying assumptions about the domestic and international economies.

3/ It also includes specific policy decisions under active consideration by the government at the time of the finalisation of the forecasts.

4/ In the case of New Zealand, long-term projections are presented at least every 4 years, and cover the following 40 years.

5/ New Zealand and Australia classify them into quantifiable and non-quantifiable.

F. Financial Sector Policies: Balancing Competition and Stability in the Quest for Growth

25. **Financial sector reforms are a key element in the authorities' strategy to boost growth.** New developments include: a financial contracts law that provides for repurchase agreements; a real time gross settlement system (which reduces banks' settlement risks); and a primary dealer system, which has helped heighten interest of foreign financial intermediaries in local currency bonds. Proposals have been made to permit the sale of asset backed securities by banks; foster the portability from one tax-supported savings product to another; and free up the annuity market.

26. **There was agreement that the many reforms, while diversifying the economy and contributing to higher economic growth, had altered the risk profile of financial institutions and their products.** Staff was concerned that as global liquidity conditions tighten, financial institutions might be faced with a combination of rising interest rates and risk premia. In this setting, several issues needed attention:

- *The growing share of risk borne by households.* The share of household saving in risky assets—held on their behalf by insurance companies as well as provident and pension funds—is growing rapidly. Staff considered that this required strong disclosure requirements, more robust governance structures, better investment advice, and more investor education. The authorities explained that past reforms had fostered the growth and independence of investment advice, which was also being subject to closer supervision. And laws were under preparation to strengthen disclosure requirements on provident funds and allow foreign mutual funds and investment advice companies from certain countries to offer their services without the need for a local license.
- *The relatively low profit and capital in banks, particularly if viewed against the high levels of poorly performing loans.* However, the authorities argued that the collateral held against problem loans was adequate; that banks were moving increasingly into mortgage and consumer lending, profitable and relatively less risky activities; and that efforts were underway to switch to a more risk-based approach to bank supervision, notably in the context of work toward the adoption of Basel II.
- *The new risks taken on by institutional investors.* Insurance companies and pension and provident funds are still developing the corporate governance and risk management capabilities to manage the credit, legal, operational and other risks that come from venturing into new product areas. The authorities reported that they intended to introduce risk-based capital requirements for insurance companies and step up on-site supervision.

27. **All concurred that the new risks required a commensurate and coordinated response from prudential policies and practices.** Stronger enforcement requires more independence for supervisors. In this regard, staff pushed for prompt adoption of the draft BoI law;⁷ moving the supervision of insurance companies, provident funds, and pension funds outside the MoF; and granting the Israel Securities Authority (ISA) more extensive regulatory powers, commensurate with those of the BoI and Commissioner of Insurance. The authorities reported that work on a memorandum of understanding between all supervisors was ongoing and staff pressed for this to also cover contingency planning.⁸

28. **For the future, the authorities considered some unification of regulatory and supervisory functions useful, a topic that would be studied by a government-appointed commission.** Staff observed that all options for restructuring had pros and cons (Box 4). Key was that any restructuring provide for (i) more independent supervision, supported by a strong governance structure; (ii) adequate resources for supervision, including a salary structure that enables the new institution(s) to attract top-quality staff; (iii) a strong regulatory capacity for the new institution(s); and (iv) less prudential gaps and a level playing field across financial service industries. Moreover, there was agreement that restructuring should not set back the ongoing work on improving prudential policies and practices.

G. Combating Poverty

29. **The authorities explained that they intended to place greater emphasis on combating poverty.** More than one fifth of families are considered poor because their (equivalent) incomes are less than half the median income. There was agreement that sustaining the adjustment and reform momentum required addressing the challenges posed by sectors and workers with skills that faced falling demand and that the most efficient policy responses were better education and training. The authorities were particularly concerned about poverty among jobholders. They elaborated that, therefore, the minimum wage had and would be increased; labor market legislation would be better enforced; and the number of foreign workers reduced—the mission questioned the benefit of these measures. Moreover, the authorities were considering introducing an Earned Income Tax Credit (EITC). While attractive in principle, the mission underscored that much depended on the design of this program, particularly its fit within the local tax and welfare benefit system as well as labor market programs and regulations. Some interlocutors were also concerned that an EITC would benefit some segments of the poor in Israel more than others and thus might trigger

⁷ See IMF Country Report 06/120, page 15.

⁸ Regarding AML/CFT the authorities drew attention to the following points: (i) there had been agreement to allow Israeli banks to continue to provide clearing services for Palestinian banks, subject to proper identity checks and other safeguards; (ii) the BoI had asked all Israeli banks to conduct an examination of the compliance by their banks with the AML/CFT rules imposed by the local laws where their overseas branches and subsidiaries are based; (iii) the BoI is imposing AML/CFT regulations on credit card companies; (iv) a MONEYVAL evaluation is tentatively scheduled for late 2007; and (v) the ISA had conducted 9 AML/CFT on-site inspections.

demands for more support under other programs. In the staff's view, these technical and political economy interactions demand that EITC be considered in the context of a wider, budget-neutral review of poverty reduction and employment policies, which is envisaged by the National Economic Council.

Box 4: Financial Sector Supervision

Given the changes in the financial sector, the authorities intend to examine how best to adapt the structure of supervision, which is presently performed by several entities. There are many models, all with some advantages and disadvantages over the present structure (see Selected Issues paper, Chapter II).

Key potential advantages of an **integrated supervisor**:

- reflects more closely the increasingly integrated financial markets in Israel, where products offered by different sectors have many common characteristics;
- fosters use of the experience in one sector to address supervisory weaknesses in other sectors, mitigating regulatory arbitrage;
- leverages synergies and economies of scale that reduce cost.

Key potential advantages of **separate supervisory entities**:

- narrower focus of supervision and therefore enhanced accountability and more effective delivery;
- more checks and balances because of less concentration of powers;
- avoids major restructuring and related disruptions to important ongoing supervisory activities (e.g., introduction of Basel II).

III. STAFF APPRAISAL

30. **The economy is performing very well and the key challenge for policymakers is to strengthen its resilience to shocks, particularly through public debt reduction.** Strong growth and a benign external environment offer an opportunity to advance fiscal consolidation and strengthen institutional structures that should not be missed. Continued headway along both dimensions is crucial to nurture the confidence of investors and create room for policies to respond to unexpected changes in economic and social conditions without risking adverse debt dynamics.

31. **The foundation for continued real GDP growth of 4 percent or more in 2007 is strong but the risks lie mainly on the downside.** The recovery has become increasingly broad based and the impact of the conflict in the north on economic activity has been limited, which bodes well for the year ahead. However, external downside risks loom, notably a disruptive unwinding of global imbalances, investor flight from risk, and geopolitical uncertainties. And, from a domestic perspective, the central scenario assumes a stable political and benign security setting. On both accounts downside risks prevail.

32. **Inflation is forecast to return toward the mid-point of the 1–3 percent range later in 2007.** Wage developments, including in the public sector, and energy prices present

upside risks if activity evolves as projected. But these are offset by downside risks related to a potential weakening in external demand or further appreciation of the exchange rate.

33. **Accordingly, for as long as the downside risks to inflation do not grow noticeably, a fundamental change in the monetary policy stance is not needed.** There might be room for some further easing because headline inflation is projected to run below the mid-point of the target range for some time. But the central scenario is for above-potential economic growth and thus a significant addition of stimulus appears unnecessary, unless the downside risks for prices related to external demand and the exchange rate—which might be somewhat undervalued—increase markedly.

34. **The publication of minutes of discussions has added to the transparency of the monetary policy process but some scope is left for doing more.** While inflation has temporarily been outside the target range, inflation expectations have remained well-anchored thus far. However, maintaining this performance would probably be easier if the Bank were to publish regularly an inflation forecast, as is common practice among inflation-targeting central banks in advanced economies.

35. **Fiscal policy has strengthened considerably and should target an appreciable overperformance relative to the proposed budget deficit ceiling for 2007.** Notwithstanding the war, the central government deficit is projected to fall to 1½ percent of GDP in 2006, which reflects remarkable expenditure discipline. Also, the 2007 draft expenditure budget commendably advances the consolidation of the public finances. However, no effort should be spared to hold the 2007 budget deficit considerably below the 2.9 percent budget ceiling and rapidly lower the 90 percent debt-to-GDP ratio.

36. **For the medium run, fiscal policy needs to remain on a predictable and credible path toward a significantly lower debt-to-GDP ratio.** The 1.7 percent real expenditure growth ceiling must be adhered to rigorously and debt reduction be given priority over tax cuts. Together with some cuts in the many tax expenditure programs, this would bring the general government accounts close to balance in just over 5 years, rapidly lower the debt ratio, and create a buffer against shocks as well as room for more policy maneuver.

37. **A more holistic and forward-looking fiscal policy debate would likely facilitate public debt reduction.** Budget documents need to include an analysis of medium-term fiscal policy challenges and risks. This would also foster the constituency for deficit and debt reduction, which tends to be smaller than those for immediate tax cuts or expenditure increases. Mindful of existing institutions, it might also be useful to introduce independent, nonpartisan fiscal governance mechanisms that appraise policies in a forward-looking manner.

38. **Accelerated financial deepening is fostering economic growth but also raising new challenges for supervisors, whose resources, independence, and cooperation need to be buttressed commensurately.** Economic agents and corporations are assuming new risks and the traditional dividing lines between financial institutions are becoming increasingly blurred. Key policy priorities are: passing swiftly the draft Bank of Israel law; re-enforcing risk-based supervision, notably in the context of accelerated progress toward

implementing Basel II; adding resources to the supervision of insurance companies and pension and provident funds, and moving this activity outside the Ministry of Finance, consistent with future plans for the structure of supervision in Israel; improving the regulatory infrastructure for insurance companies; and aligning prudential policies and practices across all sectors.

39. Israel has subscribed to the Special Data Dissemination Standards and its macroeconomic statistical system is generally adequate for Fund surveillance.

40. It is proposed that the next Article IV Consultation be held on the standard 12-month cycle.

Table 1. Israel: Selected Economic and Financial Indicators, 2001–07

	2001	2002	2003	2004	2005	2006 1/	2007 1/
(Percent change unless otherwise indicated)							
National accounts indicators (constant prices)							
Domestic demand	1.7	-0.5	-2.0	2.6	4.5	3.6	3.9
Private consumption	2.6	0.8	0.9	5.5	3.4	4.7	4.0
Public consumption	3.8	5.0	-2.3	-2.3	2.7	4.0	3.0
Gross capital formation	-3.2	-11.7	-9.6	1.2	11.5	-0.4	4.9
Fixed capital formation	-3.5	-6.0	-5.5	0.3	2.9	4.8	3.0
Imports of goods and services	-5.1	-1.1	-1.4	12.1	3.4	3.0	4.6
Exports of goods and services	-11.2	-2.3	8.2	18.2	5.1	5.5	5.8
Real GDP	-0.6	-0.9	1.5	4.8	5.2	4.8	4.4
Labor market indicators							
Israeli civilian labor force	2.5	2.0	2.6	2.6	2.3	2.3	...
Employment	1.9	0.8	2.1	3.1	3.8	2.6	...
Unemployment rate (in percent)	9.3	10.3	10.8	10.3	9.0	8.7	8.5
Real wages 2/	-2.6	-6.0	-3.0	2.5	1.0	1.0	...
Business sector	3.0	-6.2	-3.0	2.5	1.0	1.5	...
Public sector	3.3	-6.6	-2.5	1.5	1.5	1.4	...
Prices							
CPI (end period)	1.4	6.5	-1.9	1.2	2.4	0.4	1.9
CPI (period average)	1.1	5.7	0.7	-0.4	1.3	2.4	0.4
CPI (excluding housing and energy, end period) 3/	0.9	5.3	-1.0	0.9	-0.2	1.9	...
Interest rates (average, in percent) BOI policy rate 4/							
	6.8	6.8	7.5	4.2	3.7	5.0	...
Money and credit (period average)							
Private sector credit 5/	14.3	11.7	-3.1	3.9	7.1	5.3	...
Narrow money (M1) 2/	14.2	15.6	0.5	18.0	17.5	12.2	...
Broad money (M3) 5/	15.5	6.1	2.2	4.6	7.9	5.5	...
Public finance (percent of GDP)							
Central government revenue	35.6	37.4	35.5	35.3	35.7	36.0	34.2
Central government expenditure	39.8	41.0	40.9	39.0	37.6	37.4	36.5
Central government balance 6/	-4.2	-3.6	-5.4	-3.7	-1.9	-1.4	-2.3
General government revenue	46.9	47.2	44.9	44.4	44.2	44.2	42.7
General government expenditure	51.8	56.3	50.2	49.8	48.7	47.0	46.7
General government balance 7/	-4.9	-9.1	-5.3	-5.4	-4.6	-2.8	-4.0
General government primary balance	1.4	-0.1	-0.2	1.2	2.2	2.8	2.1
General government structural primary balance	0.8	0.4	0.8	2.1	2.5	2.6	1.7
General government debt	92.1	99.8	102.3	100.9	97.0	89.9	88.7
Balance of payments							
Trade balance (percent of GDP)	-3.2	-4.1	-2.6	-2.3	-2.9	-2.6	-1.7
Current account (percent of GDP)	-0.6	-0.5	1.6	2.6	2.9	4.8	4.2
Foreign direct investment (percent of GDP)	3.1	1.6	3.4	1.4	4.3	6.6	2.1
Foreign reserves (e.o.p., in US\$ billion) 3/	23.5	24.2	26.5	27.2	28.2	27.5	...
Exchange rate and terms of trade indices							
NEER (period average) 8/	1.0	-12.6	-3.7	-3.3	-0.8	2.7	...
REER (period average) 8/	-0.9	-9.7	-5.3	-6.0	-2.1	2.0	...
Terms of trade (2000=100; index level)	99.1	99.3	97.8	95.9	96.5	95.9	...

Sources: Bank of Israel, *Annual Report*; Central Bureau of Statistics; IMF, *International Financial Statistics*; World Bank, *World Development Indicators*; and Fund staff estimates and projections.

1/ Fund staff projections.

2/ As of August, 2006.

3/ As of October, 2006.

4/ The Bank of Israel set the policy rate at 5.0 percent for December 2006.

5/ As of July, 2006.

6/ National definition, cash basis.

7/ International definition, accrual basis. On the difference between central and general government deficits during 2001-05: some 0.4 percent of GDP is accounted for by local governments' deficits and the remainder by the difference between accrual and cash bases accounting. On the latter, the key factor is the CPI indexation component that is paid on all NIS debt when it matures and is recorded below the line in the central government balance, but above the line in the general government balance when it accrues.

8/ As of September, 2006.

Table 2. Israel: Central Government Accounts, 2002-07

(In percent of GDP)

	2002	2003	2004	2005	2006	2007
					Estimate 1/	Budget 2/
Revenue (excluding repayment of credit)	37.4	35.5	35.3	35.7	36.0	34.1
Domestic	32.6	31.8	32.4	32.7	34.0	31.9
Tax	28.4	27.4	27.6	28.0	28.8	27.9
<i>Of which:</i> On income and profits	15.4	14.5	14.5	15.0	16.3	15.3
On domestic goods and services	13.0	12.9	13.1	13.0	12.5	12.6
Nontax	4.2	4.4	4.8	4.7	5.2	4.0
<i>Of which:</i> Loans from the National Insurance Institute	1.5	1.8	2.0	2.1	2.1	1.9
Other	2.7	2.6	2.9	2.6	3.1	2.2
Foreign	4.8	3.7	2.9	2.9	1.9	2.2
<i>Of which:</i> Grants	2.9	2.0	1.9	2.0	1.7	1.7
Vat on defense imports	0.4	0.3	0.2	0.3	0.2	0.2
Other	1.5	1.4	0.7	0.5	0.0	0.3
Expenditure (excluding lending and expenditure by public hospitals)	41.0	40.9	39.0	37.6	37.4	37.0
Current expenditure	39.2	38.9	36.7	35.6	35.4	35.0
Wages	8.3	8.4	8.2	8.2	8.0	7.8
Subsidies & transfers	13.7	13.9	13.2	12.7	14.2	12.3
Interest	5.3	6.2	5.8	5.7	5.6	5.5
Other	11.8	10.5	9.4	9.1	7.6	9.4
Capital expenditure	1.8	2.0	2.3	2.0	2.0	2.0
Budget balance	-3.6	-5.4	-3.7	-1.9	-1.4	-2.9
Financing	3.6	5.4	3.7	1.9	1.4	2.9
Domestic (net)	4.7	4.2	2.2	-0.4	...	...
Foreign (net)	-0.4	1.3	1.4	-0.4	...	...
Sale of assets (net)	0.1	0.1	0.2	1.5	...	...
Change in cash balances and other financing (net)	-0.8	-0.1	-0.1	1.2	...	...
Memorandum item:						
Defense expenditure	11.2	10.4	9.2	8.9	...	7.9
Primary balance	1.7	0.8	2.2	3.8	4.2	2.6

Sources: Data provided by the Israeli authorities; and Fund staff estimates.

1/ Based on preliminary staff estimates and projected data from the authorities.

2/ Based on the proposed 2007 budget.

Table 3. Israel: Balance of Payments, 2004–11

(In billions of U.S. dollars)

	2004	2005	2006 1/	2007 1/	2008 1/	2009 1/	2010 1/	2011 1/
Current account balance	3.2	3.8	6.6	6.0	6.1	6.0	5.5	5.5
Merchandise	-2.8	-3.8	-3.5	-2.4	-1.0	-0.6	-1.1	-1.9
Exports, f.o.b.	36.7	40.1	42.7	44.5	46.2	47.4	49.1	50.0
Imports, f.o.b.	39.5	43.9	46.2	47.0	47.1	48.1	50.2	51.9
Civilian imports	37.6	41.7	43.7	44.3	44.3	45.0	46.9	48.5
Military imports	1.9	2.2	2.5	2.7	2.9	3.1	3.3	3.5
Services	3.3	4.1	4.6	4.0	3.7	3.2	3.7	4.3
Exports	16.1	17.8	19.0	19.5	20.4	21.2	23.1	25.1
Imports	12.8	13.7	14.4	15.5	16.7	18.0	19.3	20.8
Factor Income	-3.6	-2.6	-1.0	-2.0	-3.0	-3.0	-3.5	-3.2
Receipts	3.0	4.7	4.5	4.0	4.0	4.0	4.0	4.0
Payments	6.6	7.3	5.5	6.0	7.0	7.0	7.5	7.2
Net transfers	6.3	6.0	6.5	6.4	6.4	6.4	6.4	6.4
Capital and financial account balance 2/	-3.4	-4.4	-3.7	-4.7	-4.7	-4.9	-4.9	-3.3
Capital account	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.3
Financial account	-4.1	-5.2	-4.4	-5.4	-5.4	-5.6	-5.6	-3.6
Direct investment, net	-2.8	3.1	-3.0	1.0	1.0	1.0	1.0	3.0
Foreign direct investment (in Israel)	1.8	5.6	9.0	3.0	3.0	3.0	3.0	4.2
Portfolio investment, net	4.5	-3.4	1.0	-4.0	-4.0	-4.0	-4.0	-4.0
Other investment	-5.7	-4.8	-2.4	-2.4	-2.4	-2.6	-2.6	-2.6
Errors and omissions	0.5	2.6	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves 3/	-0.3	-1.9	-3.0	-1.3	-1.4	-1.1	-0.6	-2.2
Memorandum items (percentage of GDP):								
Current account balance	2.6	2.9	4.8	4.2	4.2	4.0	3.7	3.6
Civilian trade balance	-0.8	-1.2	-0.8	0.2	1.3	1.7	1.4	1.0
Gross external debt	61.3	57.6	57.0	53.9	54.9	56.0	57.3	58.5
GDP (in billions of U.S. dollars)	122.5	129.8	137.1	142.1	145.3	148.2	150.6	153.4

Sources: Central Bureau of Statistics, *Monthly Bulletin of Statistics*.

1/ Fund staff estimates and projections.

2/ Excludes reserve assets.

3/ Negative (positive) sign denotes increase (decrease) in reserves.

Table 4. Israel: Indicators of External and Financial Sector Vulnerability, 2001–06

(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	Latest Data	
						2006	Date
Financial indicators							
Broad money (percent change, 12-month basis)	15.5	6.1	2.2	4.6	7.9	5.5	Jul-06
Private sector credit (percent change, 12 month basis)	14.3	11.7	-3.1	3.9	7.1	5.3	Jul-06
External Indicators							
Terms of trade (percent change, average) 1/	-2.2	0.2	-1.4	-1.9	0.6	-0.7	
Current account balance	-0.6	-0.5	1.6	2.6	2.9	4.8	
Capital and financial account balance	0.0	-1.7	-1.6	-3.0	-4.9	-0.2	Jun-06
Gross official reserves (in US\$ billions; e.o.p.)	23.5	24.2	26.5	27.2	28.2	27.5	Oct-06
Official reserves in months of imports GNFS	6.5	6.8	7.2	6.2	5.9	...	
Total gross external debt/GDP (in percent)	54.9	63.3	61.0	61.3	57.6	58.7	Jun-06
Total net external debt/GDP (in percent)	0.1	-0.6	-5.6	-9.6	-18.1	-17.3	Jun-06
Country risk ratings (S. & P. / Moody's) 2/	A- / A2	A- / A2	A- / A2	A- / A2	A- / A2	A- / A2	
Exchange rate (per US\$, period average)	4.20	4.74	4.55	4.48	4.48	4.52	Aug-06
Change in Stock Market Index (in percent)	-6.6	-19.9	55.4	17.6	32.8	5.0	Aug-06
Share of foreign exchange credit in total credit to the public (e.o.p.)	35.7	37.5	35.5	32.2	26.5	25.7	Mar-06
Share of foreigners' deposits in total deposits of the public (e.o.p.)	31.1	32.9	32.2	33.3	33.4	35.1	Mar-06
Share of foreign currency liabilities in total liabilities (e.o.p.)	28.4	30.0	29.3	29.5	29.0	29.9	Mar-06

Sources: Bank of Israel; Central Bureau of Statistics; International Monetary Fund; Fund staff estimates and projections.

1/ According to WEO GEE trade deflators.

2/ On foreign currency long-term debt, Moody's upgrade in July 2000.

Table 5. Israel: Financial Soundness Indicators, 2001–06

(In percent)

	2001	2002	2003	2004	2005	2006 March	2006 June
Core Set							
Deposit Takers							
Regulatory capital to risk-weighted assets	9.4	9.9	10.3	10.8	10.7	10.8	10.9
Regulatory Tier 1 capital to risk-weighted assets	6.4	6.6	6.9	7.3	7.1	7.3	7.4
Nonperforming loans net of provisions to capital	...	35.1	33.3	31.0	27.2	24.8	24.1
Nonperforming loans to total gross loans	...	2.4	2.6	2.5	2.3	2.2	2.2
<i>Of which:</i>							
Other financial corporations (OFCs)	7.2	7.6	7.2	7.9	8.7	8.5	8.2
General government	3.6	3.5	3.3	2.7	2.5	2.4	2.4
Nonfinancial corporations (NFCs)	50.2	49.7	48.1	44.7	43.4	43.1	42.7
Other domestic sectors	24.5	24.7	26.0	28.4	28.5	28.7	28.9
Nonresidents	14.4	14.5	15.4	16.2	16.9	17.3	17.8
Return on assets	0.6	0.3	0.7	1.0	1.1	1.1	1.1
Interest margin to gross income	63.5	63.5	64.1	63.1	62.6	60.6	61.4
Noninterest expenses to gross income	65.5	64.6	60.2	59.7	61.7	70.5	67.5
Net open position in foreign exchange to capital	-0.5	4.1	2.1	3.9	-0.5	-0.5	0.5
Encouraged Set							
Deposit Takers							
Capital to assets	4.9	4.9	5.3	5.5	5.6	5.8	5.9
Gross asset position in financial derivatives to capital	...	...	36.0	32.5	28.7	25.6	...
Gross liability position in financial derivatives to capital	...	...	32.4	31.6	29.3	26.8	...
Trading income to total income	36.4	19.4	12.3	17.9	23.7	...	...
Personnel expenses to noninterest expenses	61.8	62.8	61.0	60.3	59.7	64.0	63.1
Spread between reference lending and deposit rates (in basis points)	1.5	2.3	2.0	2.7	3.0	...	...
Customer deposits to total (non interbank) loans	118.7	115.3	115.6	117.7	119.5	121.5	120.1
Foreign-currency-denominated loans to total loans	34.8	36.0	35.4	34.5	31.4	31.6	30.9
Foreign-currency-denominated liabilities to total liabilities	38.0	40.6	40.1	41.5	42.5	44.2	43.5
Net open position in equities to capital	7.2	5.4	11.4	12.8	11.5	...	...
Other Financial Corporations (OFCs)							
OFCs' assets to total financial system assets	35.4	35.5	38.1	40.0	42.3	42.4	42.3
OFCs' assets to Gross Domestic Product (GDP)	86.0	87.8	94.7	98.7	104.0	103.8	101.5
Nonfinancial Corporations							
Total debt to equity	198.5	227.3	206.8	196.9	195.8	197.7	197.7
Return on equity	-9.4	-3.3	5.2	11.6	15.3	0.7	14.5
Earnings to interest and principal expenses	61.9	74.1	96.4	128.0	133.7	127.8	120.8
Households							
Household debt to GDP	27.0	28.0	28.5	28.0	28.2	...	...
Market Liquidity							
Average daily turnover ratio in the securities markets	1.4	2.2	2.2	2.2	2.1	2.0	2.1
Real Estate Markets							
Residential real estate prices (annual percentage increase)	0.2	2.5	-6.1	-1.3	4.4	4.3	-0.1
Residential real estate loans to total loans	10.9	11.8	11.9	12.4	13.1	14.0	13.8
Commercial real estate loans to total loans	18.2	18.2	17.9	16.6	16.1	15.8	15.7

Source: Bank of Israel.

Table 6. Israel: Medium-Term Scenarios, 2004–11

	2004	2005	2006	2007	2008	2009	2010	2011
(In percent unless indicated otherwise)								
GDP growth rate	4.8	5.2	4.8	4.4	4.2	4.0	3.5	3.5
Inflation (average)	-0.4	1.3	2.4	0.4	2.0	2.0	2.0	2.0
Fiscal deficit/GDP 1/								
Central government balance (baseline) 2/	-3.7	-1.9	-1.4	-2.3	-1.4	-1.0	-0.6	-0.6
Central government balance (alternative) 3/	-3.7	-1.9	-2.0	-3.0	-3.0	-3.0	-3.0	-3.0
Public debt/GDP (end of period) 2/	100.9	97.0	89.9	88.7	86.0	83.2	80.9	78.7
Public debt/GDP (end of period) 3/	100.9	97.0	89.9	88.7	88.2	87.5	87.4	87.4
Current account/GDP	2.6	2.9	4.8	4.2	4.2	4.0	3.7	3.6
Foreign reserves (in billions of U.S. dollars) 4/	27.2	28.2	27.5	30.4	31.1	31.6	31.9	33.1
(Percent changes)								
Memorandum Items:								
Aggregate domestic demand	2.6	4.5	3.6	3.9	3.7	4.0	4.0	3.7
Private consumption	5.5	3.4	4.7	4.0	4.0	4.0	4.0	4.0
Public consumption	-2.3	2.7	4.0	3.0	3.0	2.0	2.0	2.0
Gross capital formation	1.2	11.5	-0.4	4.9	3.7	7.3	7.0	5.1
Exports of goods and services	18.2	5.1	5.5	5.8	6.5	6.1	6.2	5.2
Imports of goods and services	12.1	3.4	3.0	4.6	5.3	6.3	7.5	5.8

Source: Fund staff estimates and projections.

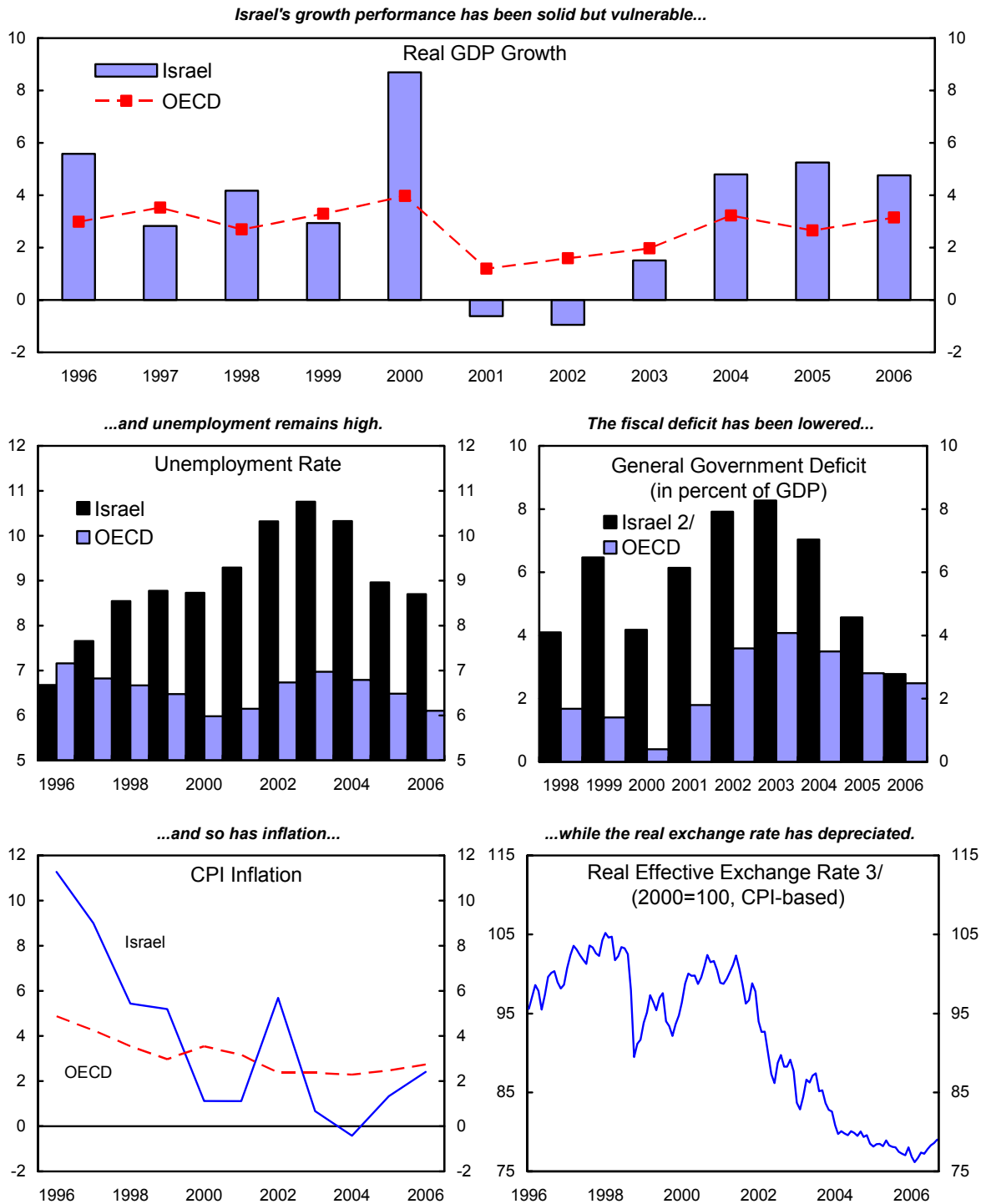
1/ For the purpose of its budget deficit targets, the central government excludes net credit.

2/ Baseline scenario (2007–11) assumes the government adheres to the 1.7 percent growth in real expenditure, excluding war-related spending.

3/ Illustrative alternative scenario (2007–11) assumes a constant deficit of 3 percent of GDP.

4/ Data for 2006 as of October.

Figure 1. Israel: The Long View, 1996–2006 1/
(In percent)



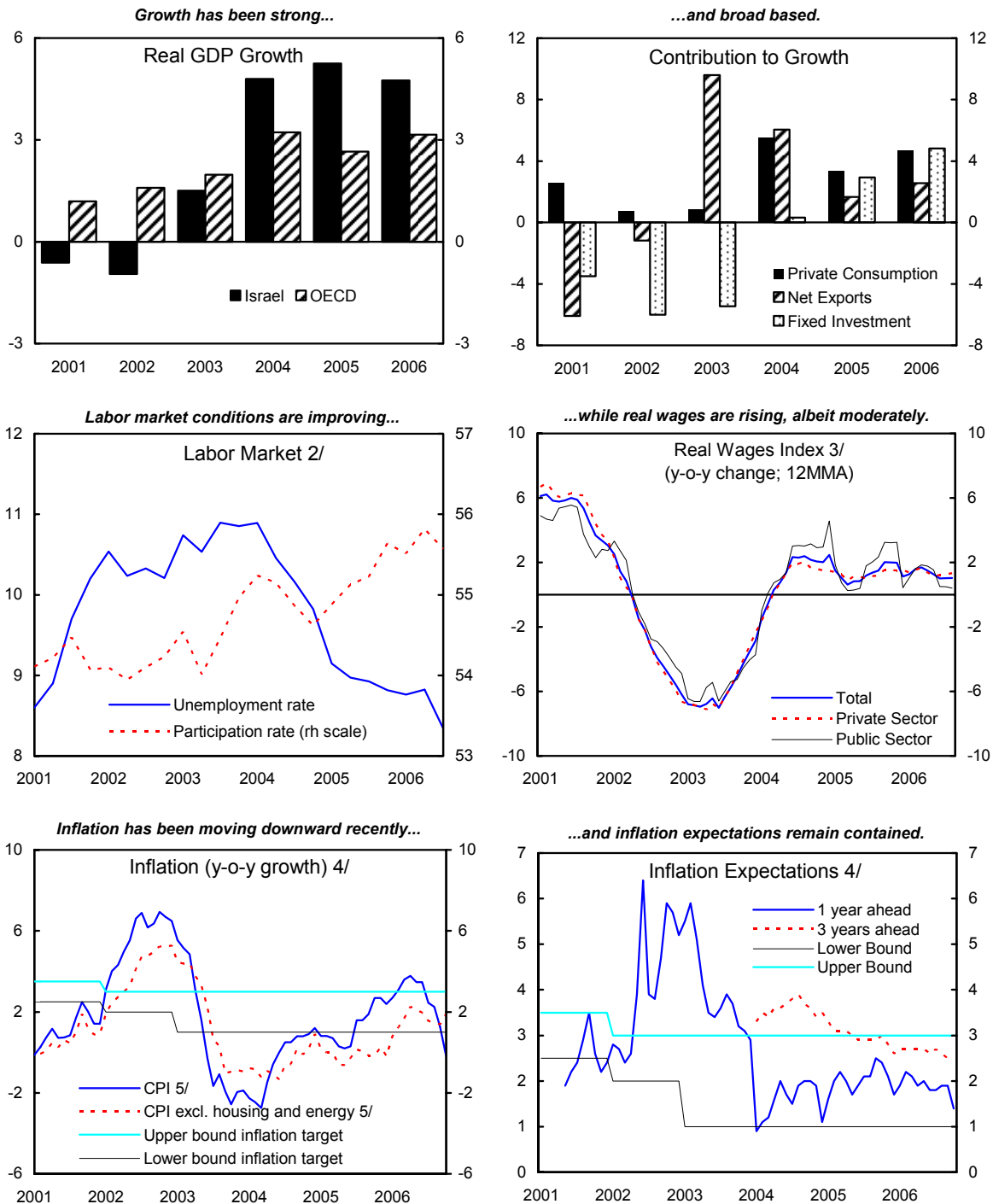
Sources: IMF, *World Economic Outlook*; and IMF, *Information Notice System*.

1/ Staff projections for 2006 unless otherwise noted.

2/ International definition, accrual basis.

3/ Data for 2006 as of September.

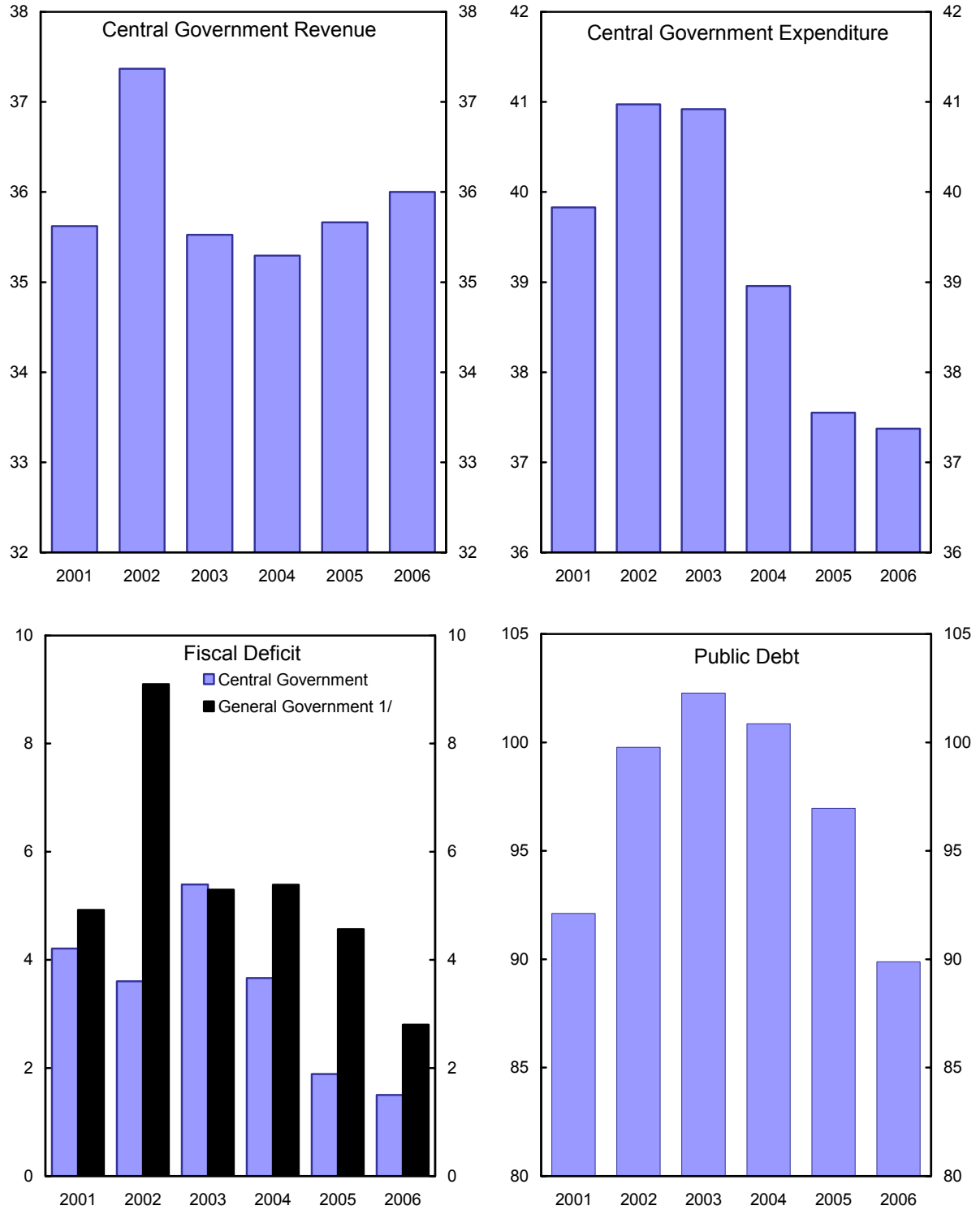
Figure 2. Israel: Recent Economic Indicators, 2001–06 1/
(In percent)



Sources: Central Bureau of Statistics; Bank of Israel; and IMF, *World Economic Outlook*.

1/ Staff projections for 2006 unless otherwise noted.
 2/ Seasonally adjusted; data for 2006 as of June.
 3/ Data for 2006 as of August.
 4/ Data for 2006 as of October.
 5/ Percentage change from the corresponding period one year earlier.

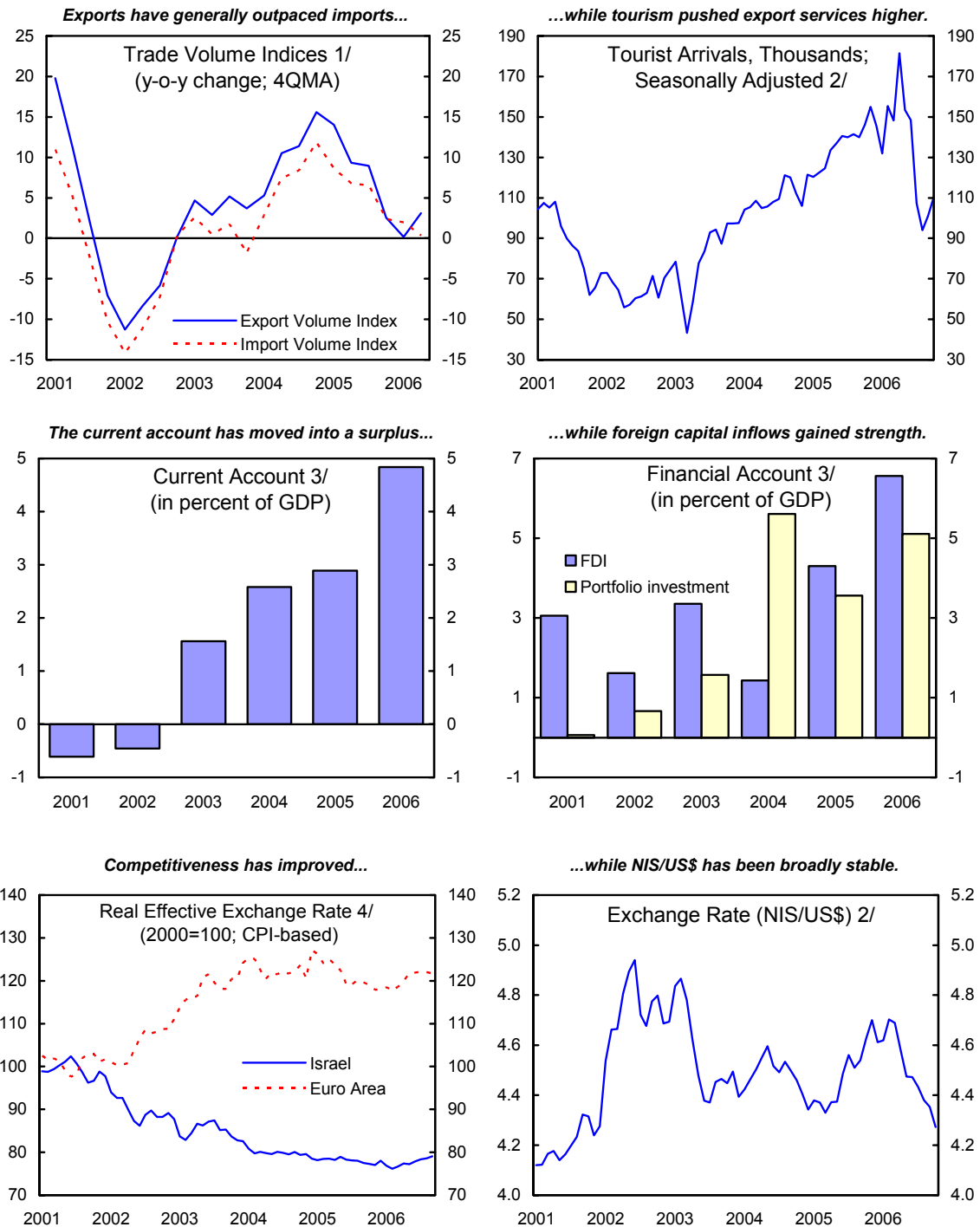
Figure 3. Israel: Fiscal Developments, 2001–06
(In percent of GDP)



Source: Ministry of Finance, national definition; and IMF staff estimates.

1/ International definition, accrual basis.

Figure 4. Israel: External Indicators, 2001–06



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

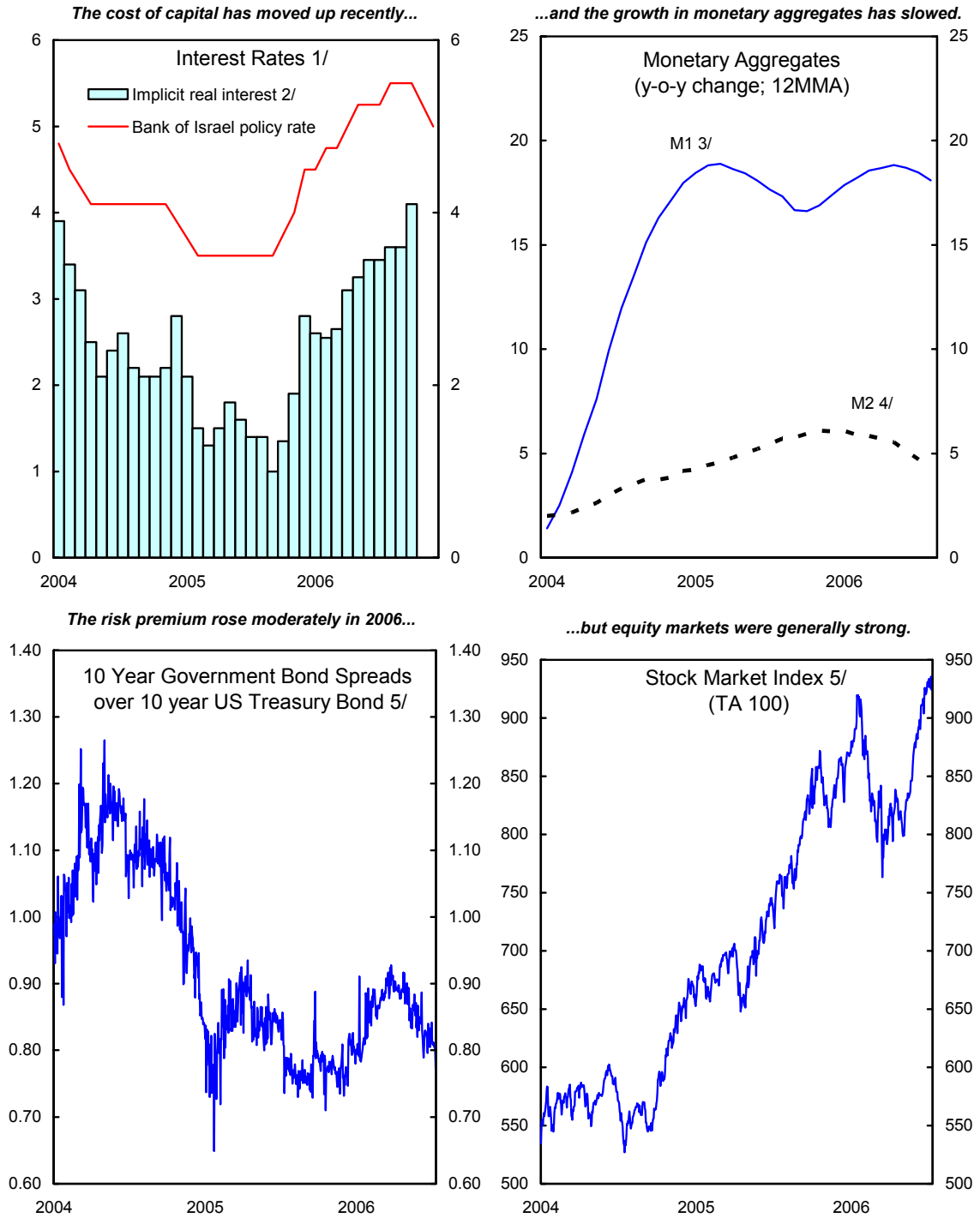
1/ Inclusive of goods and services; data for 2006 as of June.

2/ Data for 2006 as of October.

3/ Data for 2006 are projections.

4/ A decrease represents depreciation. Data for 2006 as of September.

Figure 5. Israel: Selected Financial Indicators, 2004–06



Sources: Bank of Israel; IMF, *International Financial Statistics*; and Bloomberg.

1/ Data for 2006 as of October.

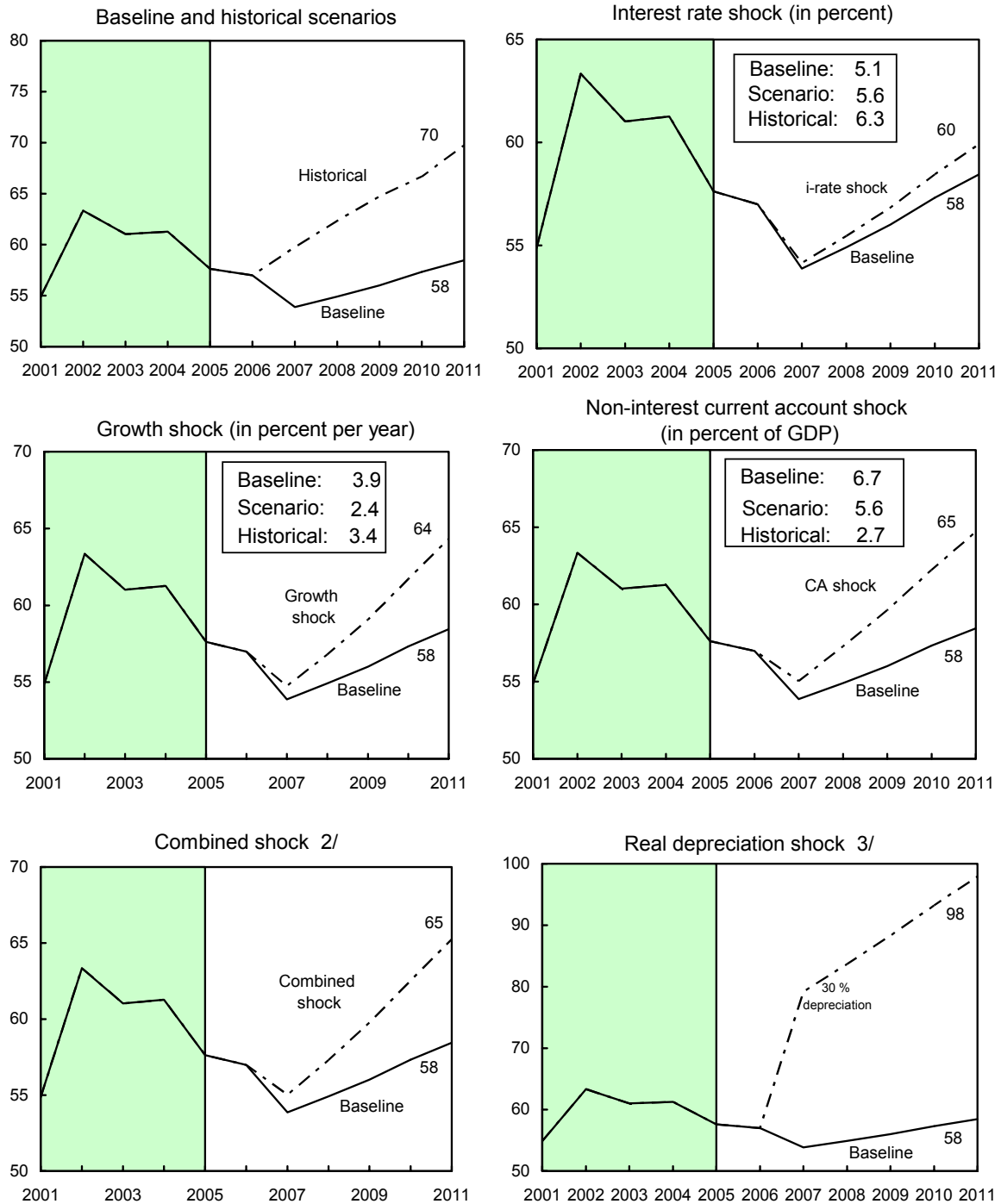
2/ Defined as the Bank of Israel policy rate minus inflation expectations. Data for 2006 as of October.

3/ Data for 2006 as of August.

4/ Data for 2006 as of July.

5/ Data for 2006 as of November.

Figure 6. Israel: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



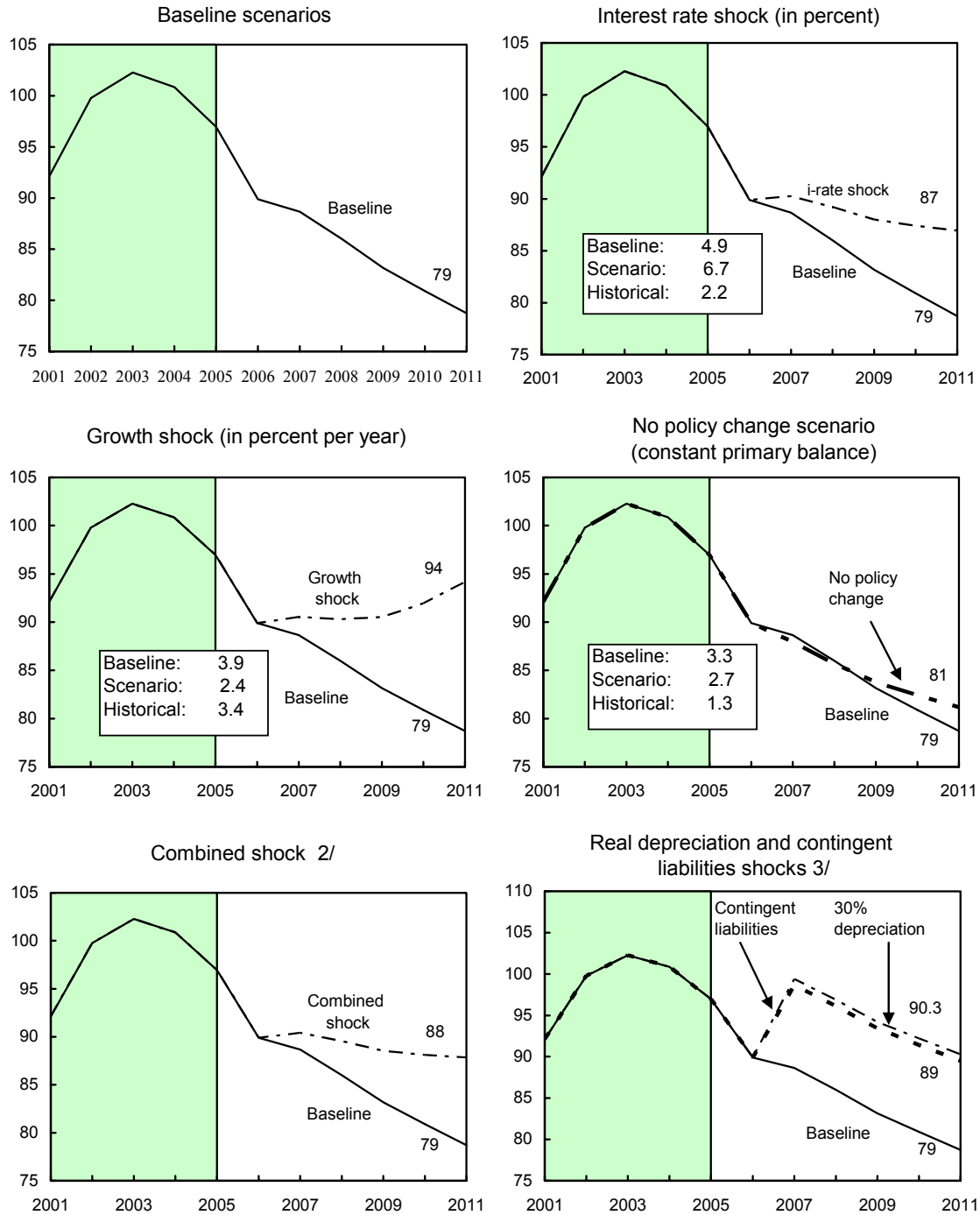
Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2006.

Figure 7. Israel: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix I: Fund Relations

(As of October 31, 2006)

I. **Membership Status:** Israel became a member of the Fund on July 12, 1954, and accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 21, 1993, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. 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.¹

II. General Resources Account:	SDR Millions	% Quota
Quota	928.20	100.00
Fund holdings of currency	831.02	89.53
Reserve position in Fund	97.19	10.47

III. SDR Department:	SDR Millions	% Allocation
Net cumulative allocation	106.36	100.0
Holdings	13.00	12.23

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Payments to Fund:**

Forthcoming					
	2006	2007	2008	2009	2010
Principal					
Charges/Interest	0.91	3.78	3.79	3.78	3.78
Total	0.91	3.78	3.79	3.78	3.78

VII. **Implementation of HIPC Initiative:** Not applicable

VIII. **Safeguards Assessments:** Not applicable

¹ For purposes of Fund relations, the West Bank and Gaza are considered to be under the authority of Israel within the terms of Article XXXI, Section 2(g) of the Articles of Agreement. The Article IV mission did only focus on the Israeli economy and did not meet with representatives of the Palestinian Authority.

IX. Exchange Rate Arrangement:

As of June 9, 2005 Israel's exchange rate regime is officially classified as independently floating. This step by the Government of Israel was taken to remove the last vestige of a policy in which the exchange rate of the NIS fluctuated within the limits of a crawling band. In practice, however, the NIS has been floating since 1997, when the Bank of Israel stopped intervening to protect the band.

X. Article IV consultation:

The last Article IV consultation was concluded on April 18, 2005. Israel is on the standard 12-month consultation cycle.

XI. ROSCs:

- Financial System Stability Assessment was conducted in 2000, issued in August 2001.
- Fiscal Transparency ROSC was conducted in 2003, issued in March 2004.
- 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.

XII. Technical Assistance:

For purposes of the Fund's operational activities, the West Bank and Gaza (WBG) continue to fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement.

The IMF has provided technical assistance to the Palestinian Authority (PA) in the WBG, with a focus on assisting the PA in establishing economic and financial institutions, and in monitoring and reporting on fiscal developments and institution building. In particular, technical assistance has been provided in the areas of tax and customs administration, expenditure management (Fiscal Affairs Department); in the areas of bank supervision (Monetary and Exchange Affairs Department); and in the areas of national accounts and monetary statistics (Statistics Department).

XIII. Resident Representative:

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

APPENDIX II. ISRAEL STAFF RESEARCH, 2005–07

Monetary Policy and Inflation

“A Simple Forecasting and Policy Analysis System for Israel: Structure and Applications,” (Natan Epstein, Philippe Karam, Douglas Laxton, and David Rose, 2006, IMF Country Report 06/121).

- Develops a simple forecasting and policy analysis system (FPAS) model to prepare baseline forecasts and risk assessments for monetary policy and the Israeli economy. The model is designed to support policy analysis for an inflation-targeting regime and captures the essential small, open, flexible-exchange-rate economy linkages between the policy rate and output, inflation and the exchange rate. Conducts risk assessments on three key sources of uncertainty underlying the baseline forecast— exchange rate, output gap, and oil prices—and reviews model properties and performance.

“Inflation-Targeting Practices in Israel,” (Allan D. Brunner, 2005, IMF Country Report 05/134).

- Examines Israel’s monetary policy under the inflation targeting regime with an eye toward understanding why breaches of the targeting range have been occurring and how to address them. Argues that putting a great deal of weight on outside forecasts of inflation in setting the policy rate induces price instability. Maintains that, in order to provide a solid anchor for market expectations and for the inflation targeting regime, the Bank of Israel should rely more on its own forecasts of inflation.

Fiscal Policy

“The Political Economy and Fiscal Institutions in Israel,” (Mario Catalan, 2007, Selected Issues).

- Analyze the political economy factors that have affected fiscal policy and performance in Israel. Finds that fragmented parliaments and short average government duration have boosted public debt and deficits. Argues that strengthening fiscal governance mechanisms can counter political economy biases to fiscal policy, notably through enhanced budgetary transparency and analysis and independent fiscal policy assessment.

“Fiscal Consolidation in Israel: A Global Fiscal Model Perspective,” (Selim Elekdag, Natan Epstein, and Marialuz Moreno-Badía, 2006, Working Paper 06/253).

- Employs the IMF’s Global Fiscal Model to quantify the costs of delaying fiscal consolidation in Israel. Finds that early consolidation through expenditure cuts would

result in a substantial increase in Israel's long-term output growth relative to the case with delayed fiscal adjustment. Using an alternative fiscal instrument, it also finds that delaying tax cuts would result in long-run cumulative real GDP that is five times larger than when the tax cuts are immediately implemented.

Financial Sector

“Financial Sector Supervision Structures: Assessing the Alternatives for Israel,” (Natan Epstein and Richard Pratt, 2007, Selected Issues).

- Reviews the international experience with various financial supervision structures. Examine the key advantages of the different models and provide a neutral assessment of the existing options. Highlights that any restructuring must provide for more independent supervision, supported by a strong governance structure; adequate resources for supervision; a strong regulatory capacity; and a level playing field across financial service industries.

“Corporate Balance Sheets and Investment: Empirical Estimates for Israel,” (Marialuz Moreno-Badía, 2006, IMF Country Report 06/121).

- Analyzes the empirical relationship between corporate leverage— and other indicators of financial health— and investment in Israel, using dynamic panel data techniques. Finds that weak balance sheets may well have contributed to the investment decline of recent years. Leverage, measured as the debt-to-assets ratio, is found to have a large negative effect on investment.

“The Reform of the Capital Markets in Israel,” (Richard Pratt, 2006, IMF Country Report 06/121).

- Reviews and analyzes the capital market reforms in Israel. Highlights that, together with the forced divestiture of banks' holdings of mutual and provident funds, actions that the authorities have taken to remove the legal, tax, and regulatory barriers to the further development of capital markets, are leading to growth and innovation in the creation of new instruments for investment and risk management. Maintains that the rapid development of the capital markets have created new supervisory and regulatory challenges.

“Banking Sector Developments and Issues,” (Jonathan L. Fiechter, Michael Moore, John Palmer, and William Ryback, 2006, IMF Country Report 06/121).

- Reviews developments and issues affecting the banking system in Israel and examines the supervision function by the Bank of Israel. Argues that while the banking system has grown stronger in recent years following the 2001-2002 recession, the level of problem loans remained stubbornly high, contributing to a low level of profitability. Finds that the caliber of the BoI supervisors is strong and

supervisors are highly qualified, but highlights the need to increase efficiency in the operations of the supervisory function.

Structural Reforms

“Active Labor Market Policies,” (Gil Mehrez and Franziska Ohnsorge, 2005, IMF Country Report 05/134).

- Reviews labor market policies in Israel and examine the extent to which active labor market policies (ALMP) can reduce unemployment. Argues that while institutional barriers and distortions are broadly in line with other industrial countries, expenditures on ALMPs are very low by international standards. Finds that increasing ALMP expenditures from 0.2 percent of GDP to 0.7 percent would reduce the long-run unemployment rate by about 0.8 percentage point in the long term. Also finds that the welfare reforms in recent years have enhanced incentives for job seekers and have contributed to rising labor force participation and declining unemployment rates.

APPENDIX III. ISRAEL: STATISTICAL ISSUES

Israel is generally in observance of the Special Data Dissemination Standard, meeting specifications for coverage, periodicity, timeliness, and dissemination of advance release calendars. 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.

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. The Bank of Israel has indicated its intention to develop a comprehensive reporting system for statistical purposes. Bank of Israel officials have also expressed their intention to report monetary statistics to the Fund using the IMF Statistics Department's standardized report forms.

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. Data submitted by the Central Bureau for Statistics for the 2006 *Government Finance Statistics Yearbook* present cash and accrual data for revenue and expense, as well as transactions in non-financial assets, broadly following the *GFSM 2001* format. However, data on transactions and stocks of financial assets and liabilities, the compilation of which requires MoF collaboration, have not been submitted. 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.

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.

ISRAEL: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF DECEMBER 1, 2006

	Date of latest observation	Date received	Frequency of Data ¹	Frequency of Reporting ¹	Frequency of publication ¹	Memo items:	
						Data quality – methodological soundness ²	Data quality – accuracy and reliability ³
Exchange Rates	10/2006	11/06/06	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ⁴	10/2006	11/2006	M	M	M		
Reserve/Base Money	09/2006	10/16/06	M	M	M		
Broad Money	09/2006	10/16/06	M	M	M	LNO, LO, NO, LO	O, O, O, NA, NA
Central Bank Balance Sheet	09/2006	10/16/06	M	M	M		
Consolidated Balance Sheet of the Banking System	06/2006	09/11/06	M	M	M		
Interest Rates ⁵	07/31/06	09/11/06	D and M	D and M	D and M		
Consumer Price Index	10/2006	11/15/06	M	M	M	O, O, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing ⁶ – General Government ⁷	2005	08/05/06	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ⁶ – Central Government	10/06	11/06	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt ⁸	Q3/06	10/06	Q	Q	Q		
External Current Account Balance	Q2 2006	11/15/06	Q	Q	Q	NA	NA
Exports and Imports of Goods and Services	Q2 2006	11/15/06	Q	Q	Q		
GDP/GNP	Q3 2006	11/31/06	Q	Q	Q	O, O, O, LO	LO, O, LO, O, LO
Gross External Debt	Q2 2006	9/16/06	Q	Q	Q		

¹ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

² Reflects the assessment provided in the data ROSC published on March 13, 2006 and based on the findings of the mission that took place during November 1-15, 2005, for the data set corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), not observed (NO), or not available (NA).

³ Same as footnote 2, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

⁴ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

⁵ Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

⁶ Foreign, domestic bank, and domestic nonbank financing.

⁷ The general government consists of the central government (budgetary funds, extra-budgetary funds, and social security funds) and state and local governments.

⁸ Including currency and maturity composition.

INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 2006 Article IV Consultation—Supplementary Information

Prepared by the Staff Representatives for the 2006 Consultation with Israel

Approved by Susan Schadler and Adrienne Cheasty

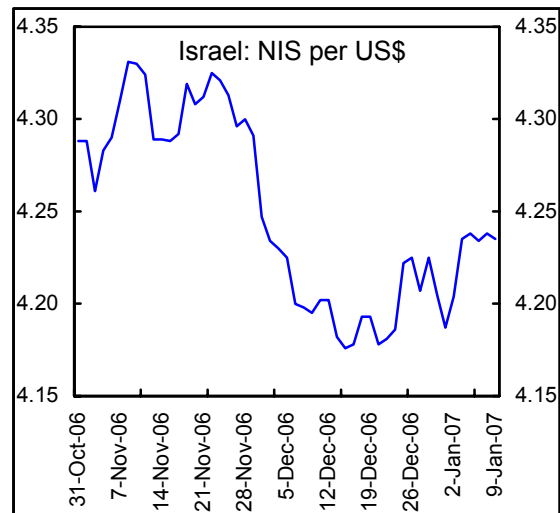
January 16, 2007

This statement contains information on recent economic developments in Israel that has become available since the circulation of the staff report for the Article IV consultation (SM/06/397, 12/14/06). The information does not alter the thrust of the staff appraisal.

1. **Preliminary national accounts data suggest that real GDP grew by 5.0 percent in 2006.** The upswing is broad based, with investment growing particularly strongly.

Real Growth Rates	2006	
	Staff Report	CBS Estimate
GDP	4.8	5.0
Private consumption	4.7	4.6
Public consumption	4.0	3.2
Fixed capital formation	4.8	6.1
Imports of G&S	3.0	2.0
Exports of G&S	5.5	5.1

2. **On December 25, the Bank of Israel lowered its policy rate by 50 bps to 4.5 percent for the month of January.** This followed a significant appreciation of the sheqel during the first half of December. The decision somewhat surprised markets, which were expecting a 25bp drop in the policy rate, but stemmed the appreciation of the exchange rate. Nonetheless, the sheqel remains appreciated against the U.S. dollar relative to staff’s end-November baseline. The rate cut is consistent with the staff report’s central scenario and risk assessment (Box 2). In December, the CPI came in at 0.1 percent below last year’s level.



3. **The 2006 central government budget deficit turned out lower than widely estimated, reaching 0.9 percent of GDP.** Indications are that revenues were significantly higher than earlier projected. On January 3, the Knesset passed the proposed 2007 budget, which targets a deficit of no more than 2.9 percent of GDP. Since the release of the staff report, the government approved an increase of about 0.3 percent of GDP in defense spending, which is to be offset by cuts across various ministries. The overperformance in 2006 lends further support to staff advice to hold the 2007 budget deficit considerably below the 2.9 percent budget ceiling.

**Statement by Jeroen Kremers, Executive Director for Israel
and Nir Klein, Senior Advisor to Executive Director
January 19, 2007**

General

The Israeli authorities thank the staff for the constructive and candid policy discussions in Jerusalem. They appreciate staff's high quality set of papers, which present a balanced assessment of economic developments and address topical issues for the Israeli economy.

Notwithstanding the considerable shocks¹ the Israeli economy experienced in the past year, economic performance remained strong, recording a substantial growth for a third year consecutively. The financial system revealed remarkable resilience, and despite the significant uncertainties that arose, financial market indicators continued to improve, with the Tel Aviv Stock Exchange index reaching record-high levels. The strong economic activity has largely benefited from relatively benign global conditions, which were reflected in the continuation of strong external demand and significant capital inflows, and were underpinned by prudent policies that reinforced investors' confidence. In 2006 the current account surplus increased to a record level of around 5 percent of GDP. Fiscal policy remained responsible, and despite the increasing security spending needs, the expenditure envelope was maintained, allowing a further reduction in the relative size of the public sector. The confluence of tight expenditure policy and higher-than-expected revenues also enabled a substantial reduction of the debt-to-GDP ratio to 88 percent. Monetary policy continued, during the first eight months, with the end-2005 gradual tightening; however, toward the end of the year, the moderation of inflationary pressures brought about a policy of interest rate cuts.

The authorities recognize the challenges ahead and are committed to pursue prudent policies to support strong and sustainable economic growth. In this regard, they proceeded, in 2006, with the implementation of their ambitious reform agenda, geared toward greater competitiveness and flexibility. This progress has been also recognized by the World Economic Forum, which ranked Israel 15th (among 125 countries) on the competitiveness index - an 8 steps climb from the 2005 ranking. The economy's high degree of development together with the authorities' commitment to maintain a market-based economy, good governance and democratic pluralism place Israel as a natural candidate for OECD membership. The authorities hope to complete the accession process successfully and become an integral part of the OECD in the near future.

Macroeconomic developments and outlook

By and large, the Israeli economy, in 2006, continued the strong cyclical upswing that was recorded in the past two years, with GDP growth projected at 5 percent - similar to the

¹ These shocks included the hospitalization of Prime Minister Sharon, early elections and the establishment of a new government, geo-political uncertainties regarding the formation of the new Palestinian government led by the Hamas and the war in the north. The high energy prices also had an adverse effect on economic activity.

average growth in 2004-05 - driven by the rapid expansion of the business sector (6.3 percent). In the first half of the year economic performance accelerated to 5.9 percent, with buoyant exports and significant increase in private consumption as the main drivers. However, the outbreak of the war in Lebanon (mid-July), which affected economic activity and sharply reduced incoming tourism, led to contraction in the third quarter (1.1 percent). Recent economic indicators point out that economic growth is continuing again at a fast pace. Consequently, the Bank of Israel (BoI) has recently revised its GDP growth projection for 2007 upward by 0.6 percent to 4.6 percent.

Overall, the strong economic performance and outlook largely reflect the continuous improvement of the external stance. Despite the deterioration in the terms of trade (excl. diamonds, ships and aircraft), acceleration of imports (excl. diamonds) and a sharp decline in incoming tourism, the high external demand for Israeli products contributed to the increase of the current account surplus, for a fourth year consecutively, to a record-high level estimated at around 5 percent of GDP for 2006. The capital and financial accounts also demonstrated great vigor. Notwithstanding the remarkable level of foreign direct investment (9 percent of GDP), net capital exports continued to increase, reflecting *inter alia* the ongoing adjustment process to the series of far-reaching reforms that were introduced in 2005.²

The strong economic activity was clearly reflected in labor market developments. The unemployment rate declined from 8.8 percent in the second quarter of 2006 to 8.3 percent in the third quarter of the year, thus continuing the gradual decline from the record-high level of 10.9 percent at the end of 2003. This decline took place despite a significant increase in the participation rate and was reflected in the absorption of more than 200,000 new employees (increase of 9 percent) in the past three years. In 2006, high labor demand also contributed to nominal wage increase in both the business (3.8 percent) and public (4.2 percent) sectors, however, in view of the surge in labor productivity, unit labor cost growth remained low, thus mitigating inflationary pressures from the supply side.

Fiscal policy

Despite the political transition and the increasing security needs, the authorities continued, in 2006, with their strategy of fiscal consolidation and remained committed to the key principles that were agreed upon during the budget preparations at the end of 2005. The tight expenditure envelope, which adhered to real spending growth of 1 percent (annually), was maintained, and together with the buoyant revenues, contributed to the reduction of the budget deficit to 0.9 percent of GDP and to the fall of the debt-to-GDP ratio to 88 percent. In 2006, fiscal restraint and a firm privatization process continued to support the business sector's activity and were reflected in downsizing of the public sector to 47 percent of GDP, compared to 56 percent in 2002.

Looking forward, the authorities are committed to continue with fiscal retrenchment. However, to allow a temporally increase in the defense-related expenditures following the war, and in view of the government's decision to raise the limit of public spending growth (in

² These reforms included the removal of several restrictions on institutional investors' investment abroad as well as a reduction of the tax rate differential on investments in Israel and abroad.

real terms) to 1.7 percent from 2007 onward,³ the authorities saw merit in adjusting the deficit ceilings for 2007 and 2008 upward, yet maintaining a downward pattern of the deficit rules.⁴ While acknowledging that the spending increase may result in a temporary increase of the deficit (compared to the 2006 actual level), particularly given the potentially lower growth of revenues,⁵ the authorities share staff's assessment on the need to give debt reduction high priority. According to the Deficit Reduction Law (DRL) the central government deficit will not exceed 1 percent of GDP from 2009 onwards, noting their intention to refer to the deficit rule as a ceiling and not as a target.

The authorities recognize the need to further strengthen fiscal governance mechanisms. Accordingly, the government established a National Economic Council (NEC) – an expert advisory body to the Prime Minister - that will support the government's decision process on economic and social issues. Among other things, the NEC is responsible for analyzing the budget proposal and its long-term effects before its submission to the government, suggesting alternatives if needed and designing policy measures to promote growth and reduce social gaps. Furthermore, the authorities took some steps to increase control and transparency of the budget such as, publishing around one third of the defense budget and setting a limit for approval of the budget to the end of the calendar year.

Monetary issues

In 2006, the rapidly varying inflationary forces, largely affected by unpredictable and sharp fluctuations of exchange rate and oil prices, shifted the monetary policy stance from tightening to easing. During the first five months of the year, the mounting inflationary pressures, stemming mainly from significant depreciation of the Sheqel (in the first quarter), strong domestic demand and an energy price hike, pushed headline inflation slightly above the upper limit of the inflation target range (1-3 percent), thus contributing to the continuation of a gradual policy rate increase from the record-low level of 3.5 percent (September 2005) to 5.25 percent (May 2006). The outbreak of the conflict in the north prompted an additional 25bp policy rate increase (August 2006) with a view to mitigating the impact of a potential increase in risk premium and its adverse impact on financial and foreign currency markets. These concerns, however, faded away toward the end of the year following the significant appreciation of the Sheqel against the US dollar, which alongside the decline of energy prices, pushed the inflation rate downward below the lower limit of the inflation target range. Consequently, the Bank of Israel (BoI) has gradually reduced the policy rate to 4.5 percent in January, allowing a negative interest rate gap between Israel and the US.

³ The 2007 budget was approved early this month. The cap of 1.7 percent on expenditure growth is in line with annual population growth.

⁴ The 2007 and 2008 deficit ceilings were increased to 2.9 and 2 percent of GDP, respectively.

⁵ In 2007, government's revenues may decline due to the planned reduction in tax rates and the fact that some of the 2006 revenues were deemed to be one-off in nature.

Overall, CPI declined in 2006 by 0.1 percentage points,⁶ which is significantly below the lower limit of inflation target range. Nonetheless, the BoI adheres to the flexible inflation targeting approach, thus permitting short-run deviations from the target in order to smooth the changes in interest rate and preserve financial stability. The BoI will continue to closely monitor price developments, with the intention of achieving the inflation target over the medium term. In this regard, the BoI's baseline scenario, which assumes *inter alia* stability in exchange rate and energy prices, indicates that the inflation rate will gradually increase toward the mid-point of the target range later in 2007. This scenario is broadly in line with staff's assessment.

It is worth noting that, despite the transformation in the political domain and to some extent the deterioration in the security situation, financial stability has maintained and inflation expectations for both the short and long term remained within the inflation target range. This serves as a testimony to Israel's strong economic fundamentals as well as to investors' confidence that the authorities will continue to carry out growth-supporting policies and maintain price and financial stability.

This year, the BoI continued to improve monetary policy transparency by starting publication of the minutes of the interest rate discussions in the format adopted by central banks of advanced economies throughout the world. Together with the semi-annual inflation reports, the minutes describe the considerations that led to the interest rate determination as well as of the risks and challenges ahead. Additionally, the Bank of Israel is currently engaged in promoting the new Bank of Israel Law, which among other things defines internal and external control mechanisms for the Bank, and will make transparency obligatory, while at the same time ensuring the Bank's essential professional independence.

Financial sector developments and policies

Although the Israeli banks have a relatively low level of profitability and capitalization, and have relatively high level of problem loans, the authorities note with satisfaction that since 2004 there has been a positive trend in most financial indicators. In this regard, banks have reported higher earnings, improved capital ratios, decreased levels of NPLs (including the construction sector) and increased levels of loan-loss reserves. Moreover, the banks have been improving, under the guidance of the Banking Supervision Department, their internal controls, which further contribute to their soundness and stability. The implementation of Basel II, which until now has been lagging behind other countries, will get the highest priority in the 2007 working plan of the Banking Supervision Department with substantial resources devoted to this project.

The authorities are fully aware of the need to devise a better supervisory system of the financial sector. This consideration of supervisory architecture is still at an early stage. Therefore, staff's discussion of pros and cons of various supervisory structures, as well as the discussion of strengths and weaknesses of the existing Israeli supervisory system makes an important contribution to this process. While this process may take time, already three

⁶ The CPI excluding housing, fruit and vegetables – a usual measure for core CPI – rose by 0.9 percentage points.

supervisors – BoI, Ministry of Finance (MoF) and Israel Securities Authority (ISA) – coordinate the supervisory rules and procedures at the highest level as well as through ad-hoc forums at which staff of those agencies meet in order to achieve consistency in, for example, rules governing conflict of interest. The signing of a Memorandum of Understanding, the drafting of which is in its final stage, will further enhance this cooperation.

Structural reforms and poverty reduction

The authorities are continuing with their reform agenda to boost competition and efficiency in the markets. In the past year they split up the Israel Oil Refineries into two separate companies (Ashdod and Haifa) and privatized the company in Ashdod with the intention of privatizing the second (and largest) oil refinery in Haifa during 2007. A step toward full privatization of the post services has been taken this year with the establishment of the Israel Post Office Company. In 2007 the authorities intend to sell the government's remaining share of Bank Leumi to the private sector. Additionally, ongoing efforts are made to reform the electricity and water sectors, merge several municipalities and sign an "Open skies" agreement with the EU in order to promote competition in air transportation.

The authorities acknowledge the essential need to reduce poverty and decrease inequality. In recent years, they addressed these issues mainly by introducing various measures designed at stimulating labor force participation through negative incentives such as cutting transfer payments and tightening eligibility criteria, which is one of the factors that had a positive effect on the rise in the participation rate. Active Labor Market Policies such as vocational training, aimed at enhancing the skills of the unemployed in order to integrate them in the job market, were also implemented, though with relatively limited success. The merits of other measures, such as the Earned Income Tax Credit (EITC), which subsidizes low wage working families, are still being examined.



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IMF Executive Board Concludes 2006 Article IV Consultation with Israel

On January 19, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Israel.¹

Background

Strong macroeconomic conditions and sound domestic policies have significantly improved Israel's growth performance and prospects, notwithstanding political uncertainties and the hostilities in the north during the summer of 2006. Since 2004, the economy expanded in the 4–6 percent range annually, with real GDP growth reaching an estimated 5.0 percent in 2006. Key drivers of the expansion included improving internal security and productivity; buoyant external demand; exceptionally benign financial conditions, notably falling risk premia; and sound macroeconomic policies. Concurrently, the current account surplus continued to widen to an estimated 5 percent of GDP for 2006.

Inflationary pressures are subdued and monetary policy has been easing as of late. As spare capacity was reduced through mid 2006, inflationary pressure first built and the Bank of Israel (BoI) raised its policy rate to 5.5 percent for August 2006. However, since then an appreciation of the sheqel has been passing through swiftly to domestic prices and energy prices have fallen. As a result, Consumer Price Index inflation moved below the BoI's 1–3 percent target range and the Bank cut its policy rate in several steps to 4.5 percent.

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. 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.

Tight expenditure policy together with the recovery reduced the central government budget deficit to 0.9 percent of GDP in 2006, notwithstanding unexpected expenditure related to the hostilities in the north. For 2007, the central government budget deficit is expected to widen on account of higher expenditure related to these hostilities and moderating revenue growth but is targeted not to exceed 2.9 percent of GDP. The public debt-to-GDP ratio has been falling faster than expected but remains high at just under 90 percent of GDP.

Financial soundness indicators have been recovering although some weaknesses on bank balance sheets that relate mainly to previous boom-bust cycles remain. Financial markets performed well during 2006 and the improved economic outlook and enhanced fiscal policy and credibility continued to attract strong foreign capital inflows.

For 2007, real GDP growth is forecast around 4½ percent. The risks to growth lie on the downside and include a disruptive unwinding of global current account imbalances as well as geopolitical uncertainties. Inflation would remain below the Bol's 1–3 percent target range but return toward the midpoint during the second half of 2007, assuming unchanged exchange rates and energy prices.

Executive Board Assessment

Executive Directors commended the authorities on the strong performance of the economy and the notable improvements in macroeconomic policies. Executive Directors identified the need to further strengthen the economy's resilience to shocks, particularly through public debt reduction, as the key challenge facing policymakers.

Directors considered the foundation for continued rapid economic expansion in 2007 to be strong. However, downside risks, notably a disruptive unwinding of global imbalances, investor flight from risk, and geopolitical uncertainties are significant.

Directors supported the recent easing of monetary policy given falling inflationary pressure. They noted that amid buoyant activity inflation is forecast to return toward the mid-point of the central bank's target range later in 2007. Absent an increase in downside risks to prices, notably related to continued appreciation of the sheqel, a further significant addition of stimulus does not appear necessary.

Directors welcomed the increased transparency resulting from the publication of minutes of monetary policy discussions. This has contributed to keeping inflation expectations well anchored despite more volatile headline inflation. Directors generally viewed that the Bol should consider the regular publication of its inflation forecast, to further bolster transparency and stabilize expectations. In this regard, a few others urged caution, considering forecasting difficulties.

Directors praised the strengthening of fiscal policy and advised an appreciable overperformance relative to the proposed central government budget deficit ceiling for 2007. This would contribute to a rapid lowering of the high public debt ratio and thereby create more room for

policies to respond to unexpected changes in economic and social conditions without risking adverse public debt dynamics. Directors stressed that fiscal policy should stay on a predictable and credible path toward a significantly lower debt-to-GDP ratio over the medium run. Real expenditure growth should be held at or below the 1.7 percent ceiling and debt reduction should be given priority over tax cuts. Together with some cuts in the many tax expenditure programs, this could bring the general government accounts close to balance in just over 5 years, rapidly lower the debt ratio, and create a buffer against shocks as well as room for more policy maneuver.

Directors advocated a more holistic and forward-looking approach to fiscal policy. In particular, budget documents should include a comprehensive analysis of medium-term fiscal policy challenges and risks. It was viewed that consideration could be given to the introduction of independent, nonpartisan fiscal governance mechanisms that could appraise policies in a forward-looking manner, building on existing institutions. This could foster the constituency for deficit and debt reduction.

Directors welcomed the accelerated financial deepening that is fostering the economy's integration with the rest of the world and adding to growth potential. However, they pointed out that this process calls for the resources and independence of financial supervisors to be buttressed commensurately. Accordingly, they highlighted several policy priorities, including quick passage of the Bol law; re-enforcing risk-based supervision through accelerated implementation of Basel II; improving the institutional framework for insurance supervision; and aligning prudential policies and practices across all sectors. Efforts to strengthen the anti-money laundering and terrorist financing regime should continue.

Directors welcomed advances in the areas of privatization and labor market policy, as well as the authorities' intention to place greater emphasis on combating poverty.

Directors observed that Israel meets the Special Data Dissemination Standard specifications for coverage, periodicity, and timeliness of the data, and that quality of the data is adequate for the purpose of surveillance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2006 Article IV Consultation with the Israel is also available.

Table 1. Israel: Selected Economic and Financial Indicators, 2001–07

	2001	2002	2003	2004	2005	2006 1/	2007 2/
(Percent change unless otherwise indicated)							
National accounts indicators (constant prices)							
Domestic demand	1.7	-0.5	-2.0	2.6	4.5	3.6	4.4
Private consumption	2.6	0.8	0.9	5.5	3.4	4.6	4.0
Public consumption	3.8	5.0	-2.3	-2.3	2.7	3.2	3.0
Fixed capital formation	-3.5	-6.0	-5.5	0.3	2.9	6.1	6.0
Imports of goods and services	-5.1	-1.1	-1.4	12.1	3.4	2.0	5.0
Exports of goods and services	-11.2	-2.3	8.2	18.2	5.1	5.1	5.2
Real GDP	-0.6	-0.9	1.5	4.8	5.2	5.0	4.5
Labor market indicators							
Unemployment rate (in percent)	9.3	10.3	10.8	10.3	9.0	8.6	8.2
Real wages 3/	-2.6	-6.0	-3.0	2.5	1.0	0.7	...
Prices							
CPI (end period)	1.4	6.5	-1.9	1.2	2.4	-0.1	2.0
CPI (period average)	1.1	5.7	0.7	-0.4	1.3	2.1	0.2
Interest rates (average, in percent) BOI policy rate 4/	6.8	6.8	7.5	4.2	3.7	5.1	4.5
Money and credit (period average)							
Private sector credit 3/	14.3	11.7	-3.1	3.9	7.1	2.5	...
Narrow money (M1) 5/	14.2	15.6	0.5	18.0	17.5	11.5	...
Broad money (M3) 5/	15.5	6.1	2.2	4.6	7.9	6.7	...
Public finance (percent of GDP)							
Central government revenue	35.6	37.4	35.5	35.3	35.7	36.5	34.2
Central government expenditure	39.8	41.0	40.9	39.0	37.6	37.4	36.5
Central government balance 6/	-4.2	-3.6	-5.4	-3.7	-1.9	-0.9	-2.3
General government balance 7/	-4.9	-9.1	-5.3	-5.4	-4.6	-2.3	-4.0
General government debt	92.1	99.8	102.3	100.9	97.0	88.0	86.5
Balance of payments							
Current account (percent of GDP)	-0.6	-0.5	1.6	2.6	2.9	5.2	4.8
Foreign direct investment (percent of GDP)	3.1	1.6	3.4	1.4	4.3	9.3	...
Foreign currency reserves (e.o.p., in US\$ billion)	23.5	24.2	26.5	27.0	27.9	28.7	...
Exchange rate and terms of trade indices							
NEER (period average) 3/	1.0	-12.6	-3.7	-3.3	-0.8	5.8	...
REER (period average) 3/	-0.9	-9.7	-5.3	-6.0	-2.1	3.9	...
Terms of trade (2000=100; index level)	99.1	99.3	97.8	95.9	96.5	95.0	...

Sources: Bank of Israel, *Annual Report*; Central Bureau of Statistics; IMF, *International Financial Statistics*; and IMF staff estimates and projections

1/ Preliminary estimates.

2/ IMF staff projections.

3/ As of October, 2006.

4/ The Bank of Israel set the policy rate at 4.5 percent for January, 2007.

5/ As of September, 2006.

6/ National definition, cash basis.

7/ International definition, accrual basis. On the difference between central and general government deficits during 2001-05: some 0.4 percent of GDP is accounted for by local governments' deficits and the remainder by the difference between accrual and cash bases accounting. On the latter, the key factor is the CPI indexation component that is paid on all NIS debt when it matures and is recorded below the line in the central government balance, but above the line in the general government balance when it accrues.